

FRANCHISE LAW INSIDER™

A Publication Reviewing Recent Franchise and Related Business Developments 1st Quarter 2006

"Success is the sum of small efforts,
repeated day in and day out."
-Robert Collier-



HOLMES & LOFSTROM, LLP
Franchise and Business Counsel

IFA QUARTERLY EVENTS
Hosted by
Holmes & Lofstrom, LLP.

July 12, 2006

Topic: TBD

LOCATIONS:

Orange County Breakfast

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

San Diego Lunch

Franchise.com Office
135 Saxony Road, Suite 200
Encinitas, CA 92024
11:30 AM

SOUTHERN CALIFORNIA

6621 E. PCH, Suite 250
Long Beach, California 90803
Tel: (562) 596-0116
Fax: (562) 596-0416
AdminLB@HolmesLofstrom.com

NORTHERN CALIFORNIA

4251 S. Higuera Street, Suite 401
San Luis Obispo, California 93401
Tel: (805) 547-0697
Fax: (805) 547-0716
Info@HolmesLofstrom.com

© 2006 Holmes & Lofstrom, LLP



Holmes and Lofstrom Announces Launch of UniFran Alliance in Four Countries

During our reception held at the IFA Convention in Palm Springs Holmes & Lofstrom, LLP announced the formation of the UniFran Alliance, an affiliation of four independent franchise law specialty firms in the United States, Australia, New Zealand and the United Kingdom.

Each firm is boutique size and specializes in serving Franchisors. Each firm has a combination of expertise in franchising and personalized service to each firm's clients, as well as recognition as being at the forefront of the franchising law field in their home countries.

The UniFran Alliance allows clients of each firm to approach international expansion with the assurance that a firm has been pre-identified in the target market which shares the working style and values of the client's law firm in their home country. These firms combine an intimate knowledge of franchise laws, regulations and practices in the new market. Additionally, each firm has extensive contacts within that market with respect to local business experts, who can assist in the transition.

Continued on page 4

Lori Lofstrom speaks at Women's Leadership Exchange Conventions Across the US

We are proud to announce that Lori Lofstrom, H&L partner, has been selected by the Women's Leadership Exchange as one of nine "Growth Gurus" for 2006. The WLE is an organization that develops conferences and events throughout the U.S. that foster education, mentoring and networking among women business owners.

Lori will be traveling to Dallas, Chicago, Atlanta and New York this year to talk to approximately 5,000 business owners about the prospects of expanding their businesses via franchising and things to think about before doing so. The fifth location is in Long Beach on August 8th at the Convention Center, so if you're interested in registering, visit www.womensleadershipexchange.com. Also, the book that Lori recently

Continued on page 4

IN THIS ISSUE

H&L Announces Launch of UniFran Alliance in Four Countries.....	1
Business Plan and Earnings Claim Traps for the Helpful But Naive Franchisor.....	2
State Tax "Nexus" Questionnaire.....	2
Trial Waivers – Choice of Law.....	4
Franchise Legal Updates	5

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.



HOLMES & LOFSTROM, LLP Franchise and Business Counsel

Attorneys

David E. Holmes, Partner
Lori M. Lofstrom, Partner
Margaret E. Narodick,
Senior Counsel
Nicola J. McDowall, Of Counsel
The Mulcahy Law Firm, Of Counsel

Paralegals

Lynne C. Anderson,
Senior Paralegal
Peggy J. Karavanich, CLA
Catherine M. Carroll,
Contractor, Paralegal

Administrative Staff

Jill A. Thiercof, Firm Administrator
Liz Lubin, Administration & Events
Richard Devine, Executive Assistant

For more information, contact us
by phone: (562) 596-0116

by e-mail:
adminLB@HolmesLofstrom.com
or visit our website at
www.HolmesLofstrom.com

© 2006 Holmes & Lofstrom, LLP

BUSINESS PLAN AND EARNINGS CLAIM TRAPS FOR THE HELPFUL BUT NAÏVE FRANCHISOR

By: David E. Holmes, Partner,
Holmes & Lofstrom LLP.

The Scenario

Peter Prospect is a prospective Franchisee who is considering the purchase of one of your franchises. He's well-qualified, would be a great addition to the system, and may become a multi-unit owner. However, before he makes a purchase decision, he plans to take his accountant's advice and do a preliminary business plan, to see if this really makes economic sense for him.

To do that, he's asked you, the system's Vice President of Franchise Development, to assist him, by providing some numbers for gross revenues, labor cost percentage, rent factor and other amounts, based on historical numbers achieved by company-owned stores and for franchised units. All of these numbers are easily available to you, as shown by royalty and other reports already in your company's accounting system.

Alternatively, he may come up with these numbers, and the draft business plan, on his own, and then ask you to "look it over and let me know if you think the numbers are reasonable."

Once the business plan is put together, he'll probably use it to secure financing from your recommended SBA lender, or some partners he may bring on board.

As Peter says, "I just want to do that kind of review, with your guidance, before I make what is probably the most important

State Tax "Nexus" Questionnaire

Questionnaires or other requests for information from state tax or other agencies should not be answered until reviewed by tax and franchising counsel.

As various states continue to deal with fiscal challenges, their tax agencies have intensified their searches for additional sources of revenue. As part of that dynamic, those tax agencies, whether focusing on sales, income or gross receipts taxes, have recently concentrated their attention on franchise systems, hoping to characterize various sources of revenue, including (but not limited to) royalty receipts by Franchisors, as subject to the tax laws of the states concerned, including the states where Franchisees may be located.

As part of this effort, states often send questionnaires (and/or letters) to Franchisors or Franchisees inquiring as to their activities and operations. Responses to such questionnaires or otherwise can be used as the basis for a state claim that past activities give rise to tax obligations (possibly fines and penalties), and that revenue to be received in the future is also subject to tax.

Franchisors should **not** respond to such inquiries without first discussing the inquiry and all related matters with tax counsel, working closely with the system's franchise counsel, since any

Continued on page 3

Continued on page 7

business decision of my life, especially in an industry I know almost nothing about, and where you are the experts. And I'll be glad to sign something that says this was at my request, I'll hold you harmless and not sue, you can't guarantee I'll achieve those results, whatever you want."

Are there any problems with giving Peter the help he so obviously needs, and that you can so easily supply?

The Danger

Doing what Peter requests is probably, for many systems, the front end of what a six figure lawsuit (with equivalent legal expenses) looks like, if Peter is wants to sue you and is successful.

"Earnings claims" are defined by the UFOC Instructions to include:

"information given to a prospective Franchisee by the Franchisor from which a specific level or range of actual or potential sales, costs, income or profit from franchised or non-franchised units may be easily ascertained."

The UFOC Guidelines make it clear that an earnings claim made in connection with the offer of a franchise must be included in the UFOC, in Item 19, and comply with Item 19's requirements. The FTC Franchise Rule mandates a similar result.

Supplying your prospect with numbers (even if historically accurate) regarding unit level sales, costs, operating income, etc., whether for use by the prospective Franchisee in putting together a business plan or otherwise, could be held to satisfy the definition of "earnings claim."

Providing such numbers outside of Item 19 (and without complying with its requirements regarding substantiation, cautionary statements, statistical analysis, etc.) could be held to be a violation of both state franchise registration and disclosure laws and the FTC Franchise Rule.

Therefore, both the underlying numbers Peter Prospect is asking you to supply, as well as the projection or forecast implicitly made by a business plan based on numbers you've supplied, or reviewed and commented on by you (even if the numbers were generated by the Franchisee independently), could be held by a court to

constitute an earnings claim.

The FTC has ruled, consistent with Item 19 Instructions, that a chart or table (similar in concept to a business plan or related spreadsheet) showing possible results at different levels of sales, is an "earnings claim."

In addition, the FTC rule has indicated that if a Franchisor supplies information regarding financial performance to a prospective Franchisee, where the purpose of supplying that information is to assist the prospective Franchisee in making a loan application, then an "earnings claim" has been made.

Therefore, supplying a prospective Franchisee such as Peter with unit-level operating results, or other numbers relevant to financial performance of units, is highly dangerous, even where it is simply for the purpose of the prospect completing a business plan.

Also, reviewing any numbers generated by the prospective Franchisee, whether in a business plan or otherwise, can generate similar levels of risk of litigation, whether on the basis that the Franchisor directly violated the UFOC and FTC rules regarding earnings claims or, in effect, "ratified" the numbers generated by the prospective Franchisee. In fact, if a plan is required of a prospect before awarding the franchise, an implicit approval of its reasonableness might be found in the act of awarding the franchise itself, thereby subjecting the Franchisor to exposure for having made an earnings claim.

Note that essentially the same potential for legal problems exists even if the numbers you've supplied or reviewed are reasonable, truthful and accurate and you had no intention to defraud. Unfortunately, there's no provision in the UFOC Instructions or the FTC Rule that grants you immunity based on "good faith"; providing an earnings claim without complying with the relevant UFOC and FTC requirements may subject you to possible liability.

Finally, having the prospective Franchisee sign a waiver or similar document will probably not be effective; many states have anti-waiver provisions in their franchise and other consumer protection laws.

The Solution

How can the ethical Franchisor help Peter Prospect with his legitimate need to have some understanding of the economic realities associated with the franchised business?

The most effective and legal way to do so is for the Franchisor to have a formal Item 19 earnings claim as part of their UFOC, based on historical results of company-owned and franchised units, as prepared by experienced franchise counsel.

While not entirely free of legal risk this approach may represent a reasonable balancing of the Franchisor's desire to avoid legal entanglements and the prospective Franchisee's understandable need for the Franchisor to share significant economic information.

Finally, reviewing business plans after the Franchisee has joined the system, as a legitimate part of training or counseling during operation, is generally acceptable. And should be done professionally and not in connection with the offer or sale of an additional or other franchise. ■

UniFran Alliance Continued from page 1

Holmes & Lofstrom is a founding member of UniFran.

The goal of UniFran is to facilitate a "seamless" international expansion for our clients. ■

Lori Lofstrom WLE honor
Continued from page 1

contributed to entitled, *What No One Ever Tells You About Franchising*, by Jan Norman, has recently been released and will be available at the WLE conferences and to the public generally. **Congratulations!**

Next events: May 17th in Chicago, Aug. 8th in Long Beach, and Sept. 19th in Atlanta. ■

UniFran Alliance members:

HOLMES & LOFSTROM, LLP
Franchise & Business Counsel

United States

BAYBRIDGE lawyers

Australia

HAMILTON PRATT

United Kingdom

SGL
STEWART GERMANN LAW OFFICE
Lawyers, Notary Public
New Zealand

Jury Trial Waivers – Choice of Law

By: David E. Holmes, Partner, Holmes & Lofstrom LLP

Franchisors are generally reluctant to have disputes with Franchisees decided by a jury. They believe the jury is likely to identify with and be friendlier to the Franchisee. In order to avoid juries, one technique used is including a jury trial waiver in the Franchise Agreement. Often this is done in connection with a clause selecting binding arbitration as the required method to resolve any disputes.

Are jury trial waivers in franchise agreements valid and enforceable? Although they may not be enforceable in California, they are enforceable in a number of other states, and Franchisors should not assume that they are generally unenforceable.

Bishop v. GNC Franchising [CCH Bus. Fran. Guide ¶ 13,248] involved a dispute between GNC and its Franchisees, each of whom had signed franchise agreements containing clear and conspicuous jury trial waivers. As a result, the Franchisees' claims would not be presented to a jury.

In this case, the court held that the jury trial waivers were conspicuous in the franchise agreements and the fact they were not negotiable did not invalidate the waivers.

Given California's laws, if the Franchisee Agreement selects California as the source for the applicable law, the Franchisor runs the risk that many pro-Franchisee laws will be applied, one of which would be California's prohibition of pre-dispute jury trial waivers.

In a related case, Hopkins v. GNC Franchising [CCH Bus. Fran. Guide ¶ 13,247] a federal court in Pennsylvania held that the clause in the Franchise Agreement selecting Pennsylvania law as applicable was enforceable, since the Franchisor was incorporated and headquartered in Pennsylvania. And that the Franchisor had a legitimate interest in the uniformity of its dealings with Franchisees located throughout numerous states.

Finally, a federal appeals court, in a separate case (Bakrac v. Villager Franchise Systems CCH Bus. Fran. Guide ¶ 13,213) involving a jury trial waiver in a hotel Franchise Agreement, held the waiver enforceable.

The Franchisee had been able to negotiate portions of the Franchise Agreement (including a reduced franchise fee and royalties, plus multiple no-penalty termination rights), indicating that the Franchise Agreement was negotiable.

On that basis, the court concluded that the jury trial waiver was knowing, voluntary and binding.

Continued on Page 7

FRANCHISE INTERNATIONAL LEGAL UPDATES

CANADA

Prince Edward Island (Canada) has released a draft of proposed franchise regulations, which will affect those franchise systems planning to award franchises in that province.

Recently, Canada's smallest province, Prince Edward Island (PEI), released for comment a draft form of regulations related to the Franchise Act put into effect last June. This is of some interest to Franchisors which might award

franchises in this province, since, when regulations are finalized, the PEI Franchise Act will come into effect.

[The draft regulations can be found at www.gov.pe.ca/oag/index.php3 under "Online Resources, Franchises Act Regulations."]

Among other things, the draft Regulations: will allow use of a disclosure document prepared under the laws of another jurisdiction (such as the U.S.), with a

"wrapper" related to the PEI requirements, make "substantial compliance" with disclosure requirements a possible defense to Franchisee claims for rescission, and provide for certain exemptions for larger Franchisors.

The PEI Government realistically understands that if it adopts regulations that mandate substantially greater burdens than other Canadian provinces, many U.S., Canadian and other franchisors will simply not award franchises within the small PEI market.

Greece

As anticipated for at least a year, Greece is in the process of drafting a franchise disclosure law. While the details have not yet been settled, features of the new law could include the following:

- 30 day pre-sale disclosure of specified information, including a copy of the proposed agreement, trademark information, a "system summary," and information regarding disputes.
- Possible registration by Franchisors, although it's unclear if

this would involve any substantive review of agreements or disclosure documents, or merely a "notice" filing.

It's also possible that the new law will include specific requirements that a Franchisor will need to meet before it is allowed to franchise in Greece. These may include a requirement that there first be an operating unit in place for a minimum of two years.

This requirement may be somewhat less onerous if it can be met through a unit located anywhere in the EU, but that's unknown at this time. Clearly, a requirement

for such a unit to have been in operation in Greece, a relatively small market, might prove to be a significant barrier to entry to many franchise systems, especially if it was a barrier to awarding a country-wide master license.

There may be a provision in the law addressing a Franchisee's rights in intellectual property, such as improvements to the system.

Finally, the law will, likely contain relationship elements (termination, renewal, etc.) and will not be limited to merely disclosure obligations.

Belgium

Belgium was scheduled to put into effect a new franchise disclosure law on October 18, 2005. However, the implementation of this law has been delayed by action in the Belgian Senate and is now under review by the Senate Commission on Finances and Economics.

The effective date or whether

there will be any changes to the proposed law are unknown. Since the review requirement was the result of a parliamentary exercise by a political party which is not part of the national government, it's entirely possible that no significant changes will be made.

Belgium has joined the expanding list of countries which regulate franchising by enacting a pre-sale

disclosure law. While similar in some ways to laws in North America, it has a significant number of distinct, and ambiguous, provisions and should be approached with caution by those considering franchising in Belgium.

Over the past few years, Belgium has been considering various franchise law proposals. That process has now come to a close

continued page 6

and a new franchise law came into effect on September 1, 2005. We will address the main points as well as some of the questions and concerns that remain unaddressed.

The new law, perhaps creatively, uses the phrase "commercial partnerships" to refer to what we would call franchise relationships and uses a definition differently from those common in the U.S. and Canada. The effect of this different definition of this "partnership" concept may have some unintended consequences.

The law requires the Franchisor to deliver a disclosure document at least one month prior to closing the prospective Franchisees. The Franchisor cannot accept any sums for one month following the delivery of the disclosure document. From a general policy standpoint, this is similar to the approach taken in the U. S., Canada and many other jurisdictions.

A disclosure document prepared for, and accepted by, another jurisdiction (such as the UFOC) cannot be used, even with a "wrapper" document noting the information required under Belgian law. In effect, Franchisors will have to go to the expense of having their home country's legal counsel prepare a draft disclosure document, which should then be reviewed by Belgian counsel hired for the purpose.

The disclosure document will have two sections, one summarizing the "main terms" of the franchise agreement,

and the other supplying "information relating to the correct evaluation of the commercial partnership agreement [the franchise]."

The first section is essentially a summary of the main points of the Franchise Agreement (or possibly the Master Franchise Agreement). These "main points" will include such predictable topics as a description of obligations, means of calculating payments, renewal rights, non-competition clauses, termination provisions and exclusive territorial or other rights.

The requirements of the second section of the disclosure document are much more problematic. The Franchisor is required to provide information regarding the prospects of the market in which the activities are carried out from both a general and a local point of view, the background, and status where appropriate for each of the three previous years.

To North American attorneys, this type of requirement appears very difficult to comply with. For example, how can a Franchisor situated in California or Calgary reliably estimate the prospects for what level of market share might be obtained by a unit operator in Brussels?

Litigators will probably characterize such a requirement as "what the front end of the multi-million dollar lawsuit looks like."

Even with disclaimers, providing such projections is extremely

dangerous, and is almost never done in North American practice. If Franchisors are compelled to make such projections and if local counsel cannot develop appropriate alternatives and a means of reducing that liability to manageable levels, their potential liability seems very high and may affect the viability of franchising in Belgium.

Statements of historical performance in the Franchisor's home markets are not easily compared to estimates of "prospects" particularly if that requirement is interpreted to mandate estimates of future performance in Belgium.

These provisions are especially disturbing in light of a clause in the law allowing rescission by the Franchisee if the Franchisor fails to comply with the disclosure requirements, particularly in the absence a provision providing a defense where there has been "substantial compliance," even though a technical violation may have taken place.

Finally, and almost uniquely among international franchise laws, with respect to each disclosure document, there will be an evaluation report issued by a government agency reviewing the degree to which the document "contributes to the integrity, the clarity and the balance of [franchise] agreements." Any terms will be highlighted in proposed franchise agreements which are believed to "create an imbalance between the parties, [such as] non-competition clauses and

continued page 7

Termination for Good Cause – Master Franchise

Cases involving master franchise arrangements are relatively rare, and those involving termination of the Master Franchisee for failure to meet its development obligations are even rarer. But, a recent Wisconsin case gives insights into how a court, even in a state with a strongly pro-Franchisee relationship law, will enforce the termination provisions of the Master Franchise Agreement.

[Brown Dog v. Quinzo's](#) [CCH Bus. Fran. Guide ¶ 13,229] involved a Master Franchisee who admitted to failing to meet its development schedule obligations for six quarters in a row.

The Master Franchisee claimed that it had substantially complied with those requirements. By missing the target numbers of one or two restaurants in each quarter The Master Franchisee caught the stores up with the previous quarter's requirements in the next quarter. The federal court rejected the argument, on the basis that the Master Franchisee did not have the prerogative to redefine the agreement's requirements to show that it was "close enough."

The court also noted that the Franchisor applied its development quota policies fairly and uniformly, and had not discriminated against the Master Franchisee.

However, the court found that the Franchisor had not suffered any economic damage as a result of the Master Franchisee's breaches, and only allowed \$1 in damages. The Franchisor was able to

terminate, but not collect any substantial monetary award.

Arbitration Clauses – Enforceability

Arbitration clauses in Franchise Agreements are another technique used by Franchisors to avoid having disputes with Franchisees decided by either a jury or a judge. Although some cases have challenged the enforceability of such clauses, most courts have enforced them. This has been confirmed by a recent Ohio case, [English v. Cornwall Quality Tools](#) [CCH Bus. Fran. Guide ¶ 13,218], with multiple claims that the clause was "unconscionable," or inherently unfair, and therefore invalid.

Applying Ohio law, the court rejected the argument that the arbitration clause was unconscionable because the costs to the Franchisee in arbitration would be higher than in a court trial. The court pointed out that costs of litigation, through trial and possible appeal might actually be greater, and that the arbitration clause was, therefore, a commercially reasonable term in the agreement.

Similarly, the Franchisees' arguments that they were discouraged from reading the contracts before signing and that they had unequal bargaining power compared to the Franchisor were rejected. The court concluded that the Franchisees could have obtained legal advice prior to signing, and that the Franchisor had no obligation to suggest that they read the Franchise Agreement or retain counsel. ■

clauses which determine the resale value, the rescission and termination clauses, and the obligations to achieve a result."

This provision is very interesting, clearly goes beyond the relatively pure disclosure philosophy adopted by most other countries and raises

questions as to the effect of a negative evaluation. Does such a report imply non-enforceability of the disapproved provisions? Or, alternatively, if the report is provided to the purchaser before any closing, put him or her on notice as to those provisions and enhance enforceability?

Clearly, the new Belgian law raises at least as many questions as it answers and we can only advise Franchisors planning to approach the Belgian market to do so with caution, and with the assistance of experienced franchise U. S. legal counsel and their correspondent firms in Belgium. ■

statements in a response could be used against the Franchisor and/or its Franchisees. Similarly,

Franchisors should alert their Franchisees to the possibility of such inquiries and ask that the

Franchisees contact the Franchisor before any response is generated. ■

FRANCHISE LAW INSIDER™

A Publication Reviewing Recent Franchise and Related Business Developments 1st Quarter 2006

Main Office
6621 E. PCH, Suite 250
Long Beach, California 90803
Tel: (562) 596-0116
Fax: (562) 596-0416
AdminLB@HolmesLofstrom.com

Northern California Office
4251 S. Higuera Street, Suite 401
San Luis Obispo, CA 93401
Tel: (805) 547-0697
Fax: (805) 547-0716
Info@HolmesLofstrom.com



HOLMES & LOFSTROM, LLP
Franchise and Business Counsel

Main Office:
6621 E. Pacific Coast Highway, Suite 250
Long Beach, CA 90803
Tel: (562) 596-0116

Northern California Office:
4251 S. Higuera Street, Suite 401
San Luis Obispo, California 93401
Tel: (805) 547-0697

Place
Stamp
Here