

FRANCHISE LAW INSIDER™

A Publication Reviewing Recent Franchise and Related Business Developments 2nd Quarter 2006

"Those who say it can't be done are usually interrupted by others doing it." -Joel A. Barker-



HOLMES & LOFSTROM, LLP
Franchise and Business Counsel

IFA QUARTERLY EVENTS
Hosted by
Holmes & Lofstrom, LLP.

July 12, 2006

**Topic: How to Get
The Most From Your
IFA Membership**

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

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Franchisee Satisfaction Surveys and the Competitive Advantage

What do your "other consumers" think and does it really matter?

By: Jeff Johnson, Founder/CEO, FranSurvey

With over 20 years as a multi-unit franchisee, Area Developer and now Consultant/Founder of a research company working exclusively with franchise companies, I remain fascinated by what franchisors don't understand or don't put into practice.

Here's a simple fact: the best way to understand franchise excellence is by listening to what franchisees have to say. I've spent the last three years doing just that — after all, franchisors have two separate and distinct consumers. First there's the end user/consumer. The "other consumer" or for most franchise executives the forgotten consumers are the franchisees and prospective franchisees. They, too, are individuals who "purchase or invest" in the franchise product.

We are obsessed with what end users (consumers) think of our products/services. For example, on a recent trip to buy kitty litter, I was handed the receipt and encouraged, by the 16 year old young lady behind the cash register no less, to call the toll free number listed on the receipt, answer a few questions and I might win \$25,000! If only more Franchise Executives had the same passion that was displayed by this 16-year old, about obtaining the opinions of their "other/forgotten" consumers, the individuals that purchase/own the franchise. Understanding the franchisee is just as, if not even more vital to their success than understanding the end user.

Despite the official definition, business format franchising is not simply just one of the options that you can choose to expand or grow "your" business. Once you ask others to invest their time, energy and MONEY in "your business" it becomes more than an option that you have chosen...it becomes THEIR business. Remember, the Webster's definition of an entrepreneur is "someone who has accepted risk for the sake of profit" and your franchisees certainly meet that definition.

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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.



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
Jim Mulcahy, Of Counsel

Paralegals

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

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Firm News!

Peggy Narodick moderates panel at IFA Symposium

Senior counsel Margaret "Peggy" Narodick moderated a panel discussion, "Franchise Agreement Drafting (Basics Track)" during the International Franchise Association's 39th Annual Legal Symposium held May 7-9th in Washington DC. Speakers James Mulcahy of the Mulcahy Law Firm and Of Counsel for H&L, Mary Beth Trice of Fitzgerald, Abbott & Beardsley, and Kerry Olson of Buffalo Wild Wings provided information on a basic understanding of a Franchise Agreement, including:

- Identifying the key business objectives and areas of potential exposure
- The drafting process and the evolution of a franchise agreement
- Balancing marketability and risk in the franchise agreement
- Obtaining franchise system buy-in
- Common types of disputes and drafting to protect against them

The symposium gave the attendees a chance to learn from some of the top franchise law practitioners and business leaders as well as gain valuable networking time. The symposium was well-attended with about 550 attendees.

Lori Lofstrom featured in Texas radio interview broadcast and to speak at NAWBO Convention

Partner Lori Lofstrom was featured on a radio interview on BizRadio, station 1360 AM, broadcast from the University of North Texas on April 5th. The one-hour interview was conducted by host Eddie Reyes. The program's theme "Everything about Franchising Opportunities and Law" allowed for further promotion of the book "What No One Ever Tells You About Franchising" by Jan Norman, to which Lori contributed a chapter in the "experts" section.

Lori was also invited to speak at the Annual Convention of the National Association of Women Business Owners in San Francisco. NAWBO is the largest membership organization for women business owners in the U.S. She will participate on a panel discussing franchise and intellectual property considerations for growing business.

David Holmes presents at conferences in New Zealand

Partner David Holmes recently completed an international trip to Hamilton, New Zealand to speak at the 2006 Franchise Association Conference. Being known as one of America's top franchise attorney Holmes co-presented with Stewart Germann, Partner of the Stewart Germann Law Office in New Zealand in the International Trends program. Mr. Holmes will also participate in a panel discussion with other overseas presenters.

Robert T. Justis, PhD, in his book *Achieving Wealth Through Franchising*, states "The franchisor/franchisee relationship must be a win-win situation. The business relationship must be one of a partnership (not a legal partnership) where franchisees have input on those matters that are of concern to them." Do you "really" know the matters that are of most concern to your franchisees, or just the ones that they feel comfortable bringing up in front of "you"?

As franchisees mature in your system they assume that they have earned, by virtue of their senior franchisee status, some form of junior partnership position. They clearly understand the importance of a strong, fair senior partner — the franchisor — to guide and direct the company/brand.

However, mature franchisees feel they have earned the "right" to be consulted on matters of importance. An understanding of this "brand ownership" is terrific if understood and made a part of your overall information gathering process and team building. Justis continues by saying "Most decisions in a successful well managed franchise system are frequently the product of consensus."

Most franchise executives believe that they already know what is on the minds of their franchisees and how those franchisees would rate them on specific operational or training

areas. Seldom — if ever — are executives able to correctly rank franchisee concerns from highest to lowest or to identify the true depth of the concerns the franchisees may have.

How do we improve in any area that we can't measure? Where do we begin? Which issues are most pressing? What questions should we even be asking? Are we asking questions that "we" want answered or are we asking questions that the franchisees would like to respond to!

As Greg Nathan states in his recent book *Profitable Partnerships*, "My experience is that good relationships in a franchise system are more than just a nice thing to have—they are absolutely essential..."

At FranSurvey, we ask every franchisee a series of 20 very specific, field-tested questions and 3 open-ended (verbatim) questions. We continue re-contacting non-respondents as often as our methodology requires, to complete a minimum of 70% of your total franchisees. The survey is designed for a quick, 4 to 5 minute, Internet response which minimizes the time necessary for the respondent and maximizes the quantity of information that can be gathered.

Our questions do not approach any legal or earnings claim issues. They are specifically designed to obtain, from your franchisees their responses to questions that they would typically receive from prospects,

from their neighbor or from "the guy" at the soccer game.

So what's the buzz with your franchisees...or should I say, your *other consumers*? Do you know? Can you gain a competitive advantage if you aren't measuring the quality of this relationship? Is your competition doing a better job at relationship and team building than you are? Don't let them. Take charge of the situation today.

"The art and science of asking questions is the source of all knowledge." –Thomas Berger

Jeff Johnson, the Founder/CEO of FranSurvey® can be reached at 1.800.410.5205 ext. 211 or at Jeff@FranSurvey.com

FranSurvey® was launched by veteran franchise business entrepreneur Jeff Johnson, who purchased his first franchise in 1984. He has been involved in franchising for more than 20 years as a multi-unit franchisee, an Area Developer and a franchise business consultant and is headquartered in Lincoln, Nebraska.

¹ [Achieving Wealth Through Franchising](#) by Robert T. Justis Ph.D and William S. Vincent, J. D., M.B.A. [Currently a best seller in China]

² [Profitable Partnerships](#), Sixth Edition, by Greg Nathan

New and Proposed Regulations Provide for Electronic Disclosures/Use of Diskettes and CD Rom for Exemptions from Registration in California

Amendments to the California Franchise Regulations now specifically authorize franchisors to satisfy franchise disclosure obligations using the internet or other electronic means, including "machine-readable media." Before delivering a UFOC to a prospective

franchisee, a franchisor must inform the prospect of the formats in which the disclosure is available and all prerequisites or conditions for obtaining or reviewing it in that format.

The UFOC itself must be delivered as a single,

integrated document or file, without extraneous content. Scroll bars and internal links and search features may be used, but all other features are prohibited. The new rules became effective April 2, 2006.

INTERNATIONAL LEGAL UPDATES

French Supreme Court Limits Franchisor's Disclosure Obligations

The French Supreme Court recently rejected a claim by a franchisee based on alleged failure of the franchisor to make proper disclosures, as otherwise required by the French "Loi Doubin" franchise disclosure law.

The court determined that the prospective franchisee had not been given the documents required by French disclosure rules and that there had been a technical violation of the law. However, the franchisee had been active in the business segment concerned (gas stations) for a number of years before the franchise agreement was signed. Based on that history, the court concluded that the franchisee was knowledgeable as to the risks involved in operating such a business, as well as the investments required for participation in the business.

The franchisee's business history, then led the court to the conclusion that where the prospective franchisee had prior knowledge of the relevant business, at least to the degree present in this case, there was no need for the franchisor to present this information again in the disclosure document. The court also concluded that the franchisee could not use the franchisor's "technical" violation of the disclosure law to serve as the basis for a successful claim for damages. While a UFOC presents industry-specific information such as competitive factors and costs to open, which a previous participant in the industry might already be aware of, the UFOC presents a vast amount of unrelated information in regard to prior industry experience. This information includes the franchisor's background, recent litigation history, the franchisee's and franchisor's respective obligations, data regarding training, audited financials statements, statistical information regarding franchise

system turnover and contact information for current and former franchisees. Few U.S. courts would conclude that prior industry experience substitutes adequately for those disclosures.

Mexico Adopts "Just Cause" Termination Standard; New Disclosure and Franchise Agreement Content Provisions

New franchise regulations that recently took effect in Mexico, may result in increased challenges in operating franchise systems. The new regulations prohibit a franchisor or franchisee from unilaterally terminating or rescinding an agreement, unless the agreement was for an unspecified term or where there is "just cause."

The new regulations clarify a franchisor's disclosure duties, by providing that a disclosure document must be delivered at least 30 days before the franchise agreement is signed, a substantially longer period than is generally applies in the U. S.

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U.S. LEGAL UPDATES

Franchisee Cannot Waive Protections of Minnesota Franchise Law

A recent decision (Twin Cities Gallerias v. Media Arts Group, CCH Bus. Fran. Guide ¶ 13,270) by a Minnesota Federal District Court between a franchisor and a franchisee, arose from a request to change the venue of the proceedings in the presence of arguably contrary clauses in the franchise agreement.

The franchise agreement included a choice-of-law clause, which the court specified that California law would apply, despite the fact the Franchisee was based in Minnesota, along with an agreement that disputes would be referred to binding arbitration.

The arbitration panel hearing the case, using these two provisions of the franchise agreement, held that the franchisee's claims against the franchisor under the Minnesota Franchise Act (the "MFA") were pre-empted under the Federal Arbitration Act, and dismissed those claims.

The District Court disagreed, concluding the franchisor could not contract out of compliance with the MFA. This was based on specific legislation in Minnesota in response to an earlier, related decision, that Minnesota had an explicit, well-defined public policy of protecting Minnesota franchisees under the MFA. While the court agreed that the dispute would have to be arbitrated, the franchisee would still be entitled to the protections afforded by the MFA.

The decision reminds us that many courts will not enforce franchise agreement provisions to the extent to allow a franchisee to surrender his or her rights under state franchise disclosure or relationship laws. At the same time, they will also generally enforce the provisions of a franchise agreement mandating binding arbitration.

Court Upholds Franchisor's Right to Terminate for Non-Payment in California

Many states, California included, have statutes regulating the relationship between franchisors and franchisees. One of the most commonly regulated areas is termination, both as to when termination of a franchisee's rights is allowed and how that termination may be accomplished.

Ramada v. Kouza (CCH Bus. Fran. Guide ¶ 13,282) concerned a situation in which the franchisor claimed that the franchisee had failed to make certain required payments and was pursuing termination of the franchisee.

The franchisee had payment problems and received at least two notices of default within a one-year period. The franchise agreement contained a clause that allowed the franchisor to terminate in that situation.

In addition, a section of the California Franchise Relations Act (the "CFRA") allows termination on immediate notice and without an opportunity to cure if the franchisee "repeatedly fails to comply with one or more requirements of the franchise, whether or not cor-

rected after notice."

The franchisee failed to make a required payment and the franchisor, three days after the date the payment was due, terminated.

The federal trial court, reading the provisions of the CFRA and the agreement together, concluded that termination, in these circumstances, was reasonable and legal, whether or not the franchisee had cured any prior defaults.

Franchisors need to consult with experienced franchise counsel in each situation, to verify that appropriate procedures are followed, and that any termination will be upheld if challenged.

Franchisee's Release of Franchisor Was Valid and Enforceable

Releases are an important tool in managing Franchisor/Franchisee relationships, often providing both parties with the confidence that they have reached an effective resolution of a dispute and need not be concerned that what they thought was resolved will be reopened to controversy.

The utility of that franchise management tool was challenged in a recent case (Aulakh v. 7-Eleven, CCH Bus. Fran. Guide ¶ 13,265), but the California trial court supported the enforceability of the release which the Franchisee had given.

In connection with the termination of the Franchisee's poorly performing stores (compared to other units in the system), the

Continued on page 6

Franchisee purchased the franchised premises from the Franchisor in order to de-brand it and manage it as an independent business. As part of that transaction, the Franchisor and the Franchisee signed mutual releases. Subsequently, the Franchisee claimed that his release was invalid as being “unconscionable.”

The court disagreed, noting that even if the Franchisor and Franchisee had unequal bargaining power, the agreements did not contain hidden terms and noted that the releases were mutual.

Post-Termination Non-Compete Enforced Against Franchisee and Assignees in Florida

The widest range of treatment by different courts in the interpretation and enforcement of non-competition clauses in franchise agreements, particularly those which attempt to prevent competition after the franchise agreement has expired or the franchisee’s rights have been terminated (for example, as a result of a default).

A recent Florida case (Pirtek v. Layer, CCH Bus. Fran. Guide ¶ 13,257) involved an industrial hose business master franchisor who asked for an injunction against a terminated franchisee (and three other defendants) enforcing a non-competition clause in the agreement with the franchisee.

Under a Florida law generally supporting such enforcement, the court decided that the non-competition clause was enforceable, not only against

the former franchisee but also against the assignees of the former franchisee, which included the wife of the former franchisee. The court saw through the assignment transaction and enforced the non-competition clause, even without reference to the “binding on assignees” provision in the non-competition clause.

A related issue that typically comes up in these cases is the reasonableness of the non-competition restriction, whether as to duration, geographic coverage or type of business activities involved. In this case, the court decided that the clauses provisions (two years, 15 miles and “any business that sells products and services similar” to those sold by the franchised business) was reasonable.

Forum Selection Clause Enforced Against Distributor in Rhode Island

As in sports, the “home court advantage” also applies in legal disputes, and can have a significant practical effect on the outcome of a case. This is why experienced franchise lawyers invest so much time and attention to “venue” or “choice of forum” clauses, those parts of franchise agreements that specify in which state or federal court a dispute will be heard.

In a recent federal trial court located in Rhode Island (American Biopgyisics v. Dubois Marine, CCH Bus. Fran. Guide ¶ 13,261), a decision concerned a dispute between a Rhode Island-based manufacturer

and a Canadian distributor, covering approximately \$500,000 for goods and almost \$100,000 in interest.

The insect repellent device distributorship agreement contained a clause selecting the federal and state courts of Rhode Island as the exclusive courts having jurisdiction over matters relating to the agreement.

When the dispute erupted, the Canadian distributor had second thoughts regarding its commitments as to the appropriate courts, and claimed that they should not be enforced based on the Rhode Island court’s claimed lack of jurisdiction over the Canadian distributor, and that trial in Rhode Island would be substantially inconvenient for the Canadian distributor.

The court rejected both claims and enforced the forum selection clause, noting that it was well established that a party to an agreement containing a forum selection clause had waived its right to challenge personal jurisdiction and could not claim lack of convenience as a basis for dismissing a suit brought in the courts selected by the agreement.

The trial court noted that the agreement had not been procured by fraud, there was no basis for believing that the Canadian distributor was compelled to enter into the agreement, nor would be deprived of its day in court.

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Forum Selection Clause Enforced Against Franchisee; Trial Court Judge Ordered to Comply in Texas

In a recent Texas case ([In re Talent Tree Crystal](#), CCH Bus. Fran. Guide ¶ 13,277) an appeals court ordered a trial court judge to enforce the choice of forum clause in a franchise agreement.

The Franchisee filed suit against the Franchisor, claiming that the Franchisor had breached their agreement by offering franchises to third par-

ties on terms more favorable than those that applied between the Franchisor and the Franchisee. The Franchisee's claim included the lack of notice of the offers they claim forfeited their right to obtain more favorable terms from the franchisor.

The Franchisor responded by filing a motion to dismiss the Franchisee's claims and to move the dispute to federal court in Texas, consistent with the choice of forum clause in the applicable employment agency franchise agreement.

The appeals court found that there was no claim of fraud or over-reaching in the case, with respect to choice of forum clause. The Franchisee had failed to show that enforcing the provision would be unreasonable. On that basis, the appeals court specifically ordered the trial court judge, under a procedure known as writ of mandamus, to dismiss the Franchisee's claims and to move the dispute to federal court in Texas.

The continuation of the case in federal court and whether the franchisee had a legitimate

Additionally, the revisions require a franchise agreement to include a number of specific terms, a feature not generally present in North American franchise law or practice.

Among these terms are a required specification of territory, which may be interpreted to mandate a grant of territorial rights where the franchised business model would not normally include one.

Also included are terms related to location, inventory, marketing and advertising policies and policies regard-

ing reimbursement and financing. Finally, the franchise agreement is mandated to describe any criteria and methods used for supervision and evaluation of the Franchisee and possible causes for termination.

Clearly, some of these requirements do not match all franchised business models, and others are often covered, at least in typical North American franchise systems, by provisions in marketing, operations or other manuals.

While not a significant barrier to entry into the Mexican market, these changes will

require additional, and possibly expensive, steps to be taken by U.S. attorneys and their associated Mexican counsel to comply with the new requirements. Depending on future interpretation of the "just cause" requirement regarding termination, more serious questions may be raised.

For further information, or if you have any questions, please contact one of the franchise counsel at Holmes & Lofstrom who practice in the international franchising area.

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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
(562) 596-0116

Northern California Office:

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

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