

# FRANCHISE LAW INSIDER™

A Newsletter Reviewing Recent Franchise and Related Business Developments

4th Quarter 2006

1st Quarter 2007

"Ability is what you're capable of doing.  
Motivation determines what you do.  
Attitude determines how well you do it."  
-Lou Holtz, football coach-



**HOLMES & LOFSTROM, LLP**  
Franchise and Business Counsel

**IFA QUARTERLY EVENTS**  
Hosted by  
Holmes & Lofstrom, LLP.

**January 24, 2007**

**Topic: High Quality  
Franchise Relationships  
Develop a Culture of  
Franchise Excellence**

#### **LOCATIONS:**

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

**San Diego Lunch**  
Postal Annex-  
corporate headquarters  
7580 Metropolitan Drive #200  
San Diego, CA 92108  
11:30 AM

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## **LEASE DANGERS: CRITICAL ISSUES AFFECTING FRANCHISES**

**By: Ryan Cunningham, President of Javelin Solutions**

A properly negotiated lease protects the interests of both franchisee and the franchise system in the marketplace. By failing to address key issues, both parties open themselves up to increased liability,

#### **Conflicting Issues**

There are some issues in which the interests of the franchise company and franchisee conflict. It is important to understand the position of both parties to find a reasonable compromise.

The franchise organization must have the right to enter the premises.

#### **Use Clause:**

A franchisee wants a broad definition of the allowable uses for the space, so, in the event the business fails, the franchisee will have more flexibility in subleasing to other retailers. On the other hand, the franchise system wants the use narrowly defined to ensure their deli doesn't become a dry cleaner. This is also why the franchise company should insist on having the right to sublease or assign the lease to a new franchisee in the event the existing franchisee fails to perform per the franchise agreement, without needing landlord's approval. To align interests, the franchise system should agree to a broad use definition as long as it has the right to take over the lease, in the event of a default. If the franchise organization opts not to take over the lease, the franchisee, still liable for the lease obligation, would have the right to sublease to a wider variety of users.

#### **Radius Restriction:**

A new issue, radius restriction, can protect the interests of the franchisee while negatively impacting the growth plans of the franchise system. Specifically, a landlord may restrict additional units within one to five miles, potentially conflicting with the terms of the franchise agreement. While a landlord's ability to enforce this restriction against a franchise firm or a different franchisee, neither of which are party to the lease, is questionable, such a restriction may discourage new franchisees to the market. A franchise must review the lease for such clauses and, in the event the radius restriction conflicts with the franchise agreement, the system must fight this clause.

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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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## Firm News!

David Holmes article featured in Franchising World magazine



"The Essence of Good Franchise Relations" was featured in the September 2006 issue of Franchising World. The article discusses the increased importance of relationships between franchisors and franchisees after the initial start up phase. Building a system that works for both that strives toward increased profitability.

## H & L Hosts October 2006 Franchise Business Network (FBN) meeting Use Your Website to Sell



Boris Bugarski, CEO & President of mUrgent Corporation spoke to the Orange County and San Diego Franchise Business Network meeting held October 25th. His presentation entitled, "Website Optimization—"The Power of Sales"" inspired many questions and discussion.

Several attendees allowed Bugarski to do a brief analysis of their website's homepage and present this information at the meetings. Attendees learned how to encourage interaction with web audiences, implement easy to use navigation techniques, and highlight their company's culture and use it to brand their company.



Learn about and attend upcoming FBN events visit:  
[www.holmeslofstrom.com/fbn.htm](http://www.holmeslofstrom.com/fbn.htm)

## LETTER FROM INDIA

By: David Holmes

[David Holmes was recently invited to be part of a trade mission to India, organized by the New South Wales, Australia, government and accompanied by Elisabeth Ritchie, a partner with Baybridge Lawyers, a founding member (with Holmes & Lofstrom) of the UniFran Alliance, a group of independent international franchise lawyers. We asked him to note some of his impressions from that visit, and they're set out below.]

From a franchise business standpoint, the most important impression I took away from my visit to India was not the size of the market. That is amazing enough in itself: the population is in excess of one billion people in a country less than one-half the size of the U.S., and with one city, Mumbai (previously called Bombay), with a population greater than that of Australia.

The most important impression was one of a country on the move, with an economy growing in excess of 8% per year, with entrepreneurs already expanding across the country as master licensees of U.S. franchise concepts, with even the poorest people on the streets busily engaged in their own businesses and with both an appetite for U.S. franchise concepts and the capital resources to acquire master franchise rights.

As an example, one of our most interesting visits was one which Ms. Ritchie and I made, on our own, to meet the owners of a "dollar store" master franchise licensed by a U.S. company, at one of their locations. Situated in a medium-sized exterior mall in Mumbai, the store was a professional retail presentation

which would have been acceptable in any American market. A McDonalds was located in the same mall.

The owners told us that there was a strongly favorable reception, at the customer level, to foreign brands and that, when properly positioned as to price point, foreign brands were meeting wide acceptance within India.

These particular owners had acquired their master franchise rights less than three years ago and had already opened over 40 stores, including both company-owned units and franchised stores, and were continuing expansion across India and looking forward to a total penetration of approximately 1000 stores. They asked us to please let them know if other U.S. or Australian retail franchise concepts were interested in expanding into India and, if so, they would be very eager to chat with them.

Among the entrepreneurial class, the capital necessary to purchase master or other rights, whether on a national or regional basis, seems to be widely available. In fact, since the country's economy was liberalized in 1991, the growth of the private sector has been exceptional and it's not unfair to say that the market, at least for investment in recognized foreign concepts, is "awash in cash."

As to the entrepreneurial traditions of this culture, a recent survey reported that, in the U.S., Indian immigrants accounted for 28% of all foreign-founded private start-up companies, India being the most common foreign

country of origin for founders of venture-backed U.S. companies. The UK accounted for 11% and China for only 5%. For public venture-backed firms, India was also the leader.

Now, successful international franchise expansion requires far more than prospective local purchasers, for either master or unit rights, with adequate capital and appropriate motivation. The first, and most important requisite, is, of course, the appropriate local partner, ideally with experience in both franchising and the relevant market segment, and/or with existing businesses that will synergistically link to the concept to be introduced.

And India seems to have an adequate number of such potential local partners, based on the people we met but also on reports of the accountants and lawyers we interviewed for possible membership in the UniFran Alliance (we believe we identified some appropriate potential candidates), and also on our interviews with the India Franchise Association.

Appointment of one or more Indian law firms as members of UniFran will substantially ease entry into the market, as the UniFran candidates already have extensive experience in assisting entry into India by U.S. and other franchise systems. In addition, the contacts we've made will be useful in identifying potential master licensees.

Of course, all of this has to be taken into perspective.

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The franchise system should provide guidance in lease negotiation.

#### Franchise System Issues

There are some lease issues that impact the franchise system exclusively. Unless the franchise company addresses these issues in a mandatory lease addendum, don't expect the franchisee to see to it that these issues make it into the lease.

#### Default Notice:

To protect the brand, the franchised business must be kept aware of the franchisee's performance of its lease obligations. The last thing the franchise company wants to happen is to lose a prime location due to the failure of the franchisee to perform under the terms of the lease. Therefore, the franchise organization must have the right to enter the premises without franchisee approval to assure the space is properly maintained, must be notified by landlord if the franchisee is in default and must approve any changes made to lease subsequent to execution, to avoid the weakening of franchisor's lease position. Some landlords, concerned about the financial strength of the franchisee, may require the franchise system to cure any lease default of the franchisee. This is a landlord's roundabout way of getting a performance guarantee from the franchise company.

#### Fixtures and Equipment:

If a tenant defaults on the lease, landlords want the right to claim and sell a tenant's equipment and fixtures to recoup their loss. In the event the franchisee is terminated, the franchise agreement expires or the franchisee defaults on the lease, the franchise company must be able to reclaim equipment, signs, fixtures and furniture to protect the brand. Therefore, it is imperative the franchise system have superior rights to the landlord to claim the equipment and fixtures in the event of franchisee default. Some expensive items such as signs, ovens, coolers, counters and

lights are considered permanent fixtures and must be left in the space as the landlord's property. Make sure to list such items as tenant's property, which may be removed upon the end of the term in the lease.

#### Franchisee Issues

To give the franchisee a greater chance to succeed, the franchise system should provide guidance in lease negotiation. To succeed, a franchisee must have a clear understanding of the costs that will be incurred to operate at a location. While rent is the obvious cost, there are many hidden costs, which could make the difference between the success and failure of a business.

#### Operating Expenses:

One of the largest potential cost dangers for a franchisee is operating expenses. While one would expect a franchisee to pay for their share of utility costs, landscaping, taxes and repair and maintenance, many franchisees are obligated to pay for potential large, unbudgeted costs such as replacing the roof, parking lot, elevators and air conditioning systems. It is critical that the franchisee understand all costs that will be passed through. Traditional "costs of ownership" such as roofs, elevators, and so forth should be paid for by landlord. If these costs are the responsibility of the tenant, get a copy of the roof warranty and a current maintenance report on the air-conditioning system to better understand the inherent risk of being surprised by a big bill.

#### Construction Costs:

Another potential cost danger for franchisees lies in constructing the space. In many leases, the franchisee takes the space "as-is." Many franchisees have had unexpected build-out cost increases when, after the lease was signed, it was discovered the electrical system was inadequate, the restrooms didn't comply with code or the space required fire sprinklers. The fran-

chise system should provide the franchisee a list of "vanilla shell specifications" that spell out the condition the landlord will hand over the space to the franchisee. This document pushes costs for basic infrastructure back on the landlord. To push the cost to prepare the space for the next tenant on the current tenant, some leases require tenants to return the space upon the end of the lease term to the original condition. For example, if the space was delivered in a shell condition, the franchisee may be required to remove all improvements—an expensive, unbudgeted proposition. The franchisee should only be required to return the space in a clean condition.

In the end, the lease and all related documents need to be read and understood by all involved parties.

#### Insurance Coverage:

A little-reviewed section of the lease involves required insurance coverage. Many landlords require the same coverage for a small tenant as they would the anchor tenant. In fact, since anchor tenants have more negotiating leverage, many small tenants end up with more coverage than their larger neighbors. In addition, most leases provide that in the event tenant fails to carry required insurance, the landlord may purchase it on the tenant's behalf and pass on the cost. Plenty of small tenants don't carry business interruption, health care, plate glass window or auto insurance specifically for their businesses. The franchisee's insurance agent must review this section and advise the franchisee on the costs to carry required coverage. Many leases dictate the insurance company that a franchisee should use, require default notices and renewal notices from the insurer be sent to the landlord and may allow the landlord to arbitrarily increase coverage limits during the lease term.

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### Rules and Regulations

Most leases reference standard rules and regulations and covenants which the tenant must abide by. Many times these documents are only provided upon request. These seemingly-harmless documents can contain some of the biggest challenges. For example, these two documents may forbid a tenant from placing signs of any kind in the front window, may set the hours a store must remain open or restrict the products or services provided. Rules created for the good of the property may conflict with the planned use. For example, not allowing dogs could be a problem for a pet groomer, preventing hazardous materials onsite won't work for a copy center or dry cleaner and disallowing food odors may be a problem for an Italian restaurant.

### Grace Period:

The repercussions of late rent can have a dire effect on a franchisee, even if rent is only one day late. Usually a landlord collects a preset late fee in addition to a hefty interest penalty. Worse yet, the franchisee is in default of the lease, triggering landlord reme-

dies such as acceleration of all remaining rent, locking the franchisee out of the space and "reletting" or recommitting the space to another tenant. All this is because the franchisee was on vacation and forgot to mail the rent check.

For all payments and performance requirements in the lease, a franchisee should receive a notice from the landlord of the potential default and a reasonable period to cure. For rent payment, the payment date should be extended at least five days after receipt of the landlord's notice. For performance issues, such as a requirement for the franchisee to paint the exterior, the performance deadline should be extended at least a month.

### The Secret to a Strong Lease

In the end, the lease and all related documents need to be read and understood by all involved parties. Critical franchisor issues must be addressed upfront with a mandatory lease amendment, the terms of which will supersede any conflicting language in the lease. The franchisor must provide the franchisee with

a checklist of critical issues and guidance on how to address them properly. Both franchisee and franchisor must be clear on each other's lease needs. The franchisor's requirement to control a site long term can dovetail with the franchisee's more immediate needs to dictate occupancy parameters if both parties present a coordinated front to the landlord.

A lease is meant to protect the tenant and the landlord, laying out the requirements of both parties to ensure a successful, profitable relationship. If handled correctly, lease "land mines" can be avoided, eliminating these costly and sometimes deadly occurrences. ■

*Ryan Cunningham is president of Javelin Solutions, a Greenwood, Colo.-based site selection and growth management company. He can be reached at 303-759-0765 or ryan@javelinsolutions.net.*

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### Letter from India Continued on page 3

On the positive side, India is a huge market (even if only 5% of the population has the requisite economics to afford a U.S.-based system's goods or services, that is still a market of almost 60 million people), English is the predominant language of commerce, the legal system is fully supportive of a Franchisor's intellectual property rights and the retail public is familiar with both franchising and many U.S. brands. In addition, a significant number of well-financed, existing or prospective master franchisees appear to al-

ready be in place, on both the regional and national level.

But challenges undoubtedly exist. India is a long way from the U.S., cultural adaptations will need to be made, real estate is expensive (partially balanced by low labor costs) and India ranks relatively high on international scales for domestic corruption (which may be more of an issue for any local master franchisee, than for the U.S.-based Franchisor, but is still an item of concern.)

So, for U.S.-based Franchisors, initial expansion to Canada, Australia/New Zealand and Britain may be a wiser choice, but our joint impression is that India is a highly attractive market which should be considered, at the right point in their development, by systems considering international expansion.

Please let us know if you have any questions, or Holmes & Lofstrom can help in any way.

## LESSONS LEARNED

By David E. Holmes

*A continuing column drawing lessons for franchise systems from franchise litigation and other sources.*

### No Liability for Sale of Unregistered Franchises

Normally, a Franchisor's sale of an unregistered franchise would result in something close to a "slam dunk" judgment in favor of a Franchisee suing under a state franchise law. After all, proving that the Franchisee bought the franchise, and that the Franchisor was not registered at the time, should be a relatively simple process for the Franchisee's attorney, assuming that the actual facts support the claim.

However, as a recent California case (FF Orthotics v. Joe Paul) demonstrates, things are not always that simple, and in this case the Franchisor was able to avoid liability due to a close reading of some of the provisions of the California Franchise Investment Law (CFIL).

The facts in the case showed that the defendant company was advised by its attorney to not register as a Franchisor (supposedly, so as to avoid disclosure of a felony conviction involving the founder). And the company should expand its business by using a "dealership agreement" rather than a franchise agreement, advice which is, at the very least, questionable in light of the court's opinion.

Following the attorney's advice, the defendant company awarded "dealerships" to several California-based individuals and companies, as well as to persons and companies in other states. Perhaps not surprisingly, some of the "dealers" ultimately sued, claiming that the relationship was, in fact, a franchise and that the defendant had violated the CFIL by selling an unregistered franchise.

By the time the case reached the appellate court, the defendants conceded that the dealership agreements were franchise agreements that should have been, and were not, registered under the CFIL, contrary to the opinion of the company's attorney. In most cases, this would have been fatal to the defendant's hopes to avoid liability to the Franchisees, but two provisions in the CFIL operated to save the Franchisor.

First of all, the suing Franchisees located in California bought their franchises more than four years before they filed suit and the relevant portion of the CFIL imposes a four year statute of limitations on violations, including those of the registration requirements. Therefore, since the Franchisees had not filed suit within that time period, they were barred from obtaining any recovery.

Second, as to Franchisees located in Alabama and North Carolina, while they may have filed their lawsuit within the proper time, a specific section of the CFIL (Section 31105, originally drafted by Holmes & Lofstrom attorneys, and passed into law with their participation) exempts from the CFIL's registration requirement offers and sales to out-of-state residents, where the franchised business is also physically located outside California. The court found that that was true as to the Alabama and North Carolina Franchisees and their business, and denied recovery to them.

Here the Franchisor was lucky, and three lessons emerge: (1) In structuring any distribution system which might be a franchise, obtain (and follow!) the advice of sophisticated, conservative and experienced franchise counsel; (2) when in doubt, register the offering; and (3) do not assume that an unregistered sale will automatically result in liability – it may, but a close review of the applicable rules may reveal an

"escape hatch" or two!

### Franchise Agreement "Boilerplate" Defeats Fraud Claim

Many businesspeople report that "their eyes glaze over" when they reach the last third of their Franchise Agreements: the portion with the "legal boilerplate" and after the business essentials of the relationship (payments, service and support, marketing fund, etc.) have already been covered.

As it turns out, those parts of the Franchise Agreement can be the most crucial if a dispute develops between the Franchisor and the Franchisee. An excellent example of just how important those provisions are recently arose in a Georgia case (Holiday Hospitality Franchising v. Mitsubishi), involving a claim by a Franchisee that the Franchisor had made false statements and material omissions during negotiations for the franchise. In that case, the boilerplate operated to completely deflect the Franchisee's claims.

In summary, the court upheld the "merger and integration" clauses of the Franchise Agreement; those providing that the Franchise Agreement itself contains all of the parties' representations and agreements, and prohibiting reference to any discussions' promises or otherwise which were not included in the written Franchise Agreement itself.

As a result of that holding, the "liquidated damages" clause in the Franchise Agreement was enforced. (In general, a liquidated damages clause limits the damages payable by either party to an agreement, generally should limit each party similarly and is enforceable in many states under various circumstances and limitations.)

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Here, the liquidated damages clause provided for 3 years income to the Franchisor in the event of early termination by the Franchisee. The court concluded that this amount of damages was “heavy” but not unreasonable in light of a ten year franchise term, and reasonably related to the effect of the Franchisor no longer having a Franchisee in the market. On that basis, damages were assessed against the Franchisee.

One lesson to be taken from this case is to consider the use of properly drafted liquidated damages clauses in Franchise Agreements. They may prove to be of significant assistance in litigation, although they can also raise some issues in various contexts.

#### **Arbitration Panel Enforces Post-Term Non-Compete; Denies Franchisor’s Lost Profits Claim; Related Non-Competition Cases**

Most of the cases on which we report are those decided by trial judges or appeals courts. Therefore, it’s interesting to see how an arbitration panel handles similar cases, particularly since such a large proportion of Franchisor/Franchisee disputes today are resolved through arbitration, and the results of those decisions are not normally publicly available. A summary of a recent Georgia arbitration decision (Wilcox v. Pirtek USA, LLC) gives us several insights into the thinking of the arbitrators.

In this case, a hydraulic hose business Franchisor was able to enforce, against terminated Franchisees, the post-term obligations of their franchise agreements, including non-competition provisions. Those provisions, which prohibited operation of a similar business within 15 miles of the Franchisee’s territory, were found to be reasonable. Also, reflecting some business realities not always apparent to courts, the arbitrators cited the fact that the goodwill associated with the Franchisor’s system was a legitimate business interest justify-

ing enforcement of the post-term non-compete.

On the other hand, the Franchisor was denied the right to recover lost profits in the form of potential future payments of royalties and product purchases, the arbitrators concluding that the losses were the result of the Franchisor’s termination of the franchise agreements, rather than the Franchisees’ breaches of those agreements. Note that this is a position taken by some, but not all, courts.

In the non-competition area, of interest also is a similar decision (Caring Senior Service Partnership LP v. Batson) by a Tennessee court, deciding that a Franchisor’s claims for enforcement of a non-compete provision were likely to succeed. In that case, the non-compete provision lasted for one year after termination and covered a territory 75 miles from the Franchisee’s former location or from the location of any other Franchisee, significantly broadening the reach of the non-compete clause.

Demonstrating that different courts can reach opposite conclusions, in an comparable Illinois case (Papa John’s Int’l v. Rezko), a court determined that a non-competition clause contained in a Franchisee’s 37 franchise agreements and prohibiting competition within 10 miles of the franchised business or within 10 miles of any other Franchisee’s businesses, for two years after termination or expiration, was overly broad and unenforceable.

As the court noted, the clause would have prevented competition in approximately 2000 of the largest cities in the country. Therefore, although the two year duration of the clause was reasonable, its geographic scope was not.

Here the lesson may be to think carefully about your Franchise Agreement’s non-competition

clause and perhaps be conservative in designing its scope and reach.

#### **Venue Clause Enforced**

As we’ve noted above, the “boilerplate” in the last third of a Franchise Agreement may have as much impact on the outcome of a dispute as the rest of the Franchise Agreement. An example of that is the “forum selection clause” which determines where a dispute will be heard and resolved. Obviously, a party that has to travel across the country to deal with a court case or arbitration may have to incur expenses that otherwise would not be present if the dispute was heard on their “home field.”

An Alabama Supreme Court decision (In Re the Lanthan Co. v. Soprema) dealt with a clause contained in an Ohio manufacturer’s agreement with an Alabama roofing company that any lawsuit between them would be heard in Ohio. The court held that enforcement of the clause, requiring trial in Ohio, was not unreasonable or seriously inconvenient, as well as the fact that the dispute arose under the terms of the same contract that contained the forum selection clause, which the court felt was justification for enforcement of the clause.

While there’s no guarantee that another court would have reached the same decision in other situations (disputes regarding forum selection clauses tend to be very dependent on the particular fact situation involved), the decision is a signal that in many situations courts (and, presumably, arbitrators) will enforce such provisions. Therefore, Holmes & Lofstrom generally recommends inclusion of such clauses in all franchise agreements.

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