



Proactive Strategies for Franchisors to Prevent Litigation Risk

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Is Litigation Always Avoidable?

No

However, there are proactive steps you can take to protect your relationships, reputation, and financial health to avoid or resolve conflict.

And there are proactive things you need to do to give you the best chance to win, should litigation be unavoidable.

The Issues



Litigation landscape

Joint employment claims and vicarious liability

Franchisee disputes

Inadequate operational practices

Third party sellers

Non-competes

Franchisor controlling supply contracts



Key Proactive Strategies

Create an ethical culture

Communication is key

Provide support without overstepping boundaries

Franchise agreement is not a management tool

Be aware of what is often overlooked

Documentation that is proper for the business

Stay up to date on changes in the law

Key Proactive Strategies

The five tenets needed for a successful franchise system

- **Consistent**
- **Sustainable**
- **Replication**
- **Communication**
- **Culture**

Key Proactive Strategies

The business side of avoiding disputes

Key Proactive Strategies

Create a Culture of Ethical Business Decisions

- The IFA's Code of Ethics makes the point that franchisors should “maintain high standards of honesty, integrity, and fairness in all business dealings.”
- The IFA's Statement of Guiding Principles states that “Franchisors and franchisees should maintain proactive business policies, communication practices and regularly consult with each other for the enhancement of franchise relations.”

Key Proactive Strategies

Creating the Culture

- Establishing standards
- Managing the brand
- Recruiting franchisees
- Supporting franchisees

Key Proactive Strategies

Communication: What Works

- Direct communication allows for clarity
- Direct communication allows you to manage the issue
- Direct communication allows for understanding

Key Proactive Strategies

Communication: What Creates Tension and Risk

- Electronic/written communication as substitute for direct communication
 - Automatic and routine letters of default
 - Use of lawyers in the communication chain
 - Language that is ambiguous, soft and lacks clarity
 - Incomplete thoughts and haste of response
 - Legal jargon – quoting the agreement
- Written communication is not a substitute for direct communication
 - Telephone and Zoom is not a substitute for face-to-face
 - Field staff should be training and empowered – with clear limits
- Being vindictive - adds nothing
 - Forgetting that franchise systems are a glass house is unproductive
 - Inconsistency with brand culture
 - Failure to allow franchisees to leave with equity and dignity

Key Proactive Strategies

The legal side of avoiding disputes and winning when needed

The Litigation Landscape

Franchisee Disputes

- Disputes related to the franchise agreement – lead to breach of contract claims
 - Territory
 - Fees
 - Operational standards
 - Adequate (or inadequate) support
 - System changes
 - Supply chain
 - Disclosure document
 - Recruitment
- Breach of fiduciary duty claims

The Litigation Landscape

Third Party Disputes

- Vicarious liability
- Joint Employment
- Misclassification of relationship
- Mergers and Acquisitions
- Valuation
- Intellectual Property – trade secrets

Key Proactive Strategies

Understand the Franchise Agreement is not a Management Tool

Avoid overly prescription terms



Have a clear allocation of responsibilities



Regular legal review

Key Proactive Strategies

Ensure System Documentation Can Educate the Court

- Organize and standardize
 - Franchise agreement
 - Operations manual
 - Policies and procedures
 - Training
- Consistency in documentation and enforcement
- Historical preservation can be very helpful

Key Proactive Strategies

Franchisee Disputes

- Define the elements of the relationship clearly
- Definitions are key
- Define how disputes should be handled
- Create an environment of open communication
- Control is achieved by defining and measuring output – not by controlling the process unnecessarily

Key Proactive Strategies

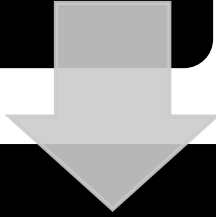
Create a Culture of Ethical Business Decisions

- Possible language for franchise agreement:
 - “Franchisee agrees to operate the franchised business in accordance with the highest standards of honesty, integrity, and fair dealing, and to comply with all applicable laws and regulations.”
 - “The Franchisee and the Franchisor agree to refrain from any business practices that are misleading, deceptive, or that could damage the reputation or goodwill of the franchise brand.”
 - “The Franchisee and the Franchisor agree to adhere to the highest standards of honesty, integrity, fair dealing, and ethical conduct in all aspects of their relationship, including but not limited to, the operation of the Franchisee's business, the provision of services, and all communications and interactions.”

The Litigation Landscape

Joint Employment Claims and Vicarious Liability

Blurred lines between franchisor and franchisee –
BRAND STANDARDS vs RECOMMENDATIONS vs
CONTROL



Need is to maintain control to protect IP and
goodwill without creating an agency
relationship

Key Proactive Strategies

Joint Employment Claims and Vicarious Liability

- Language of the agreement is important to define the relationship
- Wording of the Manuals and Training important
- Integration clause and Independent Operator Plaque is insufficient
- Conduct of the parties is more important
 - Establishing unnecessary Human Resource Policies
 - Field Staff execution of their role and responsibility
 - There is ZERO reason for any field consultant – in any franchise system – to review the personnel files of a franchisee

Key Proactive Strategies

Provide Franchisee Support Without Overstepping Boundaries

- Operations Manual should provide guidelines and best practices
 - Definitions
 - Proper disclaimers
 - Proper language
 - Clarity
- Inclusion of H.R. forms for guidance (Employee Handbooks) are OK to provide
 - Proper disclaimers
 - Proper guidance on use
- Direct training of franchisee's employees problematic – train the trainer
- Outward messaging by franchisee should be conspicuous

Key Proactive Strategies

Communication: What Works & What Creates Risk in manuals

- If making a recommendation, say it:
 - The franchisor recommends...: or The franchisor suggests...
 - The following are best practices guidelines for...
 - The franchisor encourages...
 - The franchisee may exercise discretion in...
 - The franchisee is free to...
 - The franchisee has the option to...
 - The franchisor understands that local conditions may require...
 - The franchisor will work with the franchisee to...
- If something is a brand standard you intend to enforce, make that clear:
 - The franchisee shall...
 - The franchisee must...
 - The franchisee is required to...
 - The franchisee is obligated to...
 - The franchisee will comply with...
 - The franchisee must adhere to...
 - The franchisee is bound by...
 - The franchisee is subject to...
 - These standards are mandatory...
 - These standards are non-negotiable...

Key Proactive Strategies

Joint Employment Claims and Vicarious Liability

- State that the franchisor does not have direct or indirect control of – or the right or authority to control – the hiring, firing, disciplining, scheduling, or supervising of the franchisee’s employees; the franchisee has exclusive control over such matters;
- Provide that the franchisee exclusively has the duty to comply with federal and state labor and employment laws;
- State that there is no employer or joint employer relationship between the franchisor and franchisee or between the franchisor and the franchisee’s employees;
- Recommend that the franchisee obtains independent legal, human resources and risk/insurance advice;
- Directly tie operational requirements to the maintenance of product and brand quality;
- Eliminate any unnecessary reserved control;
- Ensure indemnification and insurance provisions cover labor and employment law violations, and acts and omissions of franchisees and franchisees’ employees;
- Ensure you as the franchisor are named on the insurance as an additional named insured; and
- Require franchisees to carry EPL insurance, and police this requirement.

The Litigation Landscape

Third Party Sellers



Brokers and franchise sales organizations (FSOs)



Sales agents can make misleading statements to potential franchisees



Are they employees or independent contractors?



California legislation requiring third party sellers to prepare and deliver a disclosure document

Key Proactive Strategies

Watch for What Transactional Lawyers & Businesspeople Overlook

- **Third-Party Seller Oversight:** Franchisors must vet and monitor brokers and FSOs to ensure accurate, compliant representations.
- **Disclosure Compliance:** Ensure all Franchise Disclosure Documents (FDDs) are thorough, up-to-date, and consistently delivered.
- **Mandatory arbitration and mediation provisions:** If you are going to include these, ensure that you are willing to abide by the terms and that the process is clearly outlined.
- **Choice of venue:** Know the law of the jurisdiction and whether it is favorable or not before agreeing to be bound by a given state's law

Key Proactive Strategies

Third Party Sellers

- Define the relationship in the agreement
- Ensure there is a mutual understanding with the broker or FSO as to roles, responsibilities, and expectations Conduct a supported due diligence on their performance
- If there is no state disclosure requirement, you should still require your third party sellers to disclose to all prospective franchisees, at a minimum, their relationship with you and their relationship with the prospective franchisee
- Require your third-party sellers to provide you with a signed receipt from each prospect they present to you
- Possible language to add to agreements:
 - “We use the services of one or more franchise brokers, franchise sales organizations, and referral sources to assist us in recruiting franchisees. A franchise broker, franchise sales organization or referral source represents us, not you. We pay this person or organization a fee for when you sign a franchise agreement with us. We strongly recommend that you conduct a supported due diligence examination of our franchise opportunity on your own. If you have received verbal or other promises that are not included in our franchise agreement, please understand that we may not be obligated to you for those promises, unless they are included in our franchise agreement.”

The Litigation Landscape

Controlling Supply Contracts

Unfair Contractual Restraints: Franchisees may argue that certain control measures imposed by the franchisor are unreasonable or violate antitrust laws.

Conflicts of Interest: Franchisees may challenge the franchisor's financial interests in suppliers, arguing that these interests lead to inflated prices or less favorable terms.

Non-Compliance with Operating Manuals: Disputes may arise if franchisees fail to comply with the franchisor's operating manuals, particularly if those manuals dictate supply chain practices.

Key Proactive Strategies

Stay Up To Date on
Changes in the Law and
Market Conditions!

Key Takeaways

- Litigation cannot be avoided but certain things can leave a franchisor exposed
- Practical steps can be implemented to decrease chances of litigation
- Clarity and consistency is key
- Less litigation leads to better relationship, reputations, and financial health

Discussion

Thank you