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Drafting Trends – What's New in Franchise Agreements?

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Introduction

As anyone who drafts or reviews franchise agreements knows, evolving trends in the legal and business worlds can cause changes in the way we and our colleagues draft franchise agreements. The last few years have been no exception.

This paper addresses topics that have been at the forefront of this evolution for the past few years. These topics largely derive from three types of changes. Legal changes, business changes, and technological changes.

Case law developments and regulatory actions have driven changes to franchise agreements in the subject areas of encroachment, customer list ownership, joint employment, liquidated damages, and anti-poaching.

Business changes have caused franchisors to consider new provisions addressing topics such as private-equity acquisitions and the establishment of national account programs.

Technological changes have caused franchisors to address topics such as social media, third-party deliveries, and data breaches.

We discuss each of these topics in turn. In discussing each topic, we provide some background information for context. Then, we offer tips for incorporating these topics when drafting a franchise agreement. Our hope is that these tips are equally useful for attorneys who draft franchise agreements and those who review franchise agreements for franchisees or prospective franchisees.

A Note on Covid-19

Between the time your authors began drafting this paper in late 2019 and its ultimate publication for the IFA Franchise Law Virtual Summit in August 2020, as the reader is undoubtedly aware, the world has certainly changed. The Covid-19 global pandemic has impacted every corner of the global economy. The franchise industry has, of course, not been immune to such impact.

The reader may be wondering whether the pandemic should play any role in drafting franchise agreements on a going-forward basis.

In the authors' experience, the content of franchise agreements has not changed in any significant way as a result of the global pandemic. Obviously, certain industry-specific franchise agreements may be altered. For instance, many restaurant franchises are shifting their focus toward pick-up and delivery versus sit-down eating. And, in that case, the terms of the franchise agreement would reflect that operational change. However, in terms of general, boilerplate provisions, references to the pandemic do not seem to have made their way into form franchise agreements.

The most logical provision referencing a global pandemic would be a *force majeure* clause. However, in the authors' experience, most franchise agreements do not contain a *force majeure* clause. This is not surprising given the fact that franchisors typically draft the franchise agreements, and franchisors are not eager to grant franchisees a possible exception from their performance obligations.

In our experience, the issues that the pandemic poses can usually be dealt with in specific situations through waivers or deferrals in the franchisee's obligations. Franchisors and franchisees have worked around difficulties engendered by the Covid-19 pandemic by negotiating outside of the explicit terms of the franchise agreement. For instance, many franchisors have granted franchisees deferrals on royalty payments until the expiration of government "stay at home" orders. Although not required by the terms of the franchise agreement, such agreements made by the parties outside of the explicit terms of the franchise agreement show that franchisors recognize the difficulties faced by franchisees in navigating the various shut-downs and other restrictions placed on businesses by local governments.

We expect that this state of affairs will continue for so long as the pandemic endures. We also expect that any new provisions in franchise agreements will be minimal.

Private Equity Acquisitions

Background

Private equity deals in the franchise industry have been on the increase over the past several years.[1] As noted in a recent article in the *Wall Street Journal*, deals from the past few years include Harvest Partners' acquisition of Dwyer Group Inc. (now called "Neighborly") from another private-equity firm; Apax Partners' purchase of Authority Brands LLC from PNC Riverarch Capital; and Blackstone Group LP's recapitalization of Servpro Industries Inc.[2]

There are numerous reasons why franchise systems are attractive to private-equity firms.

First, private-equity firms are confident in their ability to increase the target's EBITDA through post-closing cost-saving mechanisms such as: reducing management headcount; consolidation of facilities such as warehouses, distribution centers, and regional offices; and combined purchasing power with other franchises and businesses in the private-equity firm's portfolio.[3]

Second, competition with a brand already in a private-equity firm's portfolio may be reduced when both brands are owned by the same company. This is because the private-equity firm could consolidate branding between the two, formerly competitive brands.[4]

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[1] *See*, *e.g.*, Jaewon Kang, *Private Equity-Backed Home Franchise Concepts Explores Sale*, Wall St. J., May 31, 2019, available at https://www.wsj.com/articles/private-equity-backed-home-franchise-concepts-explores-sale-11559336166?shareToken=st7b538cb3f3f74691bdbfdc0fa38f5c40 (last visited Jan. 24, 2020) (noting that "Services franchisers have proven to be popular targets among private-equity firms in the past year.").

[2] Id.

[3] David J. Kaufmann, *Attracting Private Equity*, Int'l Franchise Ass'n, 46th Annual Legal Symposium, at 5.

[4] *See generally*, Id. at 6.

Third, a private-equity firm that already owns one or more franchise brands may want to acquire a new franchise system for its portfolio so that multi-unit franchisee owners of the firm's existing portfolio brands may grow through the acquisition of franchises in the newly acquired franchise system. One benefit to acquiring new franchise systems, rather than granting more franchises of the firm's current brands to the firm's current multi-unit franchisees, is that it allows the multi-unit franchisee to grow while not giving the franchisee too much leverage and negotiating power over any single franchise system.[5]

Another reason a private-equity firm may want to purchase a franchise system is to gain access to the franchise system's predictable cash flow from royalties paid by franchisees.[6] This reason may be particularly attractive in the current business environment of low interest rates.

Drafting Considerations

In drafting a franchise agreement, the writer should always have in the back of her mind that the franchisor may eventually want to sell the franchise system. This principal will guide the writer in making sure there is enough flexibility in the franchise agreement that any due diligence review by a prospective buyer will not reveal any provisions in the agreement that may pose obstacles to closing the deal. This requires building flexible concepts into the franchise agreement. Due diligence will typically focus on the following topics:

Assignability: At the most basic level, anyone conducting due diligence as part of an acquisition of a franchise system will want to make sure the franchisor may freely assign to a third party the franchisor's rights and obligations under the franchise agreements. Language such as the following should be sufficient to satisfy this concern:

> We may sell, assign or transfer our rights and obligations under this Agreement to any party, without your approval or our prior notice to you, provided that the buyer, assignee or transferee agrees in writing to assume all of our obligations under this Agreement. We will not be liable for obligations of the transferee arising after the date of transfer.

The benefit of such language to a private equity acquiror is obvious. This provision makes it clear that the franchisor may freely assign the franchise agreement to a third party. Franchisee consent is explicitly not required, and the franchisor need not give the franchisee advance notice of the sale of the business.

Encroachment / territorial protections: Sometimes a franchisor will grant a franchisee an "exclusive" or "protected" territory in which the franchisor agrees not to operate a company outlet or allow another party to operate a franchise. If a franchisor grants this type of protected territory, the franchisor should take care to ensure that if an acquiror purchases the franchise system, any competitive businesses owned by the acquiror, will not violate the franchisee's territorial protection. This can be done by reserving to the

[5] Id.
[6] David Barr, Leonard McPhee & Ted Pearce, *A Deep Dive into Due Diligence from a Private Equity Seller or Buyer's Perspective*, Int'l Franchise Ass'n, 50th Annual Legal Symposium, at 1.

franchisor the right to be acquired by a business that provides competitive services or goods, even if the business operates within the franchisee's territory. Such language typically reads something like this:

> Except as expressly limited above in Section ___, you acknowledge and agree that we (and our affiliates) retain all rights with respect to our businesses activities, including: . . . the right to acquire, or be acquired by, (whether through acquisition of assets, ownership interests or otherwise, regardless of the form of transaction), a business providing products and services similar to those provided at Outlets, even if such business operates, franchises and/or licenses competitive businesses in the Protected Territory; . . . .

<u>Advertising Fund</u>: It's important for any prospective acquiror of a franchise system that the acquiror not take on any unnecessary risk of liability. For this reason, the franchisor's advertising fund should not be deemed a trust and the franchisor should not be deemed a fiduciary in administering the advertising fund. Use of language such as the following should help mitigate this risk to a potential acquiror:

> The Advertising Fund is not a trust or escrow, and neither we nor our affiliates have any fiduciary obligation for administering the Advertising Fund or for any other reason.

<u>Rebranding and New Trademarks</u>: Making sure that the franchisor can require franchisees to rebrand their outlets or use alternative trademarks is another issue that a prospective acquiror is likely to focus on when reviewing franchise agreements during due diligence. In some cases, a private-equity purchaser is looking to acquire a competitor franchise brand that it can rebrand to match one of the acquiror's current brands. This type of acquisition is a quick way for the private-equity firm to expand the footprint of its current brand.

A provision that broadly allows a franchisor to require franchisees to rebrand and use substitute trademarks would address this concept. The following is an example of this type of provision:

> We may at any time, in our sole discretion, require you to modify or discontinue using any Mark and/or use one or more additional or substitute trade or service marks. You agree to comply with our directions within a reasonable time after receiving notice of such changes. We are not required to reimburse you for any costs or expenses associated with making such changes, for any loss of revenue due to any modified or discontinued Mark, or for your expenses in promoting a modified or substitute trademark or service mark.

<u>Remodeling</u>: Related to the rebranding issue discussed above, in conducting a due-diligence review for the possible acquisition of a franchise system, a potential acquiror will want to make sure that the franchisor can require franchisees to remodel their outlets. This is particularly true if the acquiror has plans to rebrand the franchise system after the acquiror completes the acquisition. The following language is typical for this concept:

> You agree to renovate, refurbish, remodel, or replace, at your own expense, the real and personal property and equipment used in operating the Restaurant when

> reasonably required by us in order to comply with the image, standards of operation, and performance capability we establish from time to time. If we change our image or standards of operation, we will give you a reasonable period of time within which to comply with such changes.

Understanding the disruption and expense that a remodel can cause franchisees, franchisors will sometimes agree to limit the number of times that franchisees must complete a remodel during a given period of time. Or franchisors may agree that the expenses arising out of any single instance of remodeling will not exceed a certain amount of money. For instance, the provision above may be limited to requiring franchisees to conduct one remodeling once every five years and/or that it will not exceed a given amount. Such language setting a restriction on the frequency of remodeling could read as follows:

> Further, Franchisee will be required to thoroughly modernize or remodel the Outlet when requested by Franchisor, but no more than once every 5 years.

A provision limiting the amount of money a franchisee must spend on remodeling could read as follows:

> You agree to spend any sums required in order to comply with these remodeling obligations and our requirements (even if such expenditures cannot be amortized over the remaining term of this Agreement); provided, however, that we will not require you to spend more than $250,000 in connection with any remodeling and renovation project during the sixth (6th) through eighth (8th) years after the Outlet commences operation.

Buyout Provision: Finally, in some cases, a franchisor that wants to provide itself – and possible future acquirors – with the greatest amount of flexibility may incorporate a comprehensive buyout option in the franchise agreement. Under such a buyout provision, upon the occurrence of certain triggering events – such as the offering of the franchisor's or its parent's ownership interests in an initial public offering; any merger, recapitalization, sale of equity or other similar transaction, in which any non-owner acquires more than 50% of the franchisor's or its parent's ownership interests; or a sale of all or substantially all of the franchisor's or its parent's assets to an unaffiliated third party – the franchisor has the option to purchase the franchisee's franchise for a set purchase price that is described in the franchise agreement.

Encroachment

Background

In the world of franchising, the issue of encroachment has a long history, one that began with franchisors not being allowed to provide exclusive territory to their franchisees. Doing so was held to be a per se violation of the Sherman Act.[7] As franchise attorneys know, this is no longer the case today. The United States Supreme Court opened the door to

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[7] J. Dolman, S. Korzenowski, and E. Wulff, "STOP INVADING MY SPACE: Encroachment Issues in Franchising," International Franchise Association, 51st Annual Legal Symposium, at 2 (May 6-8, 2018).

vertical territorial restraints in two cases, one in the late 1970's, *Continental T.V. Inc. v. GTE Sylvania, Inc.,* and another in the early 1980's, *Jefferson Parish Hospital District No. 2 v. Hyde.* The Court held that a vertical territorial restraint does not constitute a per se violation of the Sherman Act but is governed by the rule of reason. By opening the door to vertical territorial restraints, the Court also opened the door to encroachment cases.[8] With the development of new ways of doing business, encroachment has grown beyond a question of geographic proximity to include everything from internet sales to pop-ups and other channels of distribution.

Encroachment ultimately leads to lost sales by the franchisee while possibly maximizing sales for the franchisor. The central question is whether the encroachment is actionable. Franchisees do not want to lose sales and franchisors want to saturate the market and establish brand dominance. With the internet as a zero-boundary large distribution channel along with mail order, grocery stores, convenience stores, pop-ups and other channels of distribution, encroachment is no longer simply a question of how close one location is to the next. Although, the physical proximity of locations is a relevant issue that still exists for many franchise systems, there is no perfect formula that encompasses all types of franchise businesses in the changing landscape. Often, we are left with the franchisee wanting an exclusive territory in order to protect its investment and the franchisor wanting to reach as many customers as possible by using all means available. When the franchised business is a physical, brick and mortar location, the franchisee typically wants the franchisor to refrain from establishing other franchised or company locations within a protected area or radius around that location. When the franchise is a service business that delivers its services to the homes or businesses of its customers, it may make more sense to have a well-defined geographic territory encompassing those customers.

For an existing franchisee, encroachment may become an issue when the franchisor creates a new concept, purchases an existing system (e.g., Burger King's purchase of Popeye's), online sales, a supplier with common ownership supplying competitors, changes in population if the territory is based on this metric. In other words, encroachment can occur in many ways.

For franchisees, the ability to negotiate for better provisions regarding encroachment with emerging concepts is greater than that of a well-established system. Of course, it doesn't hurt to initiate the negotiation of a more defined or expanded territory as there may be an opportunity to limit future encroachment.

Some franchise systems grant franchisees the right to operate at a specific location only and do not provide any protected area or territory, nor a protected customer base. The franchisee has rights to the specific location only. Although no territory is specifically granted other than the location of the franchise, a franchisee may be able to allege that the franchisor has breached the implied covenant of good faith and fair dealing. The premise is that all contracts impose on the parties a duty, or covenant, of good faith and fair dealing on each party in its performance and enforcement.[9] The franchisee's position

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[8] Id.
[9] Restatement (Second) Of Contracts § 205 (1981).

would be that although no territory was granted, other than the location, the franchisor's action has deprived the franchisee of the benefit of the bargain, *i.e.,* the franchisee's ability to engage in a profitable business by placing another unit in close proximity.[10] Of course some courts have rejected the franchisee's implied covenant claim, while others have enforced it.

With the August 1, 2018 decision in *Bryman v. El Pollo Loco, Inc.*, in the Superior Court of California, Los Angeles County (Case No. MC026045), where the franchisor opened company-owned units in close proximity to the franchisee's existing unit, cannibalizing the franchisee's business, the court found that the franchisor had ultimately breached its implied covenant of good faith and fair dealing. Of course, this case is being appealed by the franchisor, but for now it has the franchise community interested to see what's next for claims made under the implied covenant, when for many years, courts were rejecting encroachment claims based on this covenant alone.[11]

Drafting Considerations

Franchisors should reserve the right to acquire, purchase, or merge with other chains or businesses allowing for the operation or franchising of businesses that may operate under the different trademarks but will compete with franchisees. Such provisions may even allow the franchisor to rebrand the acquired locations so that they compete directly with existing franchisees. Other provisions to consider include those that address online sales, direct marketing, mail-order catalogues, and telemarketing. If a franchisor's brand is one in which locations will easily be within questionable distance from one another, the franchisor might create a procedure for the franchisees to contest the impact. Some systems allow the franchisee to pay for a sales transfer study. If the study indicates that the loss of sales is likely to exceed a certain percentage and the franchisor decides to move forward, the franchisee can then request that the sales be analyzed over a period of time to receive an award.

If the Franchise Agreement grants any protected geographic territory, it should also address the franchisor's right to franchise or open units both, within and outside, of the territory and "so that there is no confusion of whether the franchisor is fulfilling its implied duty of good faith and fair dealing to the franchisee."[12]

In doing so, the drafter should be mindful to use the word "exclusive" in a way that is consistent with the way state franchise examiners view that term. If a franchisor reserves to itself the right to open locations in "non-traditional locations", such as airports, hotels, or college campuses, that fall within the protected territory, then it is best not to use the

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[10] Catherine P Kelly, "What You Should Know about the Implied Duty of Good Faith and Fair Dealing American Bar Association," (2016), https://www.americanbar.org/groups/litigation/committees/business-torts-unfair-competition/practice/2016/duty-of-good-faith-fair-dealing/. See Scheck v. Burger King Corp., 756 F.Supp.543, 549 (S.D. Fla. 1991).

[11] D. Coldwell, "2019 Judicial Update Encroachment," International Franchise Association, 52 Annual Legal Symposium, at 51 (May 5-7, 2019).

[12] See C. S. Marion, D. J. Oates, A. N. Stern, "Stepping on Toes: Territorial Rights and Encroachment," 42nd ABA Annual Forum on Franchising at 22 (2019).

term “exclusive”.[13] Otherwise, the franchisor may face the anomalous situation of stating in the franchise agreement that the territory is exclusive while disclosing in Item 12 of the FDD that the franchisee will not receive an exclusive territory.

While it is in the best interest of the franchisor to expand the brand and saturate a market, a heavy-handed franchise agreement can allow the franchisor to act in ways that negatively affect the franchisee’s sales. Such an agreement may also adversely affect the franchisor’s ability to sell franchises. There is a delicate balance between saturating the market, creating brand awareness, and cannibalizing franchisee’s sales.

Social Media

Background

The rise of social media as a way of sharing information among one’s friends, family, peers, and colleagues has strongly impacted the way franchises operate and advertise their products and services.

Examples of social media platforms that are commonly used in the United States include Facebook, Twitter, Reddit, Instagram, Pinterest, Snapchat, TikTok[14], YouTube, and LinkedIn. In addition, countries outside of the United States have other social media platforms that also attract millions of users. For instance, Weibo is a social media platform in China that is similar to Twitter, which, like Facebook, is outlawed in China.[15]

For franchise brands, social media provide exciting opportunities to create targeted advertising for consumers. However, the flip side of this opportunity is that with social media it is equally easy for consumers to share negative reviews of a franchised brand and broadly disseminate these negative reviews to the world. It is difficult for franchised brands to control this type of information. Therefore, it is vitally important that franchise agreements be drafted with enough flexibility to allow the franchisor to have a level of control over how a franchised brand is represented on social media and how franchisees should respond to negative information regarding that franchisee’s specific outlet or outlets.

Most social media platforms allow not just individuals, but also companies, to establish user accounts. Therefore, a franchised brand can establish an account under which it may directly communicate with consumers. Conversely, consumers can communicate directly with brands with whom they do business. Travelers, for instance, regularly use social media platforms to contact airlines to help them resolve travel-related issues such

[13] Tom Pitegoff. “What’s an Exclusive Territory?” June 16, 2015. https://www.offitkurman.com/blog/2015/06/16/whats-an-exclusive-territory/

[14] TikTok is a “leading destination for short-form mobile video.” https://www.tiktok.com/about?lang=en (last visited Jan. 20, 2020).

[15] *See*, *e.g.*, Kate Conger, *Facebook and Twitter Say China Is Spreading Disinformation in Hong Kong*, NY Times, Aug. 19, 2019, available at https://www.nytimes.com/2019/08/19/technology/hong-kong-protests-china-disinformation-facebook-twitter.html (last visited Jan. 27, 2020) (noting that both Twitter and Facebook are blocked in China).

as cancelled flights and missing baggage.[16] Although useful in communicating with customers, the fact that a single customer complaint can be broadcast throughout the entire social media platform, particularly if a social media post "goes viral," it is vitally important that franchisors establish a flexible social media policy.

Social media can be useful in a number of ways other than simply communicating with customers and resolving complaints. Perhaps most importantly, franchised brands can conduct targeted advertising through any of the social media platforms. For instance, videos posted to YouTube can feature new products and services offered by a franchised brand. As another example, images posted to Instagram by an "influencer" can feature a franchise brands' products.

Job opportunities can be posted, and candidates researched, through LinkedIn. And contests and sweepstakes can use Facebook posts as a manner of entry into the contest or sweepstakes. The opportunities are truly limitless, and as new social media platforms arise, and others decline, franchise brands must devote adequate resources to continually monitor developments.

Facebook, in particular, has features that make it useful for franchised brands. Notably, the "Locations" service allows a franchised brand to set up a main brand page under which the franchised brand can manage the content for all of its outlets, for instance by adding new outlets, editing information for existing outlets, and managing all outlets from one centralized dashboard. The Locations feature allows advertisers to create scalable and locally relevant campaigns and reach audiences close to a particular outlet or outlets.[17]

With this backdrop, franchisors must consider how best to structure a social media policy that is flexible enough to address both existing technologies and not-yet-invented technologies. The next section focuses on how franchisors can craft these policies and the franchise agreement provisions to cover them.

Drafting Considerations

The franchise agreement is the first place where a franchisor's social media policy will be articulated. However, in creating a social media policy, franchisors should refrain from going into too much detail in the franchise agreement. Franchise agreements are typically long-term contracts between franchisors and franchisees. In many cases, the term of a franchise agreement runs for ten years or even longer in certain industries. With social media evolving constantly and rapidly, it would practically be impossible to create a comprehensive social media policy in an agreement when no one can accurately predict what social media may look like two years in the future, let alone ten or more years.

[16] See, e.g., Jonathan Wolfe, "Missed Connection or Canceled Flight? 6 Tips for Getting What You Want From an Airline" (NY Times, Nov. 20, 2018) available at https://www.nytimes.com/2018/11/20/travel/flight-issues-airline-help.html?searchResultPosition=4 (suggesting that contacting an airline via Twitter is where you can expect the fastest response).

[17] https://www.facebook.com/business/a/facebook-locations (last visited Jan. 27, 2020).

Therefore, franchisors typically include language such as the following in their franchise agreements:

> You must comply with the standards we develop for the System, in the manner we direct in the Operations Manual or otherwise, with regard to our authorization to use, and use of, blogs, common social networks (including "Facebook"), professional networks (including "LinkedIn"), live blogging tools (including "Twitter"), virtual worlds, file, audio and video sharing sites and other similar social networking media or tools (collectively, "Social Media") that in any way references the Marks or involves the System or your Business.

As shown by this example, franchisors will typically reserve the right to establish a more robust, flexible social media policy within the franchisor's operations manual. Using the operations manual instead of contractual provisions in a franchise agreement gives franchisors more leeway to adjust their social media policies to account for changes in technology and the business environment. Because a franchisor typically has wide latitude to revise the franchise system's operations manual, the operations manual is the more useful place to publish the details and processes of a franchisor's social media policy.[18]

Third-Party Deliveries

Background

According to eMarketer research, 44 million U.S. smartphone users will use a third-party food delivery app by 2020, representing an increase of 6 million users compared to 2019.[19] Americans are now spending more money at restaurants than at the grocery store.[20] It only makes sense that restaurants get on board and make it easier for their customers to order their food and have it delivered to their front door, office or anywhere else they may desire.

Third-party delivery services provide customers the ability to browse a restaurant's menu, place an order, and have the food delivered to the customer's location of choice through a third-party courier. These services are generally app based with the technology being provided by the delivery service. It sounds great, but upon a closer look, these deliveries typically reduce revenue to the franchisee, as the cost for the deliveries is passed directly to the franchisees. Even more burdensome to the franchisees is the scenario where the

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[18] *See*, *e.g.*, Marlén Cortez Morris, Jim Goniea & Gerald Wells, *How to Develop a Comprehensive and Balanced Social Media Policy*, Am. Bar Ass'n. 42nd Annual Forum on Franchising (2019), at Exhibit A (providing sample social media policies).

[19] Lauren Stine, "23% of US smartphone users will use a food delivery app by 2023," (July 9, 2019), https://www.restaurantdive.com/news/23-of-us-smartphone-users-will-use-a-food-delivery-app-by-2023/558336/.

[20] Derek Thompson, "Business of Food Delivery, Meal-delivery companies are the ultimate symbol of the most powerful force in business today: convenience maximalism," (August 2, 2019), https://www.theatlantic.com/ideas/archive/2019/08/all-food-will-be-delivered/595222/

franchisor collects royalties based on a percentage of gross sales, further diminishing the franchisee's profits.

As customer demand for delivery continues to grow, franchisees and their franchisors will need to figure out how to fulfill orders while ensuring that the franchisees are still able to turn a profit. As the delivery market continues to rapidly expand beyond food and into errand running and more, franchisors need to figure out how to capitalize on this growing trend or else risk becoming obsolete.

Some brands are partnering with well-known, established service providers, such as Uber Eats, Grubhub, and DoorDash. McDonalds partnered with Uber Eats in 2017 and created McDelivery. In October of 2018, for the first time in McDonald's history, many franchisees voted to form an independent association.[21] Crain's Chicago Business reported that three-quarters of McDonald's U.S. franchisees met in December of 2018 and one of the topics of discussion was franchisee's concerns with the Uber Eats deal. A majority of the McDonald's franchisees clearly saw the issue very differently than the franchisor. With delivery growing to a $3 billion business for McDonald's within two years, it is easy to see why this happened. The franchisees were clearly concerned by the fact that Uber Eats was taking 20 percent of each order. The franchisees paid a 5 percent royalty on a total customer sale, so their profit margins were directly impacted. McDonald's franchisees were also concerned that delivery sales in the future might replace an increasing volume of store sales, further hurting franchisee's profitability. As the repeat customer of a third-party delivery service will be a customer that requires the franchisee to incur added fees, these customers would remain less profitable to the franchisee than the customer who dines-in or uses the self-fulfilled delivery option. Simply put, an increase of delivery may mean a decrease of profitability unless the franchisor can come up with a solution. As of July 2019, McDonald's added DoorDash as a delivery partner, ending its exclusivity with UberEats.[22]

Burger King as of October of 2019 also partnered with Uber Eats.[23]

Meanwhile, Panera Bread developed its own in-house delivery system, a substantial investment that is paying off for them. But as of August 2019, even Panera had partnered with DoorDash, Grubhub, and Uber Eats.[24] Panera's CEO explained, "We're open to it now because its additive and, very importantly, the customer experience is protected. There's a standard of quality that we believe in, and the economics work for us and very importantly, for our franchisees, which a lot of these models don't."[25]

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[21] Brigid Sweeney, "McDonald's franchisees dump on delivery," (February 15, 2019), https://www.chicagobusiness.com/restaurants/mcdonalds-franchisees-dump-delivery

[22] Amelia Luca, "McDonald's adds DoorDash as new delivery partner, ending exclusivity with UberEats," (July 16, 2019), https://www.cnbc.com/2019/07/16/mcdonalds-adds-doordash-as-partner-ending-exclusivity-with-ubereats.html

[23] Kate Taylor, "Burger King follows in McDonald's footsteps with Uber Eats Delivery," (October 15, 2019), https://www.businessinsider.com/burger-king-launches-uber-eats-delivery-2019-10

[24] Rachel Taylor, "At Last, Panera Dives into Third-Party Delivery," (August 2019), https://www.qsrmagazine.com/fast-casual/last-panera-dives-third-party-delivery

[25] Id.

Yum Brands partnered with Grubhub in 2018 and structured an arrangement for its Taco Bell and KFC franchisees in which they are not responsible for paying the delivery fees and receive the same profit margins on delivered items as on those purchased in-store.[26]

Panera Bread and Yum Brands have apparently figured out ways around the impact of delivery. Understandably, Panera's system by which they developed their own in-house delivery system is not an option for all brands. Yum Brands' arrangement is the result of successful negotiation on the part of the franchisor and the fact that they invested $200 million in Grubhub.[27]

Drafting Considerations

Franchisors should track the sales of third-party delivery services that their franchisees use.[28] This allows franchisors to analyze the impact of sales on top-line revenue growth. If this metric were added to the evaluation of a franchisee's sales and the metric shows that the franchisee is suffering from a decrease in profitability, then it may make sense to refrain from collecting royalties on this revenue. A close look at how these third-party services are directly impacting the franchisees' bottom line might lead franchisors to the conclusion that the method of determining royalties needs to be modified. As it stands now, most franchisors are collecting royalties on top of the third-party delivery fees being charged directly to the franchisees.

In our unscientific review of a number of large franchisor franchise agreements, it appears that most are not factoring in the impact of third-party delivery services. Franchisors should consider whether it makes sense to charge royalties based on gross sales without taking into account the third party delivery fees and the impact it is having on the profitability of the system's franchisees.

Franchisors will want the indemnity clause in their franchise agreements to be broad enough to cover third-party deliveries that the franchisee contracts with directly. If the franchisor is authorizing only specific third-party delivery services, then to add another layer of protection, the franchise agreement should provide a disclaimer for a customer's use of an unauthorized service[29]. In-N-Out Burger was forced to file a lawsuit against DoorDash for trademark infringement when DoorDash ignored their demands to remove In-N-Out's logo from DoorDash's website. The lawsuit was dismissed when DoorDash removed the logo and the parties settled out of court. There have been additional complaints from restaurant owners regarding DoorDash delivering food without an

[26] Erica Adams, "Yum Brands' Franchisees Don't Pay Delivery Fees, Thanks to Grubhub Partnership," (December 16, 2018), https://table.skift.com/2018/12/06/yum-brands-franchisees-dont-pay-delivery-fees-thanks-to-grubhub/.

[27] Teresa Rivas, "Yum! Brands Stock is Sliding. It's More Fallout from Grubhub's Troubles." (October 30, 2019), https://www.barrons.com/articles/yum-brands-stock-drops-earnings-grubhub-troubles-51572443554.

[28] Franchise Blast, "Is Franchisee POS Polling Enough to Capture Franchisor Royalties?," (December 2, 2017), https://www.franchiseblast.com/is-franchisee-pos-polling-enough-to-capture-franchisor-royalties/.

[29] Damien Orato and Suzanne Singer, "The cost of convenience: Understanding the third-party delivery dilemma," (April 24, 2017), https://www.nrn.com/operations/cost-convenience-understanding-third-party-delivery-dilemma.

agreement and customers submitting complaints about the quality of the delivered food, not knowing that the restaurants were not behind the delivery. The lesson is that bad delivery service can create complaints and the franchisee has no control over the delivery service. Picking up food for a customer when no agreement exists between the franchised business and the delivery service puts the franchised business' reputation on the line with no accountability from the third-party delivery service.

Another issue that may arise with a third-party service is the possibility of encroachment claims when a third-party delivery service delivers the product of one franchisee to a customer in another franchisee's exclusive territory. It is important for franchisors to address delivery areas as they relate to protected territory of its franchisees. Failure to do so may result in franchisees unknowingly soliciting and delivering to customers in another franchisee's territory.[30] For more information, see the encroachment section of this paper.

What is clear is that this is an evolving space that will continue to grow and present new challenges to franchisors and franchisees alike.

National Accounts

Background

One method for franchised businesses to increase systemwide sales and brand recognition is to sell to national companies or organizations, meaning those that may have locations in proximity to franchisees in several states. Many franchisors, particularly in the services industry, have turned to "national accounts" as a means of bringing more business and revenue to franchisees and franchisors alike.

Used in this sense, a "national account" generally means a business or entity with locations in more than one office. Examples could include nationwide banks with employees and branches throughout the country, manufacturers with employees and plants spread across multiple locations, or professional services businesses (e.g., law firms or accounting firms) with multiple offices across the country. However, outside of just businesses, "national accounts" can also encompass less-obvious accounts, such as an insurance company, in which the insurance company's policyholders, rather than its employees, are the customers. This model works particularly well for services, such as auto repair franchises, who provide repair services that may be covered by a warranty paid for through an insurance company. Likewise, health insurance providers may contract with a nationally franchised fitness club in order to provide its insureds reduced membership rates at the fitness club.

The attraction of such national accounts is obvious. A franchised brand could negotiate a deal with one of these "national accounts" to be a preferred service provider, perhaps offering discounts to customers. In turn, franchisees would have access to an expanded universe of potential customers.

[30] Cheng Cohen, "Third-Party Food Delivery Services: Navigating the Ever-Changing Waters," https://foodondemandnews.com/wp-content/uploads/2019/01/3rd-Party-deliver-WP18.pdf

Drafting Considerations

A franchisor interested in implementing a national account program should first be careful not to obligate itself to entering into arrangements with national accounts. Instead, franchisors should make the ability to enter into arrangements with national accounts discretionary. Doing so should help protect against possible future claims from franchisees who may claim that they were promised the ability to work with customers associated with a national account. For example, such a provision could read:

> We have the exclusive right, but not the obligation, to negotiate agreements with National Accounts for the provision of goods and services by all System franchisees.

Next, the franchisor should consider making participation in a national account program mandatory for franchisees. If the object is to offer a special, negotiated deal for customers of the national account, then it defeats the purpose if not all franchisees agree to offer the same service, with the same terms and prices, as other franchisees. Therefore, mandatory language such as the following might be used in a provision of a franchise agreement that governs national accounts:

> If we agree to terms with any National Account, you must provide products and services to all valid members of the National Account on those terms.

In particular, with respect to pricing, franchisors are advised to make sure that the franchise agreement provides that the franchisee must honor the maximum pricing being offered to the national account customers.[31]

Franchisors should also consider issues of franchisees' territory exclusivity and protection when drafting a provision to govern the operation of national accounts. If a franchisee has a protected territory around which the franchisor has promised not to open a competitive outlet, or if a franchisee in a service business has the rights to service all customers within a given geographic territory, then the franchisor needs to consider how to handle issues that arise when a national account requests services in multiple territories. Many franchisors will grant the franchisee in a particular territory in which a national account has requested a service or product, the right of first refusal to provide services or products to the members of such national account. If the franchisee declines to provide such services, then, notwithstanding a franchisee's territorial protection, the franchisor may itself, or may allow another party, to provide services for the national account within the franchisee's territory. Such a provision may look like the following:

> If sites within the Territory are included in Franchisor's agreement with the National Account, Franchisor will offer Franchisee the opportunity to operate the Franchised

[31] It is widely accepted that franchisors can generally set a "price ceiling" for products, without violating federal antitrust law. *See*, *e.g.*, Allan P. Hillman & Michael K. Lindsey, *The Fallout Eight Years After* Leegin*: When and Where Can Franchisors Fix the Prices Charged by Franchisse?*, Am. Bar Ass'n. 38th Annual Forum on Franchising, at 17 (suggesting that setting a maximum price would not be prohibited under federal law so long as franchisees are free to set prices lower than the maximum).

> Business at the National Account's locations, facilities, or installations within the Territory under terms and conditions that Franchisor may prescribe. If Franchisee does not operate the Franchised Business at a National Account's location, facility, or installation within 30 days after Franchisor's offer, Franchisor may choose to operate or license others to operate a business that provides the Services at those retail locations, facilities, or installations without notice or obligation to Franchisee.[32]

Along the same lines, another useful provision to include with a national account provision in a franchise agreement is a discussion of what happens if a particular national account does not want to use the services or products offered by a particular franchisee. For various reasons — perhaps poor service in the past by Franchisee A or a preference to work with Franchisee B — a national account may want to work only with a particular franchisee. A flexibly drafted national account provision should give the franchisor the right to require Franchisee A to cede the opportunity to provide products or services to the national account in favor of the national account's preferred Franchisee B, even if the opportunity arises within Franchisee A's territory.

Finally, a national account provision in a franchise agreement may require franchisees to refer prospective new national accounts to the franchisor. Doing so helps ensure that franchisees are keeping the franchisor apprised of all potential opportunities for providing products and services to a national account. This requirement could benefit the entire franchise system by making sure potentially lucrative opportunities from national accounts are acted upon. Such a provision could look like the following:

> If any prospective National Accounts contact you regarding goods or services to be provided by you and/or other System franchisees, you must promptly forward all relevant information regarding the prospective National Account to us.

Data Breaches

Background

Any discussion of data breaches would be incomplete if it omits the subject of the General Data Protection Regulation ("GDPR") of the European Union. Now we also have California's new privacy laws under the California Consumer Privacy Act ("CCPA"). The CCPA is the first major US privacy legislation to be enforced after the EU's GDPR took effect in May of 2018; the CCPA took effect in January of 2020. GDPR controls how websites, companies, and organizations handle personal data. What is included in personal data? Names, e-mail addresses, and browsing history to name a few. If this is tied to the EU, how does it affect United States based businesses? If a franchisor's website has visitors from the EU, the franchisor may not use or sell any personal customer data with the customer's consent. The GDPR has set up a privacy by default

[32] Franchisors should be cognizant of the fact that by allowing another party to provide services within a franchisee's territory, they may have to disclose this exception within Item 12 of the franchisor's FDD and include the mandatory disclaimer that the territory is not an exclusive territory. *See* 16 C.F.R. § 436(l)(5)(i).

allowing an EU user to block the processing of personal information. The CCPA allows the California consumer to “find out what of their data has already been obtained by a business or sold to a third party.”[33]

The next question is how does all of this relate to the franchise system? Franchisors and franchisees may be required to comply with these privacy laws. The franchisor creates the system that the franchisee operates. In most franchise systems the franchisor determines the personal data that is collected and how it is processed. This opens franchisors up to vicarious liability of their franchisees when the franchisee fails to comply with data protection and privacy laws.

We are no longer operating our businesses during a time when the question is “if” a data breach occurs. We are operating under the circumstances of “when” the data breach occurs. Here is a short explanation of why this is:[34]

> 1. It doesn’t matter how advanced a cybersecurity system is. It is still capable of being hacked;
>
> 2. One can never eliminate the risk of human error completely;
>
> 3. Not all businesses are giving the risk of a data breach the attention it deserves:
>
> 4. As malicious software advances it is better able to go undetected by many antivirus programs.

Obtaining a good cyber-insurance policy is one way to mitigate the damage. Requiring franchisees to maintain cybersecurity coverage in addition, may also make sense. Working with an insurance broker that understands franchising is an important consideration for franchisors today. But the franchise agreement needs to be drafted in a way that recognizes and adequately accounts for cyber risks.

Drafting Considerations

Franchisors should include provisions in their franchise agreements that specify the rights and obligations of the parties with respect to data protection policies and the ways in which the franchisee may or may not use or sell personal data. This can be further addressed in the Operations Manual. The importance of defining customer information and privacy laws should not be overlooked, in addition to language that addresses the duties of the franchisee when there is a breach or a suspected breach. Such a provision could read as follows (as used by Sola Salon Studios):

> **Data Security and Privacy.** Franchisee must comply with all applicable federal, state and local laws, rules, and regulations regarding data security, protection, and privacy, including, without limitation and if applicable, the California Consumer Privacy Act (“CCPA”), Cal. Civ. Code § 1798.100, et seq. Franchisee must comply with any privacy policies, data protection polices, and breach response policies

[33] https://www.cookiebot.com/en/ccpa-vs-gdpr/
[34] Mercia Shannon Fynn, “Data Protection and Privacy,” (April 2019), https://gettingthedealthrough.com/guide/185/article/6569/data-protection-privacy/.

that Franchisor periodically may establish. Franchisee must notify Franchisor immediately regarding any actual or suspected data breach at or in connection with the Franchised Business. Further, whenever and to the extent Franchisee operates as a "Service Provider" under the CCPA or in a similar capacity under any other applicable federal, state, or local privacy law, Franchisee represents, warrants, and covenants that:

(1) Franchisee will not sell, make available or otherwise disclose any customer's "Personal Information" (as defined in the CCPA) to any third party for valuable consideration;

(2) Franchisee will retain, use, or disclose Personal Information only for the specific purpose of performing the services specified in this Agreement, and not any commercial or noncommercial purpose other than providing the services specified in this Agreement;

(3) Franchisee will not retain, use, or disclose Personal Information outside of the direct business relationship between Franchisee and Franchisor;

(4) Franchisee will delete any Personal Information upon Franchisor's request unless Franchisee can prove that such request is subject to an exception under applicable law; and

Franchisee certifies that it understands and will fully comply with the restrictions of this section. Franchisee also acknowledges and agrees that Franchisor may modify the restrictions by written notice to Franchisee, including adding other similar privacy restrictions that may be required under other federal, state, or local privacy laws.

Insurance coverage requirements should be outlined in the franchise agreement and franchisors should require that they are listed as additional insured for any cyber policies. The franchisor should look into E&O insurance to address data breaches at the franchisor level that may harm the franchise system and brand. This is another area of the franchise agreement where strong indemnity provisions should be included.

Joint Employment

Background

Anyone who has been involved in the franchise industry over the past several years has probably gotten whiplash watching the back-and-forth that has occurred with the laws and regulations surrounding joint employment. Practitioners in the franchise industry have written several excellent articles giving a more comprehensive history of joint employment matters over the past several years.[35] So the following is only intended as a brief summary of the background behind the most-recent rules from the Department of Labor and the National Labor Relations Board regarding joint-employment status under the Fair Labor Standards Act (FLSA) and the National Labor Relations Act (NLRA), which were published in the Federal Register on January 16, 2020[36] and February 26, 2020[37] respectively.

As most franchise practitioners know, in August 2015, the National Labor Relations Board shook up decades of joint-employer precedent by setting forth a new standard for determining joint-employer status within the purview of the NLRA when it issued its *Browning-Ferris* decision.[38] Under *Browning-Ferris*, the NLRB held that indirect control, or reserved joint control, even if unexercised, or control that is limited and routine could be sufficient to establish a joint-employer relationship.

Just over two years later, however, under the *Hy-Brand Industrial Contractors* case, the NLRB overruled that decision and returned to the pre–*Browning Ferris* standard that governed joint-employer liability.[39] Nevertheless, about two months later, *that* ruling was vacated when the NLRB's Designated Agency Ethics Official determined that one of the members of the panel who decided the *Hy-Brand Industrial Contractors* case should have been disqualified.[40] Therefore, the NLRB held that the overruling of *Browning-Ferris* should be vacated, so the *Browning-Ferris* standard was, effectively, put back into place.

The Department of Labor's New Rule

It was in this setting that the Department of Labor's new rule in January 2020 finally codified the joint-employer analysis as it was under the pre-*Browning-Ferris* standard for purposes of the Fair Labor Standards Act (FLSA).[41]

At its most basic level, the analysis surrounding joint employment seeks to determine whether two or more separate business entities are joint employers of a single workforce. Under the FLSA, "an employee can have two or more employers who are jointly and severally liable for the wages due the employee (*i.e.*, joint employers)."[42]

[35] Examples of these articles which the author consulted with in drafting this section include: Stephen D. Aronson, *et al.*, *Joint Employer / Vicarious Liability Practical Applications in Enforcing System Standards Without Exercising Too Much Control*, Int'l Franchise Ass'n, 50th Annual Legal Symposium *and* Joyce Mazero, Karen Boring Satterlee & Eric H. Karp, *Best Practices for Franchisors Providing Franchise Support Services in a Post-Joint-Employer World*, Am. Bar Ass'n, 42nd Annual Forum on Franchising.
[36] United States Department of Labor, Wage and Hour Division, "Joint Employer Status Under the Fair Labor Standards Act." 85 Fed. Reg. 2,820 (Jan. 16, 2020).
[37] National Labor Relations Board, "Joint Employer Status Under the National Labor Relations Act." 85 Fed. Reg. 11,184 (Feb. 26, 2020).
[38] *Browning-Ferris Indus. of California, Inc.*, 362 NLRB No. 186 (Aug. 27, 2015).
[39] *Hy-Brand Indus. Contractors, Ltd.*, 365 NLRB No. 156 (Dec. 14, 2017).
[40] *Hy-Brand Indus. Contractors, Ltd.*, 366 NLRB No. 26 (Feb. 26, 2018).
[41] Fair Labor Standards Act of 1938, 29 U.S.C. § 201, *et seq*.
[42] United States Department of Labor, Wage and Hour Division, "Joint Employer Status Under the Fair Labor Standards Act." 85 Fed. Reg. 2,820 (Jan. 16, 2020).

The FLSA mandates that covered employers pay their employees at least the federal minimum wage for every hour worked and overtime for every hour worked over 40 in a given workweek.[43] To be liable under the FLSA for paying a minimum wage or overtime, a person or entity must be an "employer." Under the FLSA, an "employer" "includes any person acting directly or indirectly in the interest of an employer in relation to an employee . . . ."[44] Since the enactment of the FLSA, the Department of Labor – which is responsible for interpreting joint-employer status – has recognized that an employee can have two or more employers who are jointly and severally liable for the wages due to an employee.[45]

In promulgating its most-recent rules, the Department of Labor has adopted a four-factor balancing test derived from a 1983 Ninth Circuit case, *Bonnette v. California Health & Welfare Agency*.[46] Under this four-factor balancing test, to assess whether another person who is benefiting from an employee's labor is a joint employer, the fact finder will analyze whether the other person: (1) hires or fires the employee; (2) supervises and controls the employee's work schedule or conditions of employment to a substantial degree; (3) determines the employee's rate and method of payment; and (4) maintains the employee's employment records.[47]

Of specific interest to the franchising industry, the Department has revised Section 791.2(d)(2) of the regulations to state that ''[o]perating as a franchisor or entering into a brand and supply agreement, or using a similar business model does not make joint employer status more likely under the Act.''[48] Moreover, in adopting the rule, the Department of Labor set forth an example under Section 791.2(g)(10)(i) in which a franchisor – a global organization representing a hospitality brand – is found not to be a joint employer of a franchisee's employees despite providing proprietary software for business operation and payroll processing along with "a sample employee application, employee handbook, and other forms and documents for use in operating the franchise, such as sample operational plans, business plans, and marketing materials."[49] In addition, the example provided by the Department of Labor's rule states that the franchisor uses "an industry-standard document explaining that [the franchisee] is solely responsible for all day-to-day operations, including hiring and firing of employees, setting the rate and method of pay, maintaining records, and supervising and controlling conditions of employment."[50]

Under these circumstances, the Department of Labor declared that the franchisor is not a joint employer of the franchisee's employees because the franchisor does not "exercise

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[43] 29 U.S.C. § 206(a), 207(a).
[44] 29 U.S.C. § 203(d).
[45] United States Department of Labor, Wage and Hour Division, "Joint Employer Status Under the Fair Labor Standards Act." 85 Fed. Reg. 2,820 (Jan. 16, 2020).
[46] *Bonnette v. California Health & Welfare Agency*, 704 F.2d 1465 (9th Cir. 1983).
[47] 29 C.F.R. § 791.2(a)(1). Note that the new regulations also provide for a second scenario in which one employer employs a worker for one set of hours in a workweek, and another employer employs the worker for a separate set of hours in the same workweek. But this second scenario is less applicable to the franchise context, so is not focused on in this paper. 29 C.F.R. § 791.2(e)(1).
[48] United States Department of Labor, Wage and Hour Division, "Joint Employer Status Under the Fair Labor Standards Act." 85 Fed. Reg. 2,841 (Jan. 16, 2020).
[49] 29 C.F.R. § 791.2(g)(10)(i).
[50] Id.

direct or indirect control over [the franchisee's] employees." Further, the Department of Labor's analysis provides that "Providing optional samples, forms, and documents that relate to staffing and employment does not amount to direct or indirect control over [the franchisee's] employees that would establish joint liability."[51]

The National Labor Relations Board's New (Old?) Rule

Following closely in the Department of Labor's footsteps, on February 26, 2020, the National Labor Relations Board published its final rule in the Federal Register governing the joint-employer standard under the NLRA. The final rule restored the joint-employer standard that the NLRB applied before the *Browning-Ferris* decision in 2015, "but with the greater precision, clarity, and detail that rulemaking allows."[52]

Under the NLRB's final rule, to be a joint employer, a business must possess and exercise "*substantial direct and immediate control*" over one or more "*essential terms and conditions of employment*" of another employer's employees.[53] The rule defines key terms, for instance by (a) defining what are considered "essential terms and conditions of employment," (b) giving examples of what does, and what does not, constitute "direct and immediate control" as to each of these essential employment terms, and (c) defining what constitutes "substantial" direct and immediate control.[54] Finally, the rule makes clear that control exercised on a sporadic, isolated, or *de minimis* basis is not "substantial."[55]

Drafting Considerations

The new framework from the Department of Labor and NLRB for analyzing joint employment makes drafting the franchise agreement more straightforward. As described above, the example provided in the Department of Labor's rule explicitly describes "an industry-standard document explaining that [the franchisee] is solely responsible for all day-to-day operations, including hiring and firing of employees, setting the rate and method of pay, maintaining records, and supervising and controlling conditions of employment" as not being indicative of the franchisor's "direct or indirect control" over a franchisee's employees that could establish the franchisor as being a joint employer of the franchisee's employees. Therefore, it would appear that going forward, for purposes of protecting a franchisor from being deemed a joint employer with its franchisees, the use of a provision in a franchisor's form of franchise agreement such as the following should help provide evidence that there is no joint-employer relationship between the franchisor and franchisee:

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[51] Id.
[52] Press Release, National Labor Relations Board, *NLRB Issues Joint-Employer Final Rule* (Feb. 25, 2020) available at https://www.nlrb.gov/news-outreach/news-story/nlrb-issues-joint-employer-final-rule (last visited Mar. 7, 2020).
[53] Id.
[54] Id.
[55] Id.

> You acknowledge and agree that you are solely responsible for all decisions relating to employees, agents, and independent contractors that you may hire to assist in the operation of your Restaurant. You agree that any employee, agent or independent contractor that you hire will be your employee, agent or independent contractor, and not our employee, agent or independent contractor. You also agree that you are exclusively responsible for the terms and conditions of employment of your employees, including recruiting, hiring, firing, training, compensation, work hours and schedules, work assignments, safety and security, discipline, and supervision. You agree to manage the employment functions of your Restaurant in compliance with federal, state, and local employment laws.

Importantly, from the Department of Labor's most-recent rule, it should now not concern franchisors as much that providing template employment applications, employee handbooks, and other employment-related forms will trigger joint-employment status with the franchisor's franchisee.

Customer List Ownership

Background

One of the valuable assets in any business is the customer list. For decades, courts have recognized that customer lists have value and can be classified as trade secrets.[56] To be classified as a trade secret, two elements must be met. First, the customer list must not be readily ascertainable. Second, the owner of the customer list must take steps to protect its confidentiality.[57] Existence of a trade secret is a question of fact.[58]
Because of the value that a customer list can have to a business's overall goodwill, ownership of a customer list upon termination or expiration of a franchise agreement can be a contentious issue between franchisors and franchisees. On the one hand, a franchisor may view a customer list as a trade secret that belongs to the franchisor. On the other hand, the franchisee may feel that the franchisee provided the work that helped develop the customer list, and so the franchisee should be considered the owner of the customer list. However, even if the franchisee accepts the franchisor as the owner of the customer list, a franchisee is likely to be concerned that the franchisor not use the customer list during the term of the franchise agreement to compete with the franchisee within the franchisee's territory (if the franchisor grants a territory to the franchisee).

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[56] *See e.g.*, *Defiance Button Mach. Co. v. C & C Metal Prods. Corp.,* 759 F.2d 1053, 1063 (2d Cir.), *cert. denied,* 474 U.S. 844, 106 S.Ct. 131, 88 L.Ed.2d 108 (1985); *accord Leo Silfen, Inc. v. Cream,* 29 N.Y.2d 387, 392-93, 278 N.E.2d 636, 640, 328 N.Y.S.2d 423, 428 (1972) ("A customer list developed by a business through substantial effort and kept in confidence may be treated as a trade secret and protected at the owner's instance against disclosure to a competitor, provided the information it contains is not otherwise readily ascertainable.")
[57] *Id. See also* Unif. Trade Secrets Act §1(4) (amended 1985) (defining a "trade secret" as "information, including a formula, pattern, compilation, program, device, method, technique, or process, that: (i) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use, and (ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy").
[58] *Defiance Button Mach. Co.*, 759 F.2d at 1063.

Therefore, use and ownership of a customer list are key issues that should be addressed in a franchise agreement. Failure to include in the franchise agreement a contractual provision governing the use of customer lists may allow unfettered use by the franchisor and the franchisee, at least to the extent such use is not prohibited by any noncompetition covenants.[59]

Drafting Considerations

Following is an example of a provision from a franchise agreement that specifies that a customer list is included within the definition of "Confidential Information." The provision also requires the franchisee to acknowledge that the customer list is a trade secret. However, as described above, whether a customer list is a trade secret is a question of fact, and it requires two elements: that the customer list must not be readily ascertainable, and the owner of the customer list must take steps to protect the confidentiality of the customer list. Failure to take steps to maintain the secrecy of a customer list can render the customer list not a trade secret, even if the franchisor claims it as such under the terms of the franchise agreement.[60]

> Franchisee agrees that the list of the names, addresses and other information regarding Franchisee's current clients, former clients, and those who have inquired about the Services (the "Customer List") shall be included in the Confidential Information, shall be the property of Franchisor, and shall constitute a trade secret of Franchisor. Franchisee agrees that Franchisee may not disclose the Customer List, or any portion thereof, to any person other than the Franchisor, either during the term of this Agreement or thereafter.

It may also be good practice to include a specific reference to the ownership of the customer list upon termination or expiration of the franchise agreement, such as the following:

> Franchisee agrees that upon termination or expiration of this Agreement, Franchisee will … return to the Franchisor all copies of the Customer List, including past customers, present customers, and prospective customers . . . .

To the extent the franchisor takes a security interest in the franchisee's assets, the franchisor should consider whether to include the customer list in the list of assets. And, finally, if the franchisor requires the franchisee's employees to sign confidentiality agreements, it should make sure the customer list is part of the definition of "confidential information" within such confidentiality agreements. Doing so may bolster the argument that the franchisor took steps to maintain the secrecy of the customer list.

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[59] David L. Cahn & Jordan M. Halle, *At Your Service? Customer Account Ownership and Its Impact on Non-Competes, Control Determinations for Vicarious Liability, and Franchise Goodwill*, 39 Franchise Law Journal 39, 42 (Summer 2019).

[60] *See*, *e.g.*, *Fisher Stoves, Inc. v. All Nighter Stove Works*, 626 F. 2d 193, 196 (1st Cir. 1980) (holding that a dealer's customer list was not a trade secret when the dealer accidentally left the dealer's customer list in the defendant's store and there was evidence that the dealer's customer list was available for the asking).

Liquidated Damages

Background

Liquidated Damages provisions in franchise agreements address the compensation the franchisee will pay to the franchisor upon a breach of the franchise agreement, a breach that has yet to occur. The thought behind such a provision is that the calculation of actual damages upon the breach would be difficult to prove and as such the parties are agreeing beforehand how these damages will be determined if such breach were to occur.

The franchisor will want to make sure that when the time comes to enforce this provision, the court does not determine the liquidated damages provision to be a penalty. If the damages are found to be "unreasonably large", they "will be deemed a penalty and will not be enforced on public policy grounds."[61] This was the unfortunate case for Dickey's Barbecue Pit when it attempted to enforce a liquidated damages clause. The court determined that the excessive size of the liquidated damages made it a penalty instead.[62]

Drafting Considerations

The following are key points, as outlined in a paper from the IFA Legal Symposium in 2017, to think about when drafting a liquidated damages provision[63]:

> 1. Make it clear that the provision is intended to compensate for damages and is not punitive in nature.[64] Specifically avoiding words that would be synonymous with the word penalty.[65]
>
> 2. Address the different breaches that could arise and the specific liquidated damages as it applies to that specific breach. Stay away from a one size fits all approach.[66]
>
> 3. Provide the calculation that will be used to determine the damages and ensure the calculation arrives at a liquidated damages amount that is reasonable.[67]
>
> 4. Make sure the situation in which liquidated damages is being applied to is one in which it would be difficult to determine damages for the breach.[68]

Although many states will enforce a properly drafted liquidated damages provision, review the state law governing your franchise agreements, as not all states allow the

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[61] See John Verhey, Stephanie Blumstein and Andrew Beilfuss, "Basics Track: Franchise Litigation," IFA 50th ANNUAL LEGAL SYMPOSIUM at 47 (May 7-9, 2017).
[62] Dickey's Barbecue Pit, Inc. v. Neighbors, No. 4:14-CV-484, 2016 WL 3878224 (E.D. Tex. Jan. 7, 2016).
[63] P. Ferak and C. Mair, "Liquidated Damages Provisions: Best Practices & Key Considerations," International Franchise Association, 50th ANNUAL LEGAL SYMPOSIUM, at 6 (May 7-9, 2017).
[64] Id. at 6.
[65] Id. at 13.
[66] Id. at 6.
[67] Id. at 6.
[68] Id. at 6.

enforcement of a liquidated damages provision.[69] Minnesota and North Dakota are two states where franchisors will likely be precluded from collecting liquidated damages. State law in Minnesota will not allow a franchisor to collect liquidated damages when the franchisor terminates the franchise agreement and North Dakota law outright prohibits liquidated damages provisions in the franchise agreement.[70]

A well drafted liquidated damages clause may help avoid some headaches if and when a franchisee is in breach.

Anti-Poaching

Background

As anyone who has practiced in the franchise industry over the past few years will know, the issue of "anti-poaching" or "no-poaching" provisions in franchise agreements have garnered increased scrutiny among government regulators. In turn, employees of various franchisees have begun filing class-action lawsuits against franchisors (and sometimes their franchisees) alleging violation of antitrust statutes by franchisors and franchisees who have entered into franchise agreements that contain no-poach provisions.[71]

In general, a "no-poach" provision prohibits franchisees from soliciting or hiring the employees of the franchisor or other franchisees.[72] In the past, franchisors have included these provisions, in part, to help protect franchisees from the risk that other franchisees in the same franchise system may "poach" the franchisee's employees after such franchisee has expended time, effort, and money to train its employees. The franchisee's employees are not parties to these no-poach provisions, and they are often unaware of the existence of the provisions.

To understand the current state of no-poach provisions in drafting a franchise agreement, following is a brief timeline of the history of the major events regarding no-poach provisions in the franchise industry.[73]

In October 2016, the Department of Justice and the Federal Trade Commission jointly issued guidance for human resources professionals to advise them how antitrust laws apply to the employment arena.[74] In particular, the guidance put employers on notice that

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[69] Id. at 13.
[70] Id. at 14.
[71] *See, e.g.*, *Ogden v. Little Caesar's Enterprises, Inc.*, No. 2:18-cv-12792 (E.D. Mich., complaint filed Sept. 7, 2018).
[72] Press Release, Illinois Attorney General, *Attorney General Madigan Announces Investigation of No-Poach Agreements at National Fast Food Franchises* (July 9, 2018), http://www.illinoisattorneygeneral.gov/pressroom/2018_07/20180709.html (last visited Jan. 20, 2020).
[73] A more comprehensive background and timeline can be found in various papers and presentations by franchise practitioners. *See, e.g.*, Brian Forgas, Rahul Rao & Sandy Wall, *Anti-Poaching Issues in Franchising*, Am. Bar Ass'n, 42nd Annual Forum on Franchising at 9–12 (Oct. 2019).
[74] Press Release, Federal Trade Commission, *FTC and DOJ Release Guidance for Human Resource Professionals on How Antitrust Law Applies to Employee Hiring and Compensation* (Oct. 20, 2016),

the Department of Justice would proceed criminally against naked wage-fixing and no-poaching agreements.[75]

In January 2018, the Attorney General of Washington State began investigating no-poach provisions among fast-food franchisors on the basis that those provisions violated the state's antitrust laws.[76]

In March 2018, U.S. Senators Cory Booker and Elizabeth Warren introduced a Senate bill, "The End Employer Collusion Act," which would ban no-poach agreements between franchisors and franchisees.[77] As of this writing, the bill has been referred to the Committee on Health, Education, Labor, and Pensions, but has not proceeded any further. Perhaps sensing that their bill was unlikely to pass under the current administration, on July 12, 2018, Senators Booker and Warren sent a letter to nearly 100 large franchisor CEOs (1) requesting information regarding their no-poach practices and (2) urging them to remove from their franchise agreements "any language that imposes limits on worker mobility."[78]

In July 2018, attorneys general from 10 states and the District of Columbia sent a letter to eight national fast-food franchisors[79] requesting information from those franchisors on their use of no-poach provisions that restricted workers' ability to seek a job with another franchisee in the same franchise system.[80] The letter indicated the attorneys general were concerned that:

> By limiting potential job opportunities, these [no-poach] agreements may restrict employees' ability to improve their earning potential and the economic security of their families. These provisions also deprive other franchisees of the opportunity to benefit from the skills of workers covered by a No Poach Agreement whom they would otherwise wish to hire. When taken in the aggregate and replicated across our States, the economic consequences of these restrictions may be significant.[81]

Cited in the letter was a Princeton University study conducted in July 2017 that found that 80 percent of 156 quick-service restaurant franchise contracts analyzed in the study

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https://www.ftc.gov/news-events/press-releases/2016/10/ftc-doj-release-guidance-human-resource-professionals-how (last visited Jan. 27, 2020).

[75] *Id*.

[76] Press Release, Washington State Office of the Attorney General, *AG Ferguson Announces Major Milestones in Initiative to Eliminate No-Poach Clauses Nationwide, Files Lawsuit Against Jersey Mike's* (Oct. 15, 2018) available at https://www.atg.wa.gov/news/news-releases/ag-ferguson-announces-major-milestones-initiative-eliminate-no-poach-clauses (last visited Jan. 27, 2020).

[77] End Employer Collusion Act, S.2480, 115th Cong. (introduced Mar. 1, 2018).

[78] Letter from Sen. Cory A. Booker and Sen. Elizabeth Warren to Nearly 100 Large Franchise CEOs (July 12, 2018) available at https://www.warren.senate.gov/imo/media/doc/No%20poach%20letter%20generic.pdf (last visited Jan. 27, 2020).

[79] The fast-food franchisors were Arby's, Burger King, Dunkin' Donuts, Five Guys Burgers and Fries, Little Caesars, Panera Bread, Popeyes Louisiana Kitchen and Wendy's. *See* Press Release, *supra* note 72.

[80] *Id*.

[81] Letter from 11 Attorneys General to 8 Fast-Food Franchisors (July 9, 2018) redacted version available at https://ag.ny.gov/sites/default/files/npnh_letter_redacted.pdf (last visited Jan. 27, 2020).

contained no-poach provisions.[82]

Arising out of these investigations, during 2018 and 2019, the Washington Attorney General continued his efforts toward his "goal of eliminating no-poach clauses nationwide" by continuing to investigate and entering into Assurances of Discontinuance (AODs) with several franchisors in various industries.[83]

The AODs generally provided that the franchisors would agree to a number of conditions, including amending franchise agreements with Washington-state franchisees to remove no-poach provisions, removing no-poach provisions from franchise agreements with all franchisees nationwide as those franchise agreements came up for renewal or amendment, and eliminating no-poach provisions from all future template franchise agreements on a nationwide basis.[84]

As of October 28, 2019, the Washington Attorney General had entered into legally binding agreements with 155 franchisors.[85] Whereas, during 2018, the emphasis of the Washington Attorney General's investigations appeared to be on quick-service restaurants, during 2019, the Washington Attorney General expanded his effort to include franchisors in all types of industries, including gyms, automotive services, and convenience stores.[86]

Sensing an opportunity to capitalize on these franchisors entering into the assurances of discontinuance, employees of various fast-food franchisees have begun filing follow-on class-action lawsuits against franchisors (and sometimes their franchisees) alleging violation of antitrust statutes by franchisors and franchisees who have entered into franchise agreements that contain no-poach provisions.[87]

Drafting Considerations

A common no-poach provision from a franchise agreement may read like the following:

> You agree that, during the Term, neither you nor any of your owners, your or your owners' Affiliates, or the officers, directors, managers or immediate family members of any of the foregoing, will, without obtaining the employer's or former employer's prior written permission, recruit or hire any person who is then or was, within the immediately preceding 24 months, employed by us, any of our Affiliates,

[82] *Id*. *citing* Alan B. Krueger and Orley Ashenfelter, Theory and Evidence on Employer Collusion in the Franchise Sector, (July 18, 2017).

[83] Press Release, Office of the Attorney General (Washington state), *AAG to Testify to Congress as AG Ferguson's Anti-No-Poach Initiative Reaches 155 Corporate Chains* (Oct. 28, 2019) available at https://www.atg.wa.gov/news/news-releases/aag-testify-congress-ag-ferguson-s-anti-no-poach-initiative-reaches-155-corporate (last visited Jan. 27, 2020).

[84] *See*, *e.g.*, *In re Franchise No Poaching Provisions* (Cinnabon Franchisor SPV LLC), Assurance of Discontinuance, No. 18-2-17232-2SEA (entered July 12, 2018) (setting forth the conditions under which this franchisor would operate with respect to no-poach provisions on a going-forward basis).

[85] *See* Press Release, *supra* note 83.

[86] *See id*.

[87] *See, e.g.*, *Ogden v. Little Caesar's Enterprises, Inc.*, No. 2:18-cv-12792 (E.D. Mich., complaint filed Sept. 7, 2018).

> or a franchise owner as (1) a general manager or assistant manager at any Restaurant, (2) a district or regional manager or any other such person having responsibility for overseeing or supervising the operation of multiple Restaurants, or (3) any of our or our affiliates' officers.

Nevertheless, based on the aggressive actions taken by government regulators, and the risk of inviting a class action lawsuit (whether meritorious or not), most franchisors have elected to remove no-poach provisions from their franchise agreements. Therefore, most franchisors will choose to exclude the sample language above from their franchise agreements on a going-forward basis.

Other Trends – Defend Trade Secrets Act & FTC Action on Noncompetes

Defend Trade Secrets Act

In May 2016, President Obama signed into law the Defend Trade Secrets Act (DTSA).[88] Under the DTSA, for the first time, owners of trade secrets were explicitly granted the independent ability to seek civil redress in federal court for claims of trade-secret misappropriation.[89]

Of importance for those who draft franchise agreements and other franchise-related documents is a provision in the DTSA regarding the protection of whistleblowers. Specifically, the DTSA protects a whistleblower from criminal liability or civil liability to an owner of a trade secret if the whistleblower discloses a trade secret to a governmental authority for purposes of reporting a suspected violation of law or in a complaint or other document filed in a lawsuit or other proceeding, if such filing is made under seal.[90]

If an owner of a trade secret wants to avail itself of certain remedies under the DTSA for an unauthorized disclosure of a trade secret, the trade secret owner must include a statutory notice to its employees advising the employees of their immunity rights as a whistleblower under the DTSA.[91] If an employer does not comply with the notice requirement, the employer may not be awarded exemplary damages or attorneys' fees under the DTSA in an action against an employee to whom notice was not provided.[92]

Therefore, for franchisors who may provide template employee or non-disclosure agreements, for instance as an exhibit to a franchise agreement, the person drafting the form of employee non-disclosure agreement should make sure to include a notice provision in line with the requirements of the DTSA. Such a notice could read as follows:

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[88] Defend Trade Secrets Act, 18 U.S.C. § 1836.

[89] Before enactment of the DTSA, federal jurisdiction could previously have been available under diversity jurisdiction or by adding a state-law claim of trade-secret misappropriation to an independent federal cause of action.

[90] 18 U.S.C. § 1833(b)(1).

[91] Id. at § 1833(b)(3).

[92] Id. at § 1833(b)(3)(C).

Notwithstanding any provisions in this agreement or company policy applicable to the unauthorized use or disclosure of trade secrets, you are hereby notified that, pursuant to the Defend Trade Secrets Act of 2016, 18 U.S.C. § 1833(b):

> An individual shall not be held criminally or civilly liable under any federal or state trade secret law for the disclosure of a trade secret that: (a) is made (i) in confidence to a federal, state, or local government official, either directly or indirectly, or to an attorney; and (ii) solely for the purpose of reporting or investigating a suspected violation of law; or (b) is made in a complaint or other document filed in a lawsuit or other proceeding, if such filing is made under seal.
>
> Further, an individual who files a lawsuit for retaliation by an employer for reporting a suspected violation of law may disclose the trade secret to the attorney of the individual and use the trade secret information in the court proceeding if the individual: (a) files any document containing the trade secret under seal; and (b) does not disclose the trade secret, except pursuant to court order.

FTC Action on Noncompetes

Over the past several years, non-competition provisions within the employer-employee relationship have come under increased scrutiny. This scrutiny was first seen at the state level a few years back with the Jimmy John's cases involving the attorneys general of New York State and Illinois.

At the federal level, there has been increased pressure on the FTC to take action regarding what some see as the over-use of non-competition provisions. For example, in March 2019, a group of seven Democratic U.S. senators sent a letter the FTC requesting the FTC use its tools, including its rulemaking authority, to combat the use of non-competition agreements in the employment context.[93] Then, on January 9, 2020, the FTC held a day-long public workshop to explore whether there is a sufficient legal basis and empirical economic support to promulgate a rule from the FTC that would restrict the use of non-compete clauses in employer-employee employment contracts.[94] A bipartisan group of senators has urged the FTC to take action, so there appears to be some bipartisan support for FTC action on non-compete provisions, at least in the employer-employee context.[95]

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[93] Letter from Sen. Richard Blumenthal, et al., to Joseph Simons, Chairman of the Federal Trade Comm'n (Mar. 20, 2019) (available at https://www.blumenthal.senate.gov/imo/media/doc/Sen%20Blumenthal%20et%20al%20re%20non%20competes_vF.pdf) (last visited Mar. 9, 2020).

[94] Press Release, Federal Trade Commission, *Non-Competes in the Workplace: Examining Antitrust and Consumer Protection Issues* (Jan. 9, 2020) https://www.ftc.gov/news-events/events-calendar/non-competes-workplace-examining-antitrust-consumer-protection-issues.

[95] Letter from Sen. Christopher Murphy, et al., to Commissioners of the Federal Trade Comm'n (Jan. 8, 2020) (available at https://www.murphy.senate.gov/download/ftc-non-competes-comment-letter-) (last visited Mar. 9, 2020).

Many franchisors provide franchisees with template non-competition agreements for use with the franchisees' employees. In light of possible future action by the FTC with respect to employer-employee noncompetition agreements, which may limit the enforceability of certain non-competition agreements with respect to certain classes of employees, franchisors would be well advised to make sure that franchisees are obtaining the assistance of counsel to draft non-competition agreements that are likely to be enforceable.

When drafting a non-competition provision, the draftsperson should focus on the following key factors: (1) consider the class of employees who are being restrained from competitive activities – it will be less likely to be enforceable if the employee is a lower-level worker; (2) ensure that the geographic and temporal scope of the non-competition covenant is reasonable; and (3) carefully define the "competitive business" from which the covenantor is restrained.

Using a "blue-pencil" provision is also advisable in that some courts may agree to reduce the geographic or temporal scope of an unenforceable non-competition provision to a scope that would be enforceable.

Conclusion

Clearly, recent trends in business, law and technology have affected the content of franchise agreements.

As laws continue to evolve, business practices change, and technology advances, contract drafting considerations will continue to shift and change. Attorneys in the franchise industry will continue to face the challenge of drafting enduring franchise agreements with lifespans of a decade or more that provide a solid basis for the franchise relationship while adequately anticipating an unpredictable future.