

FRANCHISE LAW INSIDER™

A Publication Reviewing Recent Franchise and Related Business Developments 3rd Quarter 2005

"If we are together nothing is impossible. If we are divided all will fail."
-Winston Churchill-



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Franchise and Business Counsel

IFA QUARTERLY EVENTS
Hosted by
Holmes & Lofstrom, LLP.

July 20, 2005
"FINANCING FRANCHISE SALES"

by Shannon Vinson
Featuring Special Guest:
The Honorable Dick Ackerman,
State Senate Republican

LOCATIONS:
Orange County Breakfast
Scott's Seafood Grill & Bar
3300 Bristol Street
Costa Mesa, CA 92626
7:30 AM

San Diego Dinner
Franchise.com Office
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6:00 PM

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BANKRUPTCY BATTLEFIELDS IN FRANCHISING

By: Daniel H. Reiss, Esquire
Levene, Neale, Bender, Rankin & Brill, LLP.

Our nation's economic growth continues to be uneven; some geographic areas and business sectors are strong, while others are under performing. Franchisors and franchisees are inevitably impacted by economic uncertainties, and often encounter situations where one party or the other resorts to filing for bankruptcy, thereby seeking protection from its creditors and others holding claims against the filing party. Where a party to a Franchise Agreement is involved, a bankruptcy filing can dramatically alter the respective rights of the parties to that Agreement. This article gives a brief overview of some common issues that arise in a bankruptcy in the franchise context, and general rules that may apply.

Isn't Filing For Bankruptcy A Breach Of The Franchise Agreement?

Almost without exception, Franchise Agreements provide that a state or federal insolvency or bankruptcy proceeding constitutes a breach of the Franchise Agreement, and gives rise to cause to terminate the contract. These provisions - called *ipso facto* (literally "by the fact itself") clauses - are not enforceable against the bankrupt parties. See 11 U.S.C. § 365(e). The reason for this is that a bankruptcy filing is supposed to provide a vehicle to preserve the value of the business for the benefit of its creditors. Congress determined that enforcing such *ipso facto* provisions would prevent parties from filing bankruptcy for fear that the value of their assets would be destroyed, thereby defeating the purpose of filing a bankruptcy. Therefore, even though these provisions may have some appeal to those lawyers drafting Franchise Agreements and their clients, they offer no real protection in the event of a bankruptcy filing.

If My Franchisee Owes Me Money And Then Files Bankruptcy, Can't I Just Terminate The Franchise Agreement?

A franchisor commonly wishes to terminate its relationship with a bankrupt franchisee. For example, a franchisee may be seriously delinquent in payments owed to the franchisor, and the franchisor wants to find a replacement for its irresponsible franchisee. A bankruptcy, however, presents certain hurdles that a franchisor has to overcome to accomplish this goal.

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FRANCHISE LAW INSIDER™

FRANCHISE LAW INSIDER™ is published to provide our clients and friends with information on legal developments affecting the franchising world. The articles and/or opinions presented are necessarily of a general nature and should not be construed as legal advice or opinions on specific facts.

We're happy to provide additional information regarding any of the articles contained herein, or to discuss how they may apply to your situation. We invite your comments, questions, or any short articles of a pertinent nature for possible inclusion in a future newsletter. Please contact our offices if you're interested.



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BANKRUPTCY BATTLEGROUND IN FRANCHISING, continued from previous page

First, when a franchisee files bankruptcy, an automatic stay is imposed by the Bankruptcy Code, prohibiting parties from taking actions to enforce their claims and contracts against the bankrupt franchisee. 11 U.S.C. § 362. Therefore, to terminate the franchise for a pre-bankruptcy default, a franchisor must obtain an order from the bankruptcy court lifting or modifying the stay to permit a termination of the agreement. If the franchisee files a chapter 7 case, which is a liquidation proceeding conducted by a bankruptcy trustee and the franchisee ceases doing business, a bankruptcy court will ordinarily lift the bankruptcy stay to permit the franchisor to exercise its rights under the franchise agreement unfettered by the bankruptcy filing.

If a franchisee wishes to continue the franchise, however, under either chapter 11 (business reorganization) or chapter 13 (individual reorganization), lifting the stay may take a greater effort. In a reorganization case, a franchisor's chances of success may depend on several factors, including: (1) The length of time since the bankruptcy filing; (2) the size and nature of the pre-petition default; (3) the extent to which the franchisee is performing under the Franchise Agreement since the bankruptcy filing; i.e., post-petition. Much of the time, if a franchisee is unable to perform its obligations post-petition after a reasonable time during the bankruptcy case, the bankruptcy court will lift the bankruptcy stay as requested by the franchisor. On the other hand, if the franchisee performs under the franchise agreement now that it has been granted a respite from its pre-petition obligations and is in the process of reorganizing its business in a chapter 11 or 13 proceeding, the franchisor may not have grounds to obtain relief from the automatic stay.

What If The Franchisee Wants To Transfer The Franchise?

For example, a franchise has value, but the bankrupt franchisee would rather assign the franchise agreement for value to a willing buyer/assignee. If the franchisee/assignor cures the defaults (or provides assurance of a "prompt" cure), the franchise agreement can generally be assigned to another party, even if the franchise agreement prohibits the assignments of the franchise agreement, and even over the objection of the franchisor! The assignee only has to demonstrate that it can perform under the assigned franchise agreement in the future. See generally 11 U.S.C. § 365.

What If The Franchisor Files For Bankruptcy?

Similar to the rights of a franchisee, a franchisor can assign its rights under a franchise agreement to a buyer of all or a portion of the bankrupt franchisor's franchise network. A franchisor can also "reject" a franchise agreement – essentially terminating the franchisor's obligations to perform in the future.

The above is really the "tip of the iceberg" regarding the impact a bankruptcy may have on the franchisor-franchisee relationship. The above list of issues is far from exhaustive, and the general rules are subject to many exceptions. The author hopes that this Article will assist you in understanding some general principles, and will help you obtain proper professional counsel in the event of a real or potential bankruptcy case.

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UNIFYING CORPORATE & FRANCHISEE RELATIONS

By: Leslie Leggate &
Troi Lynn Ozburn
National Shopping Service
Network, LLC

In the growing world of franchise businesses, the importance of tailoring a program that meets the needs at both the Corporate and Franchisee level is significant. The key is to build a program together! If your program has been put together with objectives and goals of both parties in mind, the program can become a tremendous tool to increase revenue for both parties. If you have a well-organized team with clearly identified responsibilities and goals, your program can be very effective. Empowering every team member with a 'voice' on the team can help build the relationship and keep all team members headed in the same direction. Your mystery shopping company can help you develop an evaluation that identifies the needs and goals of both parties, and measures the impact of policies and procedures on actual customers in various markets.

"Mystery shops have added an extra dimension to franchisee communications. Usually it's Corporate's opinion or the Franchisee's opinion about how the business really operates and what should be done to improve it. Mystery shops add an objective opinion from a customer/user perspective. We have seen that some of the 'givens' we assumed about our business are areas of concern, now targeted for improvement. We have also seen that some of the assumed 'problems' in our business are really strengths. Mystery shopping feedback helps direct resources to issues that need attention to

from the viewpoint of the customer."

-Dan Sage, Director of Operations,
Handyman Connection Corporate

As with any other program a company might develop, there may be hurdles or obstacles to overcome in developing a successful program. A couple of obstacles that may need to be addressed up front might be:

Ideals vs. Practicality Corporate wants the best for the business overall. This means higher revenue, higher conversions, higher everything from their Franchisees. From a Franchisee standpoint, these ideals may seem impractical at the operational level and are therefore rejected by many Franchisees. Developing an evaluation form that can realistically measure the level of operation and identify a plan to achieve the ideals is key to bridging this gap.

Big Brother We have often heard it said, "I don't want Corporate to know my business ... they will tell me how to run it." Many Franchisees fear that Corporate will review their reports and institute more rules and regulations or tell them how to run their business. Building a program where Corporate serves in a supporting role rather than a Big Brother capacity is an important part of the program. Providing a forum of communication and assistance can keep all parties moving toward the common goals. Making a team effort to identify demographic and socioeconomic issues for individual Franchisees can have a very positive impact.

Mystery Shopping Companies Mystery shopping companies vary tremendously in the level of service they provide. Choosing a company that provides a venue for Corporate and Franchisees to come together is critical. Some mystery shopping companies will only represent one party in the franchise business relationship.

"We encourage all of our franchise clients to develop a multilevel program to unite mystery shopping efforts. A global form is developed and utilized by both Corporate and Franchisees. The shopping is conducted independently for each party. This allows Corporate to monitor the overall status of the business and it allows Franchisees to privately measure their own performance." - Howard Troxel, President/Co-owner of National Shopping Service Network, LLC.

Inspect What You Expect Carrying the program forward to the employees in each Franchise is equally important. Employees expect to be held accountable for their performance. Research has shown that employees perform better if they know they are mystery shopped. However, the mystery shopping must be conducted in a positive and fair manner. When used positively, this information can help the company identify both strengths and weaknesses, allowing targeting of resources and improved performance overall. When used unfairly, for the wrong reasons, or as a humiliation tactic mystery shopping can be very harmful. To promote acceptance of the program, a Franchisee might create a forum for their employees to have a voice in the program, ensure fairness to the employees, and institute some form of positive peer competition and/or incentive program for the employees.

Orley Paxton, Owner of Handyman Connection Denver, has been mystery shopping his customer service representatives and craftsmen for nearly two years. "Within four months of initiating the program, my closing rate jumped by 10%. Mystery shopping has allowed me tighter control over loss prevention and boosted the integrity of my business. It gives me a very good look at what goes on in my customers' homes when I send craftsmen to them, and then I can manage to it." Continued on page 3

Brand identity is a compilation of customer's experiences across the board. Each experience comes together to form an overall customer opinion, which can be measured through mystery shopping. A united front between Corporate and Franchise management makes mystery shopping a valuable tool in determining if the policies and programs are keeping the brand's promise.

Look for the last in a series of three articles in the 4th Quarter 2005 Franchise Law Insider for an overview of National Shopping Service Network, LLC. Also refer to Inspect What You Expect...Mystery Shopping For Your Business in the 2nd Quarter 2005 Franchise Law Insider.

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FRANCHISE LEGAL UPDATES

This quarter's legal update contains a number of cases of interest including some with substantially favorable outcomes for Franchisors.

U.S. LEGAL UPDATES

[Termination by Franchisor Upheld In Spite of Claims of Prior Disputes and Breach of "Good Faith"](#)

A district court in Pennsylvania recently upheld a prominent Franchisor's right to injunctions preventing the Franchisee from continuing to operate a franchised restaurant under the Franchisor's marks. [McDonald's Corp. v. Underdown, CCH Business Franchise Guide ¶ 13,010]

McDonald's claimed that the Franchisee owed more than

\$200,000 in past due rent, interest and franchise fees, as well as having several outstanding and unsatisfied liens or judgments against it, all in violation of the Franchise Agreement, and all of which gave it the right to terminate. The Franchisee did not deny that it was in arrears, but claimed that the Franchisor consistently failed to perform its obligations and had, in fact, contributed to the Franchisee's negative financial condition.

The court decided that the Franchisee's claims, even if true, did not excuse the Franchisee's breaches and were irrelevant as to whether the Franchisor had rights under federal trademark law to require that the Franchisee stop operating as a franchised outlet using the Franchisor's trademarks.

This case confirms the principle that a Franchisee's failure to pay amounts owed under the Franchise Agreement will result in court orders for termination and/or prohibitions against continued use of the Franchisor's marks. Franchisee's claiming lack of "good faith" by the Franchisor will not excuse or provide a defense if the Franchisee has breached.

A similar result was reached in a case involving the Quizno's system [Quizno's Master, L.L.C. v. Kadriu, CCH Business Franchise Guide ¶ 13,051]. An Illinois district court issued an injunction prohibiting the Franchisee's continued use of the Quizno's trademarks, notwithstanding her counterclaims alleging fraud and asking for cancellation of the franchise Agreement.

[Non-Competition Agreement Enforced Against Franchisee](#)

Enforcement of Non-Compete clauses depends upon governing law, the language of the clause, competing Franchisee interest and other factors. Many states do enforce such clauses, and a recent

Nebraska appeals court case involving the H & R Block system highlights that fact. [H & R Block Tax Svcs. v. Circle A Enterprises, CCH Business Franchise Guide ¶ 13,014]

The appeals court decided that Franchise Agreements were similar to agreements for the sale of a business, rather than employment agreements, and that protection of the Franchisor's goodwill and ability to gain new and repeat customers, justified enforcement of the non-compete provision. The non-compete language included a restriction on operating any competitive business within 45 miles of the franchised location for one year after termination. The fact that the non-compete was not restricted to former clients or customers did not affect its enforceability.

While not all courts will necessarily reach the same result, this case is a reminder that depending on the state involved, and other factors, the non-compete may very well be enforceable.

A similar result was reached in a federal district Court case [Dunkin' Donuts, Inc. v. Akron Donuts, Inc., CCH Business Franchise Guide ¶ 13,060] in which the court enforced the Franchisor's claims for post-termination obligations under a settlement agreement, including damages for unpaid fees, interest, rent, missing equipment and attorney's fees.

[Jury Trial Waiver Unenforceable Due to "Inconspicuous" Nature](#)

A recent federal District Court case in which an express jury trial waiver was not enforced by a court, acts as a reminder that Franchisors may need to take special steps to make sure that such waivers are prominently displayed, and therefore deemed "knowing and voluntary."

Continued on page 5

[G&R Moojestic Treats, Inc. v. Maggiemoo's Int'l], CCH Business Franchise Guide ¶ 13,066]. In this system's Franchise Agreement, the jury trial waiver was located on the 49th page of a single-spaced franchise Agreement, was not listed among the "risk factors" called out in the Franchisor's UFOC and was not initiated by the Franchisee. Apparently, the UFOC made mention of the forum selection (place of trial) and choice of applicable law provisions of the Franchise Agreement as risk factors, but did not mention the jury trial waiver.

Franchisee Required to Participate in "Loyalty" Program

A core element in the marketing programs of many franchise systems are customer "loyalty" or similar programs which offer frequent or other customers significant benefits. In the hotel industry, these benefits often include free or reduced cost stays, the associated revenue loss being borne by the Franchisee.

But suppose that a Franchisee is awarded a franchise for one brand, that brand is subsequently acquired by a new owner of the franchise system and the new owner institutes a loyalty program, which did not previously exist. Does the existing Franchisee have to honor and participate in the new loyalty program?

According to a recent decision by an arbitration panel, as conformed by an Arizona trial court [Custom house Hotel v. Doubletree Hotel System, CCH Business Franchise Guide ¶ 13,067/13,068], the Franchisee must participate in the program.

The Franchisee had argued that the loyalty program was merely one form of a "marketing program" and, as such, costs of the program should be paid for by the marketing fund created under the Franchisee's Franchise Agreement.

However, the arbitrators held that the loyalty program was beyond what had been contemplated by the reservation and marketing programs contemplated in the Franchise Agreement and held that the new loyalty program was a required operating rule or standard, mandating participation by the Franchisee at its cost, just as would be the case for a change in hours of operation, amenities or other services provided to guests.

Franchisor Loses Trademark Rights Due to "Abandonment"

Just as the trademark associated with a franchise system is probably its most valuable asset, one of the worst things that can happen to a Franchisor is for it to lose rights associated with the trademark it owns. A recent decision handed down by a federal District Court in New York. [ITC Limited v. Punchgini, Inc., CCH Business Franchise Guide ¶ 13,013] examines the scenario.

The court determined that an Indian corporation that both operated and franchised Indian-style restaurants throughout the world had abandoned the "Bukhara" trademark and related trade dress which it had previously registered in the U.S. to cover restaurant services. As a result, the Indian corporation could not prosecute an infringement action against two New York city restaurants using the name "Bukhara Grill."

The court's decision was based on a number of factors, including the facts that the Franchisor had not owned, operated or franchised a restaurant in the U.S. using the "Bukhara" trademark for over five years. Under the Lanham Act, the federal trademark statute, non-use for three consecutive years can serve as the basis for a judgment of abandonment.

The Franchisor's failure to produce any evidence of definitive plans to resume use of the mark, or to

demonstrate actions which showed an intent to resume use, were fatal to its case. Unconsummated proposals from prospective Franchisees in the U.S., which were not pursued by the Franchisor, and sales of packaged food products (rather than conducting restaurant operations), were not sufficient to show an intent to use the mark.

Perhaps more disturbingly, the court found insufficient the Franchisor's claim that business and regulatory challenges created a barrier to entry into the U.S. market, in light of the Franchisor's failure to show that it had an intent to re-enter the market when and if those barriers evaporated.

Although this case arose in the context of international franchising, its principals equally apply to domestic Franchisors. It serves as a warning that an extended "pause" in business activities, under certain circumstances, can result in possible loss of trademark rights. Therefore, Franchisors who have a period of time in which they may not be active in a market, in which they have a registered mark, should check with counsel regarding possible steps to avoid a determination of abandonment.

Arbitration Provision Controls Claim of Disclosure Law Violation

Many Franchise Agreements contain mandatory arbitration provisions.

A recent Indiana appeals court case involving the Blimpie system [Blimpie Int'l, Inc. v. Choi, CCH Business Franchise Guide ¶ 13,019] specifically held that the Franchisee's claims that the Franchisor had violated Indiana disclosure requirements was required to be heard and decided by an arbitrator, in spite of an Indiana addendum to the UFOC required by the state as a condition of registration.

H&L ANNOUNCES FORMATION OF GLOBAL FRANCHISE LAWYERS GROUP

Holmes & Lofstrom, LLP, has joined with three other well recognized international franchise law firms to form the Global Franchise Lawyers Group, an association providing, through its independent law firm members, international and domestic franchise law services for companies looking to establish or expand their franchise operations, both domestically and through entry into foreign markets.

The Global Franchise Lawyers Group consists of four select firms: Holmes & Lofstrom, LLP, in the United States, Baybridge Lawyers in Australia, Stewart Germann Law Office in New Zealand and Hamilton Pratt in the United Kingdom. Each of the firms is a recognized leader in the franchise law community in its country, is active in its national franchise association and has extensive experience in its domestic franchise market, as well as bringing foreign franchise concepts to its market and “exporting” franchise systems abroad.

As an organization of independent law firms, the members of the Global Franchise Lawyers Group combine the detailed knowledge of their local business and legal environment with the ability to call on the expertise of other members when the time comes to introduce franchise systems to a new market, as well as the appropriate business contacts to ease entry into that new market.

It's anticipated that, in the near future, the Global Franchise Lawyers Group will expand to include law firms in additional countries, selected on the basis of expertise in franchising and exceptional client service.

Information on the Global Franchise Lawyers Group, or on international franchising generally, can be obtained from any of the lawyers with Holmes & Lofstrom, LLP.



CORPORATE CORNER

WHAT IS A BUSINESS PLAN & WHY DO I NEED ONE?

Many times when clients come to us for business entity assistance they have the name, the basic operational concepts, most or all of the principals identified, a bank and maybe even have begun lease negotiations. While these are good preliminary steps, often the more detailed analysis is left to a “later time” and important considerations are missed or, worse, become irreconcilable differences among the principals, leaving the venture’s future questionable at best.

It is critical that planning of certain key elements be done early in the development of a venture. Mapping out goals both financial and operational is an excellent method to put an enterprise and its principals on the right track from the beginning. Otherwise, no one is quite sure where it is going or how they are proposing to get there. Seems very basic but it is so often a step that is skipped or put off until a time when it is too late or becomes costly to go back and re-do “gaps” in the operational or financial structure that weren’t anticipated because little or no thought was devoted to these issues.

A business plan identifies your goals, precisely defines your business, and serves as your company’s resume. A business plan shows whether or not a business has the potential to make a profit, and will require a realistic look at almost every phase of business. As a management tool, a business plan helps you track, monitor and evaluate your progress. By using a business plan to establish timelines and milestones, you can gauge your progress and compare your projections to your actual accomplishments. A comprehensive, well-thought business plan will guide you through the various phases of your business, and assist you with identifying roadblocks and obstacles so that you can avoid them and establish alternatives. Many business owners also share their business plans with their employees to foster a broader understanding of goals and planning.

The basic components of a business plan include a current and pro forma balance sheet, an income statement, and a cash flow analysis. A business plan will assist you with allocating your resources properly, help you to handle unforeseen complications and make informed business decisions. Outside funding, credit from suppliers, management of your operation and finances, promotion and marketing of your business, and achievement of your goals and objectives will be identified more easily when a comprehensive, thoughtful business plan is in place.

CORPORATE CORNER CONTINUED

Many new business owners are reluctant to develop a written document, despite the critical importance of a business plan. They believe that they don't have the time, or that the marketplace changes too fast for a business plan to be useful. However, just as a builder wouldn't begin construction without a blueprint, eager business owners shouldn't rush into new ventures without a business plan.

Before you begin writing your business plan, consider these four questions:

1. What services or goods will your business provide?
2. Who are the potential target customers for your products or service and why should they purchase from you?
3. How will you reach out to your potential customers?
4. Where will you get the capital to start your business?

What goes into a business plan?

Although there is no singular, precise formula for developing a business plan, there are some elements that are common to all business plans. The following summary is typical of items that should be included in a business plan:

1. Cover sheet
2. Statement of purpose
3. Table of contents
 - I. The Business
 - A. Description of business
 - B. Marketing
 - C. Competition
 - D. Operating procedures
 - E. Personnel
 - F. Business insurance
 - II. Financial Data
 - A. Loan applications
 - B. Capital equipment and supply list
 - C. Balance sheet
 - D. Breakeven analysis
 - E. Pro-forma income projections (profit & loss statements)
 - Three-year summary
 - Detail by month, first year
 - Detail by quarters, second and third years
 - Assumptions upon which projections were based
 - F. Pro-forma cash flow
 - III. Supporting Documents
 - Tax returns of principals for last three years
 - Personal financial statement (all banks have these forms)
 - For franchised businesses, a copy of franchise contract and all supporting documents provided by the franchisor
 - Copy of proposed lease or purchase agreement for building space
 - Copy of licenses and other legal documents
 - Copy of resumes of all principals
 - Copies of letters of intent from suppliers, etc.

One of the best ways to learn how to write a business plan is to review the plans of established businesses in your industry. The United States Small Business Association website (www.sba.gov) has many sample plans and instructional workshops available to you online at no cost, and is a great source of additional information on business start up basics.

FRANCHISE LEGAL UPDATES, continued from page 5

The addendum stated that "The waiver of the right to a jury trial will not apply to claims under the Indiana Deceptive Franchise Practices Act or the Indiana Franchise Disclosure Law." The court decided that while this language might invalidate an express waiver of jury trial, it should not be read as preventing the application of a broad, mandatory arbitration clause to claims arising under either of the Indiana franchise statutes and that if the Franchisor and the Franchisee intended to remove such claims from arbitration, they would have had to say so specifically.

While some other cases have supported attacks on arbitration clauses, this court upheld the parties' express agreement to arbitrate nearly all disputes, including those involving alleged disclosure violations.

Iowa Changes Business Opportunities Exemption

Iowa, like other states, has a law regulating the offer and sale of business opportunities and exempts offers and sales of franchises from certain requirements of the business opportunities law, if the Franchisor meets various conditions. One of those conditions had been a requirement for delivery of a UFOC at stated times in the sales process, using the "ten business day" approach of the FTC Rule.

As many of our readers know, the FTC has proposed to change the ten business day metric to 14 days, although that proposal (and others) have not yet been adopted. Iowa, however, apparently being impressed with the logic behind that part of the FTC's proposal, has passed (effective July 1, 2005) a revision to its business opportunity law adopting the 14 day approach. Franchisors who rely on this exemption in Iowa, therefore, should be careful to comply with the new requirements, since 10 business days and 14 calendar days are sometimes not the same.

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[Kentucky Anti-Obesity Lawsuit Legislation](#)

Kentucky has recently passed legislation which, in most circumstances, will protect food establishments, or "associations" of food establishments, from lawsuits based on claims of obesity or related conditions resulting from the long-term consumption of food. Exceptions exist in the case of adulteration or misbranding violations. The bill was approved on March 8 and takes effect 90 days after the legislature adjourns.

[Court Upholds Franchisee's Release in Assignment Situation](#)

Situations in which a Franchisee transfers (or "assigns") his or her franchise are a regular feature of nearly all franchise systems, whether that assignment is to a corporation or LLC, or to a new owner. In those situations, the consent of the Franchisor to the assignment is normally required, and the Franchisor's consent includes a clause under which the assigning (or selling) Franchisee gives a release of all possible claims against the Franchisor and related persons and companies.

A recent case [[Reedy v. Armstrong-McCall, Inc.](#), CCH Business Franchise Guide ¶ 13,061] handed down by the U.S. Court of Appeals and coming out of Alabama, confirmed the validity of such a release and determined that the Franchisor's consent to the assignment was sufficient legal support for the release to make it enforceable. The case serves as a reminder for Franchisors that such changes can be opportunities to obtain releases thereby protecting Franchisors and their personnel from later claims by Franchisees. In this case, the documentation the Franchisor used was legally appropriate, protecting it against claims by the selling Franchisees and their lawsuit against the Franchisor was dismissed.

[Franchisee's Fraudulent Inducement Claim Rejected Based on Franchise Agreement Provisions](#)

It's not unusual that unhappy Franchisees will claim that they were brought into the franchise system based on misleading promises that were never honored by the Franchisor, in spite of the fact that the claimed promises were never reduced to writing; the classic "the salesman told me XYZ and I never would have invested in the franchise if he hadn't said that." claims of this type are resisted by Franchisors on a number of grounds, a primary strategy being the use of what lawyers call "integration clauses": language in the Franchise Agreement that, in essence, says that anything not contained in the Franchise Agreement, or a written addendum to it, will not be enforced against the Franchisor or the Franchisee.

It's rewarding to see a recent federal appeals court case [[McDonald v. Friedman, Red Hot and Blue Restaurants, Inc.](#), CCH Business Franchise Guide ¶ 13,053] which validates this approach. Here, the Franchisees claimed that in spite of the Franchise Agreement's express requirement that the restaurant be opened within 12 months, they had been told by the president of the company which owned the Franchisor that they would have "all the time they needed" to open the restaurant.

The claim against the Franchisor was rejected by the court based on the one-year statute of limitations clause contained in the Franchise Agreement, reminding us of the importance of such clauses on Franchise Agreements and that they can be enforced by courts.

As to the claim against the parent company and its President (apparently not barred by the one-year statute of limitations clause in the Franchise Agreement, perhaps

meaning that it was not drafted broadly enough to cover all possible defendants), it was also rejected, the court noting the existence of the integration clause and the "unequivocal, clearly understandable provisions of [the] written franchise agreement."

Although not all judges will give this level of respect to the Franchise Agreement, the presence of integration clauses and clear language as to the parties' agreements makes that result all the more likely.

INTERNATIONAL LEGAL UPDATES

UNITED KINGDOM

[Unfriendly Franchise Legislation Proposed for UK](#)

Although the United Kingdom does not have any specific franchise registration or disclosure laws in effect (unlike those of a number of other countries which are members of the European Union, such as France, Spain and Italy), existing and new laws can have significant effects on the viability of franchising in the UK.

However, a newly proposed law relating to contracts generally has the potential, if adopted, to pose serious problems for U.S.-based and other Franchisors awarding franchises in the UK.

By way of background, the Unfair Contract Terms Act ("UCTA") has been in place in the UK since 1977, and regulates selected clauses in various contracts between businesses, including franchise agreements. The UCTA currently provides that any "exclusion clauses" in a standard form franchise agreement (or other agreements), which exclude or limit liability for breach of the franchise agreement, will be enforceable only if they are "fair and reasonable." However, other clauses in a franchise agreement are not generally subject to objection under the UCTA.

The Law Commission recently published for comment a new draft Unfair Contract Terms Bill ("UCTB") which would go beyond the UCTA and existing law in a number of troubling respects, substantially changing elements of contract law, and Franchisor-Franchisee relationships in the UK. Under the UCTB, "micro-businesses," in other words businesses with fewer than 10 staff members, would be able to challenge any standard term in a franchise (or other) agreement which is (1) one that has not been negotiated and (2) is not part of the main subject matter of the contract agreement or the price.

Presumably, clauses relating to arbitration, places where disputes are heard, damage limitations, default provisions, waivers, etc. would fall into this challengeable group. In any case, these and other franchise agreement provisions would not be enforced if the Franchisee could convince the court that the provision is "unfair."

The legislation, then, if adopted, will seriously affect the balance of power, in the legal area, between Franchisors and Franchisees, as well as introducing an unprecedented level of uncertainty into contract enforcement. For example, would the fact that a Franchisor has express termination rights under most Franchise Agreements, while Franchisees do not and must rely under termination rights under common law, be deemed "unfair," preventing the Franchisor from exercising any termination rights under the agreement?

No one knows, and until an extensive (and expensive!) body of case law is developed interpreting the UCTB (if it is ultimately adopted), U.S. and other Franchisors with a presence in the UK will operate in an Alice in Wonderland world in which they have no idea as to whether or not many of the most important provisions in their documents are valid. In an area where contractual certainty is at a premium, since franchise relationships generally extend for many years, the resulting uncertainty inherent in any such legislation can only be likely to work significant mischief and allocate even more scarce economic resources to legal conflicts.

While this may be less of an issue in master franchise agreements, where many of the terms of the documents are typically negotiated, and the "franchisee" may have 10 or more staff members, making the proposed legislation arguably non-applicable, the problems raised by this proposal will infect most, if not all, unit franchise agreements awarded in the UK.

For now, the UCTB is not the law, and is only a proposal. However, it is also a source of insight into the thinking of the current government in this area, and that government is likely to be returned to power in the upcoming election. We suggest that all Franchisors operating, or thinking of operating, in the UK stay alert to these possible changes. As always, consult with one of our attorneys if you have any questions in this area.

NOTES & ACTION ITEMS

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