

International Franchise Association
57th Annual Legal Symposium
May 4-6, 2025
Washington, DC

Practical Application of Artificial Intelligence in a Franchise System

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Introduction

While Artificial Intelligence, commonly referred to as “AI,” may seem futuristic or conceptual, the reality is that AI is here, and it will only become more prevalent in the franchise industry. Many experts and practitioners have done an excellent job educating the public on AI’s boundless capabilities, as the technology continues to exponentially grow and evolve, but some franchise systems are implementing AI processes and functionality at a more rapid pace than others. This paper is directed towards those franchise systems that are contemplating the use of AI in their networks by providing practical considerations and examples of how to navigate those business goals.

I. How are Franchisors Using Artificial Intelligence?

AI technology goes beyond merely automating tasks – it actively enhances decision-making capabilities. Through advanced data analytics, franchisors gain insights into customer behaviors and trends. This predictive capability enables proactive rather than reactive strategies, allowing franchises to anticipate customer needs and capitalize on emerging market opportunities. Instant, accurate answers to employee and customer queries via AI-powered chatbots lead to enhanced consumer satisfaction, fostering deeper brand connections, and providing a tailored customer support approach. Additionally, AI can serve as a revenue generator, through ensuring that upsell and cross-sell opportunities are strategically leveraged. Further, much like customer service, inbound and outbound customer sales processes are optimized.

Moreover, and as will be further discussed in this paper, AI helps identify approaches to more effective franchisee support and communication. Solutions like AI-powered search and Agentic AI allow franchisors to deliver training and support that is more efficient and targeted to the unique needs of individual franchise owners.¹

A. Uses Within Franchisor Organizations

While franchisors and franchisees each leverage the franchise business model and structure, at the end of the day, each have their own foundational business challenges and processes that aren’t necessarily unique to franchising, such as human resources, staffing, and scheduling objectives. As AI-powered business solutions continue to develop, many providers are establishing AI-powered solutions in employee recruitment, workforce management, and employee training.² For example, companies such as LinkedIn and Workday are leveraging AI to help serve their clients. LinkedIn

¹ Agentic AI refers to technology that introduces AI agents to traditional AI platforms to permit autonomous workflow without human oversight. See the following for more information: <https://www.salesforce.com/agentforce/what-is-agentic-ai/#:~:text=Agentic%20AI%20is%20the%20technology,where%20both%20can%20work%20together>.

² For more information related to general AI-powered solutions for human resources, please see one non-limiting example at the following: <https://www.rippling.com/blog/hr-ai-tools>.

uses generative AI to assist clients with candidate searching.³ And, even one step further, Workday has launched a new “AI Agent” product called Illuminate, which helps business enterprises manage their AI agents and workflows.⁴

In the franchise context, franchisors are creating “data dashboards” to help analyze data to make financial decisions for their franchise operations. For example, Home Franchise Concepts partnered with Domo and its “Domo Everywhere” product to collect and analyze data from its six CRMs across its 10 franchise brands to help the company make more informed decisions.⁵ Clearly, these types of solutions will continue to evolve throughout the franchise industry.

B. Uses with Franchise Development

Franchisors are now also beginning to use AI in connection with franchise development with the use of automated chatbots, filtering quality over quantity of leads, and identifying untapped market opportunities.

1. Lead Generation

Franchise brands are exploring and implementing AI-based lead generation solutions to directly interact with prospective franchisees. In these business cases, franchisors can upload their current franchise disclosure documents (“FDDs”) and answers to commonly asked questions from prospective franchisees into brand-specific digital environments to permit generative AI technologies to produce and create responses when interacting with prospective franchisees. Further, franchisors are beginning to use platforms, such as Calendly, to automatically schedule appointments for quality prospective franchisee leads. This allows franchise brands to increase efficiency with their inside and outside sales teams.

In a published case study, Batteries Plus engaged Lumin.ai to implement its AI-based “Sales Accelerator” platform to boost its lead generation efforts.⁶ If a prospective franchisee filled out a lead form, Lumin.ai can automatically send a text message to the prospect, introducing Batteries Plus and its franchise offering, and scheduling an introductory call based on the franchise salesperson’s availability. The automated text messages will continue interacting with the prospect, allowing the prospect to ask questions and interface with the brand even before the franchise salesperson is able to

³ For more information, please see the following: https://training.talent.linkedin.com/page/ai-powered-features#language_english.

⁴ For more information, please see the following: <https://www.workday.com/en-us/artificial-intelligence/agent-ai.html>.

⁵ For more information, please see the following: <https://www.domo.com/customers/home-franchise-concepts>.

⁶ To view the Batteries Plus case study, please visit the following: https://cdn.prod.website-files.com/674e0447ee45403edfe07262/67b796633cb1dd6f72c4e635_Lumin%E2%80%A4ai%20Case%20Study%20-%20Batteries%20Plus%202025-02-20-A.pdf.

directly connect with the prospect. According to the study, Batteries Plus increased its conversion rate from 14% to 23%, shrunk its sales cycle (from lead to a signed franchise agreement) from 120 days to 76 days, and breached 70% of its franchise development target within the first quarter of the year.⁷

As we note below, however, franchisors should exercise caution when allowing AI to make representations to prospective franchisees, as the provision of inaccurate or misleading information may create significant liability under applicable franchise laws.

2. Untapped Territories and Market Analysis

Franchise territory management and software is not a novel concept in the franchise industry. Many franchisors already invest significant resources in solutions to identify white-space opportunities, to evaluate and manage development areas for area developers, and analyze potential sites for stores and outlets. Particularly, for service-based franchisors, territory analysis and evaluation become of utmost importance.

However, with AI capabilities, territory analysis is reaching the next level. Companies like SiteZeus are using artificial intelligence to analyze real-time market data in providing predictive analytics and white-space analysis to help franchisors maximize market and franchisee opportunities.⁸ In addition, service providers can use cell phone technology, including geofencing, as data sources for large data models that are analyzing customer behavior.

3. Marketing Optimization

Many franchise systems already utilize demand generation – this is a marketing strategy where brands aim to generate demand, known as a “marketing funnel.”⁹ The idea is to identify a consumer need and bring awareness in the local market about how the company’s product and/or service can help address that need. Artificial intelligence has amplified demand generation in several ways.¹⁰ First, it can analyze vast amounts of data to comprehend user behavior, preferences, and patterns. Next, it can use that analysis to help predict trends and forecast such metrics. Then, it can use that data and predictive analytics to create personalized marketing campaigns in local markets. Finally,

⁷ *Id.*

⁸ For more information related to SiteZeus, please see the following: <https://sitezeus.com/solutions/sales-impact>.

⁹ Please see the following for more general information regarding demand generation: <https://advertising.amazon.com/library/guides/demand-generation#:~:text=Demand%20generation%20is%20a%20marketing%20strategy%20that%20looks%20at%20consumer,later%20translate%20to%20promising%20leads>.

¹⁰ Please also see the following AI capabilities with respect to demand generation: <https://www.forbes.com/councils/theyec/2023/12/13/how-generative-ai-can-help-solve-demand-generation-challenges/>.

it can monitor the effectiveness of such campaigns to adapt, evolve, and tailor for existing markets.

Additionally, AI is allowing companies to better use A/B Testing in connection with its online presence and marketing efforts. “A/B testing (also known as split testing or bucket testing) is a methodology for comparing two versions of a webpage or application against each other to determine which one performs better. It works by showing two variants of a page to users at random and using statistical analysis to determine which variation achieves better results for your conversion goals.”¹¹ The incorporation of AI expands A/B Testing by allowing companies to use predictive capabilities and personalized customer experiences to perfect their A/B Testing marketing strategies.¹²

Lastly, franchisors are beginning to utilize AI in media mix modeling (MMM), which is a marketing optimization strategy for determining the most effective media channels for particular campaigns.¹³ AI allows companies to better predict MMM success with fast-paced automation.¹⁴

4. Creating and Updating the FDD

Whether emerging franchisors are in the process of creating their first FDD, or a well-established franchisor is looking to update certain features of its existing FDD, AI can provide an additional tool to assist franchisors in ensuring their FDDs are marketable against competitors in relevant markets. While such use of market analysis may not be novel, as many franchisors and their advisors and consultants already take notes on how other brands describe and price their franchise offerings based on publicly available FDDs, emerging brands can leverage generative AI to build and price their franchise offerings in a more strategic and calculated way.

C. Uses Within Franchise System

Franchisors are also beginning to incorporate AI into the resources and capabilities they dedicate to supporting their franchisees and maintaining their franchise network.

¹¹ For more general information regarding A/B Testing, please see one non-limiting example at the following: <https://www.optimizely.com/optimization-glossary/ab-testing/>.

¹² For further information related to A/B Testing, please see the following: <https://blog.hubspot.com/marketing/ai-ab-testing>.

¹³ For more general information related to media mix modeling, please see the following: <https://www.marketingevolution.com/marketing-essentials/media-mix-modeling>.

¹⁴ For further information related to media mix modeling, please see the following: <https://www.forbes.com/councils/forbestechcouncil/2023/07/21/looking-back-reinventing-marketing-mix-modeling-with-machine-learning/>.

1. Internal Databases / Resources

As franchise systems grow, franchisors are more frequently fielded with questions from franchisees. In order to spend more time on complex and high-level questions and strategies, certain franchisors are beginning to incorporate interactive intranets that allow franchisees to leverage franchisor-produced materials and content and operational solutions. However, while the intranet capability is not new, certain AI-enablement is becoming part of the offering. For example, franchisors can implement AI technology into these intranets that will allow franchisees to ask questions or clarifications regarding things like current marketing offers or discount codes, business process troubleshooting, and already-approved social media content and messaging. Franchisor suppliers, such as Zenoti with its Zeenie AI-assistant platform¹⁵ and FranConnect with its Frannie AI platform,¹⁶ are already providing AI-based solutions to drive efficiencies. These platforms provide for a more interactive relationship between the franchisor and franchisee, similar to how brands are striving to enhance interaction with their customers.

2. Franchisee Operational Efficiencies

Franchisors are similarly investing in AI-enabled resources to help make their franchisees more efficient and effective in their operations. In March 2025, McDonald's Chief Information Officer, Brian Rice, explained to the Wall Street Journal that all 43,000 restaurants were undergoing a "technology makeover" to bring internet-connected kitchen equipment and AI-powered drive-throughs and tools for franchisees.¹⁷ The system is utilizing a technology called "edge computing," which allows for local sensors and end-user devices to conduct real-time analysis in a decentralized format, rather than relying on remote, centralized servers.¹⁸ Specifically, McDonald's is enabling applications and sensors with kitchen equipment, such as fryers and ice cream machines, to predictively analyze when maintenance may be needed before machines break down. These technological advancements aim to increase the loyal customer base from 175 million to 250 million by 2027.¹⁹

McDonald's, and other franchise giants, Yum! and Wendy's, have continued to employ resources to build out AI-powered tools and solutions for its franchisees. Each company is exploring AI-powered drive-thru solutions that would help make operators

¹⁵ For more information related to Zenoti, please see the following: <https://www.zenoti.com/zeenie>.

¹⁶ For more information related to FrannieAI, please see the following: <https://frannieai.com/>.

¹⁷ Please see the following for more information regarding McDonald's technology makeover initiative: <https://www.wsj.com/articles/mcdonalds-gives-its-restaurants-an-ai-makeover-2134f01e>.

¹⁸ Please see here for more information regarding edge computing: <https://aws.amazon.com/what-is/edge-computing/#:~:text=Edge%20computing%20is%20the%20process,give%20faster%20real%2Dtime%20in sights>.

¹⁹ For more information, please see the following: <https://nypost.com/2025/03/06/lifestyle/mcdonalds-to-employ-ai-at-43k-locations-to-speed-up-service/>.

more efficient in taking and fulfilling orders.²⁰ For example, Wendy's initiated a pilot program using an AI voice assistant, known as FreshAI, to take orders at select locations. Early results indicated that this technology simplified the ordering process and allowed employees to focus more on enhancing the overall customer experience. Based on these positive outcomes, Wendy's plans to expand AI voice ordering to 500-600 restaurants by the end of 2025.

McDonald's and Yum! have also been reported exploring a "generative AI virtual manager" to handle administrative tasks, such as shift scheduling.²¹ Specifically, Yum! has launched a "SuperApp" mobile application for restaurant managers to analyze and manage restaurant operations - Joe Park, Yum!'s chief digital and technology officer, refers to the SuperApp as a "coach in your pocket." In this instance, restaurant managers can interact with the SuperApp and ask specific questions, like "How should I set this oven temperature?" without needing to refer to separate operations manuals or materials. This increases the franchisee's compliance with system standards and helps promote uniformity among outlets, even in large systems like Pizza Hut, Taco Bell, and KFC. It also allows franchisees to learn how to make new products, which Pizza Hut did for its new "Pizza Hut Melts" product.

Dogtopia, a dog daycare franchise, leverages AI to automate inventory ordering and replenishment through an AI-powered inventory management system integrated into their point-of-sale system. By using predictive analytics along with historical sales data and current inventory levels, Dogtopia ensures optimal inventory management, reducing out-of-stock items or overstocking, thus creating a more efficient supply chain process.²²

Franchisors are also coordinating with advanced providers to help implement other AI-powered solutions for their franchisees, including financial tools. For example, providers like Stampli can automate invoicing tasks for service-based franchise systems.²³ Resources like Booke.ai can help provide franchisees with automated bookkeeping services.²⁴

²⁰ For more information, please see the following: <https://www.entrepreneur.com/franchises/yum-brands-brings-ai-to-drive-thrus-with-nvidia-partnership/488634>; <https://www.businessinsider.com/wendys-expanding-ai-ordering-hundreds-more-drive-thrus-2025-2>; <https://www.restaurantdive.com/news/wendys-acclerates-deployment-drive-thru-automation-digital-menu-boards-kiosks/740079/>.

²¹ For more information, please see the following: https://www.wsj.com/articles/taco-bell-and-pizza-hut-are-going-ai-first-yums-new-tech-chief-says-2f423d5e?mod=article_inline.

²² For more information, please see the following: <https://www.dogtopia.com/franchising-us/blog/how-franchises-are-leveraging-ai/>

²³ For more information, please see the following: <https://www.stampli.com/fully-automated-invoice-capture/>

²⁴ For more information, please see the following: <https://booke.ai/auto-categorization>.

3. Enhanced Marketing & Social Media Integration

AI has settled in as a valuable and evolving tool for creating content for brands, and some of the largest brands are heavily investing in such capabilities. For example, an early adopter of generative AI, Coca-Cola, and Microsoft recently entered into a five-year, \$1.1 billion strategic partnership to explore generative AI opportunities in connection with the beverage global brand.²⁵ The parties have not wasted time in the investment. A recent case study²⁶ has identified how Coca-Cola has already begun utilizing the technology in many ways, including personalized marketing campaigns, enhanced customer experience platforms, product research and development, and digital content creation. The company even disrupted the news cycle for its most recent AI-generated Christmas commercial for its use of generative AI.²⁷

Social media continues to play an enormous role in brand imaging and marketing, and its opportunities evolve on a rapid and compounding basis. However, third-party agents that help manage franchisors' social media presence are now using natural language processing for sentiment analysis, generative AI for content creation, and machine learning for post maximization analytics.²⁸

With the use of AI, companies are given more solutions to better maximize engagement with their social media followers. For example, certain technology providers can use AI to moderate social media comments by identifying potentially harmful or hateful speech and irrelevant (e.g., spam) posts.²⁹ Such tools can also identify potentially dissatisfied customers and immediately interact with those commenters before any escalation occurs. In the franchise context, this solution can help maintain uniformity and consistent responses and messaging to social media comments throughout franchise networks.

²⁵ For more information, please see the following: <https://news.microsoft.com/2024/04/23/the-coca-cola-company-and-microsoft-announce-five-year-strategic-partnership-to-accelerate-cloud-and-generative-ai-initiatives/>.

²⁶ For more information, please see the following: <https://digitaldefynd.com/IQ/ways-coca-cola-uses-artificial-intelligence/>.

²⁷ For more information, please see the following: <https://www.nbcnews.com/tech/innovation/coca-cola-causes-controversy-ai-made-ad-rcna180665>.

²⁸ For more information, please see the following: <https://zapier.com/blog/best-ai-social-media-management/>.

²⁹ For more information, please see the following: <https://www.greatscottsocialmedia.com/using-ai-for-automated-responses-in-social-media/>.

D. Uses to Improve the Customer Experience

Companies are always exploring innovative technologies to improve their customer experience, and with the introduction of generative AI, the opportunities are significant.

1. Customer Service

In today's society, consumers want answers quickly, and they don't want to wait on hold. With the use of AI-enabled chatbot capabilities, businesses are able to intercept that frustration by providing swift, tailored responses and solutions to inquiring customers. For example, during this year's "March Madness," Pizza Hut launched an AI chatbot through its Instagram called "Hutty" which allowed customers to interact with a digital personality during the college basketball games.³⁰ Pizza Hut was able to introduce certain sweepstakes, discount codes, and limited-edition swag. Particularly, as consumers continue to engage in "second screen" tendencies, which means consumers are engaging in mobile apps, such as X and Instagram, while viewing content on a typical TV screen, brands are capitalizing on multi-platform approaches.³¹ Pizza Hut saw this as an opportunity given the vast Internet engagement surrounding the March Madness event.

Similarly, Hand & Stone has engaged Zenoti for its HyperConnect platform to reduce the number of missed member interactions. Unanswered calls roll over to an interaction with a chatbot, and with this AI-based technology, early results show a material increase in client interactions.

2. Service-Specific Tools

While not a franchisor, Delta Airlines introduced its generative AI-based platform called "Delta Concierge" this past January. This allows Delta Airlines passengers to interact with a digital concierge-based customer service tool to help navigate their travel in a productive and efficient manner. The company has even partnered with companies like Uber to proactively book rides to and from the applicable airport and otherwise enhance the customer's travel experience.³² Given this functionality, it is only a matter of time until franchise brands in the travel industry begin adopting similar capabilities and customer experiences.

³⁰ For more information, please see the following: <https://www.nrn.com/quick-service/pizza-hut-taps-meta-ai-to-launch-hutty-the-march-madness-chatbot>

³¹ For more information, please see the following: <https://www.lemonlight.com/blog/a-complete-guide-to-second-screen-media-and-its-impact-on-marketing/>.

³² For more information, please see the following: <https://news.delta.com/delta-unveils-ai-powered-travel-journey-new-multi-modal-transportation-options>

II. Practical and Legal Considerations: Timeline of AI Implementation

When fully exploited, the franchise business model creates—within a single franchised system—a complex web of imbricate relationships and obligations. Introducing new technology into such an interconnected network can reverberate across the various strands and must be done with care. Implementing a technology like artificial intelligence, with its myriad possibilities and attendant risks, only lengthens the list of potential concerns.

However, while there are some unique elements to artificial intelligence that warrant special consideration, the implementation of an AI tool is not fundamentally distinct from the implementation of other technologies into a franchise system. The true risks arise when franchisors fail to seriously consider how to evaluate AI tools because of either a lack of trust in artificial intelligence altogether (thereby refusing to implement AI at all) or too much trust due to a lack of understanding of how the specific AI works (thereby implementing tools without review or serious consideration).

For the purposes of this section of the paper, we will walk through a “timeline of AI implementation” comprising three stages: (1) deciding to purchase an AI tool; (2) implementing an AI tool; and (3) using an AI tool. For each stage, we will list some of the practical, relational and legal considerations that should play a role in a franchisor’s decision-making process. The lines between these categories can never be firmly drawn. In jurisdictions with franchise-specific legislation, “relational” elements are necessarily “legal”. Similarly, “legal” concerns will always play a role in determining what is “practical”. Nevertheless, the high-level distinctions are useful for cataloguing some of the common considerations that franchisors must confront as they implement artificial intelligence into their franchise networks.

A. Deciding to Purchase an AI Tool

1. Practical Considerations

a) Function

The fundamental question that all franchisors should ask regarding a potential new tool, including an AI tool, is: *what do we need this tool to do?* In a basic sense, identifying the “function” of an AI tool at this early stage involves determining the “inputs” and “outputs” of the technology. Most common AI tools will be fed certain information, either before or as part of a prompt, and produce outputs based on the results of certain analytical processes performed on the prompt and underlying data set. As noted in Section I of this paper, nearly any type of “input” is possible, including specific questions about the business, customer reviews, or even images.

Related to the “input” question is who will be providing the input. A franchisor may wish to implement a tool that allows customers to gain a better understanding of the services offered by the franchised system (e.g., a virtual model of the outcome of a potential renovation service). Alternatively, a franchisor may wish to provide a tool for franchisees to better understand their obligations under the franchise agreement and

operations manual. A franchisor may also wish for no active input process, instead preferring the tool to run autonomously to routinely provide designated outputs (e.g., summaries of consumer reviews or franchisee performance metrics) on a regular basis.

While these considerations may seem basic, it is critical to start from this level of abstraction to ensure the function, inputs and outputs of a proposed tool accord with the franchisor's needs. A clear appreciation of these basic "function" questions will have a direct bearing on the focus and resources to be applied to various aspects of the tool. For example, a key aspect of a tool's "function" is how the users—whether franchisor personnel, franchisee personnel, or third-party customers—will interact with the tool. How the franchisor evaluates the "user-friendliness" of a tool and likelihood of adoption will depend on who those users will be.

Another benefit of a detailed consideration of any tool's function is that it provides the franchisor with a means of evaluating the success or failure of the tool's ultimate implementation and use. As early as possible, the franchisor should identify which features are critical and which features are simply "nice to have". Given the amount of data, time, and processing required to create AI tools, their creation or purchase tends to be expensive, so it will be essential for the franchisor to have a means of evaluating whether the cost is worth it.

b) Business Case: Build or Buy?

Closely related to the function question is whether that functionality currently exists in the market for AI tools. Is there a solution already available that meets the functionality needs? If not, is there a middle ground where an existing offering can be appropriately customized? Once the market is properly canvassed, the franchisor will need to make the critical decision of whether the AI tool in question will be built internally or sourced externally. While some franchisors have needs, resources, and contacts that lend themselves to the creation of bespoke AI tools, in many cases, franchisors will have to evaluate the overlap of what a proposed tool can do and what the franchise system ideally needs it to do. Therefore, when evaluating a specific tool, the natural corollary to the above-noted function question is: does this particular tool do what we need it to do?

Furthermore, the franchisor will need to evaluate the maintenance and upkeep costs for any tool. To the extent the franchisor builds its own tool, such obligations will be entirely borne by the franchisor itself. If the franchisor chooses to acquire an existing tool, the vendor may offer service updates and maintenance services for a certain period of time. However, the franchisor should do its due diligence on the vendor to ensure such vendor will be an appropriate and useful partner over the life of the tool, particularly if the vendor has the experience integrating and managing the use of the tool for similarly situated clients.

Given the very different paths represented by the "build" or "buy" decision, the franchisor will need to create a business plan to justify its approach. This plan can (and should) be referred to throughout the process to ensure the franchisor stays on track.

c) Resources

As part of any business plan for the decision to create or purchase an AI tool, a fundamental practical consideration is an assessment of the resources required. This will play a significant role in the “build” or “buy” decision. For the acquisition and/or customization of an existing tool, the basic starting consideration is the acquisition cost and any ongoing fees owed to the service provider to operate the tool. A frequent marketing point for AI tools is a claim for increased efficiency. It is important to confirm that initial and ongoing expenses are consistent with that claim and—of course—that the franchisor can afford the projected costs. For the creation of a bespoke AI tool, the franchisor will need to ensure it can afford the time, personnel, and other resources required to build, test and implement the tool as well as the opportunity cost losses that accrue in the development period.

Another key aspect of resourcing for an AI tool is the extent to which the tool itself needs to be trained on the franchisor’s data and who will be doing that training. For certain AI tools, the training process may be predominantly limited to feeding the tool large quantities of the franchisor’s data. While this may need to be curated and tested, other tools will need substantially more investment in time (and potentially money) in training the tool on the new materials in order to ensure that it produces the outputs desired. Furthermore, depending on the nature of the tool, training may be required for potential users of the tool. All of these elements have a cost, whether in money or time. If there are going to be continuous training obligations, this should be factored into the resourcing considerations, particularly if a significant portion of an employee’s job (or perhaps a new job) will be dedicated to management and upkeep of the tool. To the extent the tool can be tested in advance, the franchisor may be able to better predict the resources required to operate it successfully.

Taken together, the collection of related resourcing questions form the key component of any business plan for the acquisition or creation of an AI tool. Once these questions have been thoroughly considered, the franchisor should develop—in advance—a reasonable budget expected to be set aside for such a tool. To the extent possible, this budget should be carefully monitored and reassessed throughout the acquisition, implementation, and use of the AI tool.

d) Ownership of Data

Data is variously described as the “currency” or “lifeblood” of the modern economy, and this will have degrees of truth for a given franchise system. Nevertheless, the critical role of data in AI tools cannot be overstated. Many current AI tools function by ingesting large quantities of data, applying machine learning techniques, and then fine-tuning to ensure the tool can create the desired outputs. Given this fundamental role, in the decision-making process regarding the acquisition of an AI tool, it is crucial to understand who owns the training data, the inputs entered while using the tool, and the outputs generated by the tool.

Beginning in reverse order, the ownership of the tool outputs is an obvious concern: if the franchisor cannot use the tool outputs as desired, the tool's utility will be severely compromised. While less obvious, ownership of the inputs should also be considered. Franchisors often carefully draft their agreements to ensure they own as much of the system data as possible and should be wary of allowing third-party tool providers to license the inputs for their own uses. Of particular concern is the possibility that such inputs may contain proprietary, confidential, personal or other sensitive information that could cause considerable harm if the tool provider incorporated such information into its foundation model, available to be accessed—whether intentionally or otherwise—by competitors or the public.

Regarding the training data, it is likely that the franchisor will need to take a bifurcated approach. At present, many common AI tools are built on top of large language models which have been trained on enormous quantities of information, typically pulled from the “Common Crawl” or other snapshots of the Internet more broadly. The franchisor is unlikely to need (or want) ownership or control over this set of information. However, layered on top of this foundation model, customized AI tools may have been trained on a set of the franchisor's information, such as its FDD, franchise agreement, operations manual and/or policies. The franchisor will likely wish to maintain ownership and control over this customized training data and should ensure this is addressed early in the negotiation process with any potential service providers.

e) Tool Placement

Directly related to the confidentiality concerns noted earlier, franchisors should also give careful consideration to where the tool is placed in the operations of the franchise network. In a basic sense, the “placement” of the tool can refer to whether the tool will be internal to the franchisor, internal to the franchisees, or consumer-facing. However, “placement” can also refer to the tool's place in the “signal chain” of the franchisor's operations and the extent to which it is walled off from the rest of the world.

With the introduction of large language models that were trained on the Common Crawl (or the Internet in general), users of AI tools were quickly forced to confront a balancing act: to what extent should the tool be connected to the wider Internet? A web-connected tool has the advantage of real-time access to updated information or communications. However, the risk is that the user's inputs (or outputs) get incorporated into the underlying model's training data, potentially making proprietary, confidential, personal, or other sensitive information available to users outside of an organization.

In response, many enterprises (including franchisors) have opted for a “sandboxed” version of large language model tools. These tools are connected to networks that are internal to the enterprise but are walled off from the broader Internet, forgoing the benefits of connectivity in order to maintain confidentiality and data security. The extent to which a tool is connected to outside networks is a critical consideration in the acquisition or creation of AI technology.

Another key element of a tool's "placement" is whether it can be properly integrated into the franchisor's existing systems and processes (whether software or otherwise). If the franchisor is purchasing an existing tool from an established vendor, it will be worthwhile exploring whether such vendor has experience with similar integrations and the extent to which it can provide ongoing support in the integration process.

2. Relational Considerations

Given the web of interconnected relationships inherent in franchise systems, the acquisition of a new AI tool necessitates a series of considerations specific to the unique relational elements in the network. This includes considerations regarding the franchise system itself, third parties to the network, and the service provider from which the tool is acquired.

a) Franchise System

The basic relational consideration for a new tool in a franchise system is identifying who the tool is for. Will it be used by the franchisor in its back-office systems? Will it be used by franchisees for internal purposes? Will it be used by customers to access information or services? Identifying the party most affected by the implementation of a new tool will help focus further considerations in the acquisition and implementation process.

If the proposed new tool is not limited to the franchisor's back office and will affect another party in the franchise network, the next critical relational consideration is the rights the franchisor has (or does not have) in relation to that party. For example, if the proposed AI tool requires uptake and operation by franchisees, does the franchisor have the right to impose the use of that tool on its franchisees? Does the franchisor have the right to restrict how such tool is used?

A natural follow-up to questions regarding a new piece of technology in a franchise system is deciding who will pay for it. Some franchise systems can have the implementation of a new AI tool covered by an existing technology fee, provided the applicable contractual language is permissive. Alternatively, franchisors may need to determine the appropriate cost split by relying on a combination of other language in their agreements and convincing franchisees of the value of the new tool. In some cases, the franchisor may decide to fund the introduction of a new tool in the initial stages to help demonstrate its value and only gradually introduce a fee structure.

In a similar vein, the franchisor should always consider whether the implementation of a new tool will cause any relational issues in the system. For example, is there a chance that the implementation of a new tool will anger existing franchisees? This will be particularly important if the tool requires the expenditure of resources by the franchisees. In some cases, as noted below, the franchisor may need to plan for a pilot program to win franchisees over. In other cases, a strong negative reaction by franchisees may be more important than the terms of the existing agreements, permissive or otherwise. The

franchisor will need to foresee and plan for the amount of change management required in the system to ensure smooth implementation.

b) Third Parties

Third parties to the franchise network (i.e., excluding the franchisor and franchisees) also have a role to play in many networks, and they should often be part of the consideration in acquiring a new AI tool.

As noted earlier (and discussed further below), for franchisors acquiring an existing AI tool from a vendor, the franchisor should ensure such vendor is an appropriate partner for the franchisor's use of the tool, including an evaluation of its experience and the extent of its ongoing support obligations.

The other significant third party for many franchise systems will be consumers. Some AI tools involve direct consumer interaction, such as a website chatbot or a visualization tool. To the extent consumers will be interacting with the new AI tool, a franchisor acquiring such a tool will need to carefully consider how consumers will experience and respond to the technology, including testing and reviewing the user experience. The franchisor should also evaluate whether employing artificial intelligence will frustrate some consumers and if there are steps that can be taken to customize the experience and otherwise mitigate any risk of consumer frustration. It is important to learn whether the tool in mind has been tested in similar circumstances with similarly situated consumers to determine if the user experience will be welcomed by this key demographic. Finally, to the extent customer or other information will form part of the tool inputs, the franchisor should ensure it has the rights (including all required consents) to disclose such information into the AI tool.

3. Legal Considerations; Service Provider Contract Terms

As noted earlier, in the context of a franchise system acquiring (or building) an AI tool, there is significant overlap between practical, relational and legal considerations. For the purposes of this section, we will therefore focus on one particular "legal" aspect of the acquisition of an AI tool with respect to another key third party to the system: the terms of the agreement that will be entered with a third-party service provider of AI tools.

The legal context for AI tools remains fluid. To date, the best way for franchisors to protect themselves against the risks of using an AI tool is to ensure they contract prudently with the service provider. We will focus on two key elements of this process: (a) protecting the franchisor's data and intellectual property, and (b) protecting against liability.

a) Protecting Data and IP

As noted above, data—and often proprietary data—tends to be a pivotal ingredient to the use and operation of AI tools. It is therefore critical for the franchisor to do what it can to ensure it maintains the confidentiality of, and control over, its data.

The first provision to focus on in the agreement with a service provider is any language regarding confidentiality. Such language should ensure that the franchisor's data remains confidential and will not be subject to disclosure—inadvertent or otherwise—to third parties. Depending on the nature of the AI tool, the franchisor may wish to make it explicit that the service provider cannot use the tool inputs to further train the underlying model. To the extent the franchisor's inputs end up in the model's training data, there is a risk that such information could be reproduced in outputs provided to other users of the tool.

This concern leads naturally into the next consideration: use and ownership of the tool's inputs and outputs. The franchisor will want to ensure that it has the rights to use the tool's outputs in a manner that is consistent with its intended function. This will typically require outright ownership of the content that is produced by the tool; in other cases, license rights may be sufficient. Similarly, the franchisor will want to carefully consider the arrangement regarding the tool's inputs. As noted above, the franchisor should ensure that its inputs remain confidential and not subject to disclosure to other users, even if inadvertently. This can occur if the inputs will be used as part of ongoing training for the underlying AI model.

Finally, it will be important to scrutinize (or add, if necessary) language regarding privacy and data security. Attacks designed to reveal proprietary, confidential, personal or other sensitive information are increasingly common, and AI tools are no strangers to vulnerabilities, especially if the tool is new and relatively untested. It will be important to set minimum standards for data security with the service provider that are commensurate with the sensitivity of the data in question. In some cases, depending on the sensitivity of the data and local laws, this will require a detailed Data Processing Addendum in addition to the main service agreement.

b) Protecting Against Liability

As noted above, the legal and regulatory environment for artificial intelligence remains fluid, and it is essential that franchisors strongly negotiate the risk balancing provisions to mitigate any potential liability from implementing and using the AI tool. To some extent, this is not unique to AI: all service provider contracts should include carefully negotiated provisions regarding liability. However, the relative novelty of artificial intelligence adds some extra considerations into the negotiating process.

The starting point for all liability protections will be a well-drafted indemnity clause. Depending on the circumstances and the nature of the tool, a franchisor may wish to ensure it is indemnified for a range of third-party claims, including infringement of intellectual property rights, data and privacy consents, and violations of applicable law. Regarding this last point, it is difficult to know the shape of any future regulatory obligations on AI tool providers. As a result, it may be difficult to secure an indemnity commitment from a service provider to comply with laws that do not yet exist, and they may insist on a point-in-time obligation. Nevertheless, this point should be considered and negotiated.

As a complement to an indemnity clause, the franchisor should also carefully negotiate any limitations of liability in order to ensure the contractual risk balancing is meaningful. In certain circumstances, the franchisor may decide that some types of liability should not be limited or should be subject to a much higher cap than other heads of damages (such as intellectual property infringement or privacy violations).

Another key element of the service provider terms that should not be overlooked is the term and any termination rights. Given how quickly artificial intelligence is developing and how quickly service providers are adapting and improving their offerings, it may not be wise to lock into a tool for a long period of time without options to evolve along with the world of artificial intelligence. Furthermore, it may not be clear until several months have passed whether the tool truly offers the functions the franchisor requires. Careful attention should be paid to the circumstances under which the franchisor can leave the agreement without significant break fees.

The foregoing contractual protections may be difficult to get in practice, as AI tool providers will be eager to mitigate their own risks in an uncertain regulatory environment. In addition, some providers of AI services may not be able to make these commitments if their own software is based on services, data or models provided by a third party that is unwilling to absorb the risk. Nevertheless, given the unique risks presented by AI, franchisors should ensure that all contractual risk balancing is carefully considered through an AI lens.

B. Implementing Your AI Tool

Once a franchisor decides on the right AI tool, the next stage in the timeline is the process of implementation. Once again, the nature of franchise systems creates a set of unique practical, relational and legal considerations.

1. Practical Considerations

a) General Systemic Impact

The first practical consideration is determining how the tool will impact the system in a broader sense. Does its implementation change the way services are offered to customers? Does it change the way franchisees interact with the franchisor, whether by operations manual, policy or otherwise? Does it change the way franchisees order inventory or other supplies? Depending on the nature of the AI tool, the franchisor should consider whether other elements of its network will be affected and whether changes to other relationships will need to be implemented or negotiated.

b) Project Plan

A critical step that will pay dividends throughout (and beyond) the implementation process is the creation of a detailed project plan. This plan will serve as a roadmap for the tool's implementation and should include realistic goals and timelines that are appropriate for the complexity of the integration project. The franchisor should also include critical milestones and clear roles and responsibilities that can be used to hold

key personnel accountable for important project steps. These key personnel should also be carefully considered: who is the appropriate decision-maker at each step? The project plan should be overseen by a project manager who can assist in designing the plan and ensuring it is followed.

If the franchisor is purchasing the tool from a vendor, another important player in the project plan will be the vendor itself. In some cases, tool providers will have experience with integration and implementation and can assist with the planning process. Some will even have project managers on staff who can provide project management services.

The project plan will be a critical document to which the franchisor can refer when justifying timelines or important steps. It will also help reinforce the specific project goals while avoiding the “scope creep” that is an all-too-common project killer. While additional project items will necessarily surface during any reasonably complex implementation plan, it may be wise to simply keep a list of items for future consideration instead of veering off from the project plan to address unanticipated items.

The integration of a new tool into existing systems can be the most complex process of the entire project. Regardless of the tool or acquisition plan, it will be important for the franchisor to set realistic timelines and goals and do its best to stick to them.

c) Rollout

Before rolling out a new tool, the franchisor should also determine whether it will need to implement use restrictions or a new policy on how the tool will be used. Any such policy should be drafted with a careful eye to potential legal risks and be flexible enough to adapt to changing circumstances or new understandings.

The next consideration is how to structure the rollout of the new tool. Franchised networks can be a delicate balance of well-established processes and progressive innovation to adapt to market changes. Depending on the function of the proposed tool, the franchisor may need to carefully consider how to manage the rollout. In some cases, a back-office tool that simply assumes—but automates—existing processes will need no detailed rollout process. However, if the tool will have an impact on how franchisees operate, a more structured process may be required.

For example, the franchisor may consider using a pilot program approach. In this approach, the franchisor rolls out the new tool only for a select group of franchisees to evaluate its effectiveness in the system. There are significant benefits to this approach. A pilot program provides real-life testing data and subjects to provide information on how the tool will function in the broader system. In addition to helping tweak usage of the tool or policies, a successful pilot program may also create a group of enthusiastic franchisee supporters who can help with the implementation of the tool in the broader network. An alternate approach is to use corporate-owned units for the pilot project, which has the added benefit of demonstrating the franchisor’s faith in the project and willingness to demonstrate its commitment.

Franchisors should also determine how quickly the rollout should occur. In the implementation of new technology, it is often ideal to “flip the switch” to have simultaneous and widespread adoption. In some cases, this is a necessary element in order to ensure a mirrored experience for customers across the network. However, this is not always possible, and there may need to be a gradual transition before the entire franchise network is using the new tool. In such cases, the franchisor will need to ensure the transition operates smoothly by mapping out the stages (and geographies) of adoption and putting in place a project plan that has reasonable (and attainable) timelines.

2. Relational Considerations

Naturally, the first relational consideration to the implementation of a new tool is determining who the tool is for and how it will be used. As noted above, there is a near limitless range of possibilities for AI tools, some of which may have no noticeable impact on the franchisee network or its customers. Others, however, may change the way franchisees interact with their customers or the franchisor.

To the extent the new tool impacts the franchisees or customers of the system, the franchisor must also consider the range of application in the franchise network. For example, some franchisees may be more suited to initial adoption, either by virtue of sophistication or market area. Certain scheduling or inventory tools may not be needed for smaller markets or franchisees. The franchisor should decide as early as possible whether the new tool will be system-wide or whether it will be confined to certain franchisees who are more appropriately situated for the use of the tool. In either case, the franchisor must make a compelling case to the network of the tool’s value (ideally aided by a successful pilot project).

From a contractual perspective, the franchisor should determine whether it will negotiate an umbrella agreement for the entire system or whether individual franchisees will be required to contract directly with the vendor or tool provider. While the latter approach may provide more flexibility at the franchisee level and perhaps offset some of the franchisor’s risks, most franchisors will opt for the greater consistency and control offered by a single contract with the tool provider in the franchisor’s name. However, this will depend on the nature of the tool.

Another pivotal consideration from a relational perspective—perhaps the pivotal relational consideration—is determining how the costs of a new technology will be allocated. Some franchise systems may have a dedicated technology fee from which the resources can be drawn without significant pushback, but many systems will need to carefully manage the decision regarding who will pay for usage of the tool and how such payments will be made. This may be straightforward for a tool that is confined to the franchisor’s back-office operations, but it will likely be more of a negotiation or messaging task for tools that will impact franchisee operations.

Finally, it is always worth considering the extent to which the implementation of an AI tool will create friction within the system. Depending on the tool, certain AI tools may feed into the current reputation of AI as a threat to existing occupations. The franchisor

should carefully manage any messaging around the implementation of an AI tool and determine if its implementation will anger franchisees or the customers of the system. As noted above, to the extent the franchisor can get buy-in from all stakeholders by demonstrating the value of the business plan, the relational aspects will create far less friction.

3. Legal Considerations; Franchise Agreement

As with other stages in the timeline of acquisition of an AI tool, the “legal” considerations are interwoven with the practical and relational considerations. Therefore, we will use this section to point to the most important legal document for the implementation of new technology in a franchise system: the Franchise Agreement itself.

Early in the process of deciding to purchase an AI tool, the franchisor should review its Franchise Agreement to understand its rights and obligations regarding the implementation of new technology. Key provisions to review will include any language regarding system changes, information technology, fees, confidentiality, data ownership, data privacy and security, and any technology- or tool-specific language that relates to the specific function of the new tool.

Some of the relational considerations flagged above may be less of an issue in systems with robust technology provisions in the Franchise Agreement. For example, some agreements will contain an existing technology fee from which resources can be used without further negotiation with franchisees for the AI tool project. Furthermore, some larger systems may already have a franchisee advisory council (or even a franchisee technology advisory council) that can be the perfect testing ground for new tools or provide feedback regarding the franchisee experience with such tools.

While it is always possible to negotiate obligations and rights outside of the existing language in the Franchise Agreement, the language in the current Franchise Agreement will establish the framework for the implementation of any new tool. A well-drafted Franchise Agreement will allow the franchisor the flexibility to implement new technology with the flexibility, resources, and protections required to safeguard the system.

If the AI tool will be used by franchisees, it will likely be important for the franchisor to develop an AI Policy that is incorporated by reference into the Franchise Agreement. This policy should cover all relevant aspects of the franchisee’s (and its authorized users’) use of the tool, including permitted and prohibited uses, transparency obligations, sample use cases, and obligations to review and verify the tool’s output.

The franchisor should also review the rights and obligations on renewal. Even if the existing form of the Franchise Agreement lacks some of the language required to fully implement the AI tool to the franchisor’s liking, the franchisor may have a right on renewal to put a new form of agreement in front of its franchisees with stronger technology language. Some agreements also explicitly include the concept of a “technology refresh” on renewal, which may be a clearer way to require new technology implementation on renewal. In any event, depending on the nature of the tool and the renewal cycle of its

franchisees, the franchisor may need to use renewals as a means of gradually implementing the new tool throughout the system.³³

C. Using Your AI Tool

1. Monitoring and Controlling Use

Once a new AI tool has been acquired and implemented, the actual use of that tool will also need to be carefully managed to ensure the franchisor and its franchisees are receiving the full benefits of the tool—and to ensure the risks are minimized. The franchisor should consider its ability to monitor usage of the tool to ensure it is being used properly and that it is producing the intended benefits.

A critical component of this monitoring will be the project plan described above. Such a plan should include (or lead naturally to) a detailed means of measuring return on investment and key performance indicators. Of course, there may be new performance metrics that revealed themselves throughout the implementation process or added value that had not been previously predicted. Nevertheless, the franchisor must work to ensure there is (or can be) a clear answer to the question of whether the tool produced a positive return on investment and whether it solved the problems it was intended to solve. A project manager can play an important role in ensuring key performance metrics and return on investment are properly assessed.

Regarding the active and ongoing control of regular tool use, an effective means of controlling use of an AI tool is through the implementation and enforcement of an AI Policy. While allowing for flexibility, such a policy should establish the overarching principles governing all use of the AI tool, including the permitted inputs, prohibited practices, transparency obligations, how the outputs should be reviewed, and how the outputs can be used (including sample use cases). Depending on the nature of the AI tool, the franchisor may need to develop two different AI Policies: one for its franchisees and one for its internal corporate users.

2. Knowing How Your Tool Works

While monitoring the benefits of an AI tool should be a straightforward process (provided the project plan has been clearly established), it is a more difficult prospect to know whether the risks of using a tool are being properly avoided, even with a strong AI Policy. This is particularly true for tools that are based on artificial intelligence. Reporting on artificial intelligence has emphasized its limitations and risks, and users are frequently bombarded with cautionary tales and instructions to review the output of all such tools.

³³ While outside the scope of this paper, even with extremely detailed provisions in the Franchise Agreement, franchisors must always ensure that the implementation of any system changes is done in accordance with all legal obligations, including franchise-specific legislation and other statutory relationship laws. For example, Canadian franchisors will need to be mindful of the statutory and implied duty of good faith and fair dealing. Another benefit of a well-structured business case and project plan is that it will make it easier for the franchisor to comply with this duty by demonstrating that its exercise of business judgment and discretion is (or was) commercially reasonable.

The risks include not only false information (whether created by AI hallucinations or otherwise) but potential legal liability, such as violations of confidentiality, privacy or intellectual property rights. However, generic injunctions to cast a “human eye” on tool outputs are not helpful if reviewers are not sure what to look for.

Therefore, it is critically important to know how the acquired tool works. This does not necessarily mean a detailed understanding of the specific learning and training methods employed by an underlying machine learning network or foundation model. However, to the extent the user understands how outputs are generated from the information in the model, it will be much easier to understand the nature of the review required and the red flags to identify.

3. Case Study: Large Language Models

There are countless types of artificial intelligence tools that use varying approaches to machine learning and neural networks in order to produce useful outputs. However, at present, large language models (or “LLMs”) remain the dominant paradigm of artificial intelligence tools. Many such tools use a common large language model and are customized with software, specific training data and unique feedback to apply the LLM’s analytical processes to specific data sets.

The most well-known of these LLMs is ChatGPT, a product developed by OpenAI. ChatGPT was unveiled to great fanfare in 2022 and has been steadily improved in the intervening years. In all of its iterations, ChatGPT has been able to produce stunningly human-like responses to queries and other prompts. The risk, therefore, is to avoid looking under the hood and treat the AI as another human employee.

To help understand how to review content produced by ChatGPT and other large language models, a good starting point is to ask the tool itself. Here is how ChatGPT-4 describes its function:

How It Works (Simplified)

1. Training Phase

- ChatGPT was trained on a **massive amount of text** from books, websites, articles, and other sources on the internet.
- It learned **patterns in language**, like grammar, facts, reasoning steps, writing styles, and how to respond to different kinds of input.
- It doesn't "know" facts like a database—it predicts the next word based on patterns it's seen.

2. Fine-Tuning

- After the initial training, it goes through a phase called **fine-tuning**, where it's taught to follow instructions and respond helpfully, safely, and conversationally.
- OpenAI also uses **Reinforcement Learning from Human Feedback (RLHF)** to improve responses by having real people rate different outputs.

3. When You Ask a Question

- You type something → ChatGPT breaks it down and processes it using math and neural networks → it generates a response based on what it predicts is the most likely, relevant, and useful reply.

The statistical, probabilistic and predictive approach described above is critical in understanding how the output of a large language model—or at least this large language model—should be reviewed. Certain (current) limitations of large language models are directly attributable to their approach to output generation.

For example, LLMs are often limited in their ability to address unique expertise, such as regulatory compliance or other specialized knowledge, because the underlying data sets may not contain the specialized information (or may contain conflicting information). To the extent the model is based on the Common Crawl or other snapshots of the Internet writ large, such data may not have had access to specialized knowledge hubs or be able to differentiate between regulatory approaches in different jurisdictions.

A similar issue arises with certain math questions. For example, ChatGPT is known to struggle with multiplication questions involving four or more digits:

What is 2458 x 3259?

Let's do the math:

$2458 \times 3259 = 8,012,122$



Let me know if you want a breakdown or need help with anything else!

As readers will undoubtedly know, the product of 2458 and 3259 is actually 8,010,622. However, the point here is not that artificial intelligence struggles with math: there are numerous AI tools that can solve complex mathematical equations at an ability far beyond most humans. The important consideration is *why* LLMs might struggle with certain math questions. If an AI tool or its underlying model has been trained on a “snapshot” of the Internet, it is predictable that some unique math questions will simply not be found in the training data, and if the purpose of the tool is not a mathematical one, there may be no need to layer additional mathematical processing abilities on top. This understanding of how the LLM functions will give a clearer target for a reviewer seeking to validate an output.

Similarly, because LLMs tend to be based on enormous data sets, their training tends to focus on deductive reasoning and methods of synthesizing and summarizing these vast quantities of information. This means that LLMs may struggle with other kinds of reasoning, such as inductive, analogical and abductive reasoning. While more recent iterations of ChatGPT have vastly improved the reasoning capabilities of the tool, users should closely review the output of tools that require human-like reasoning, an understanding of consciousness, common sense, or a sense of self. For example, if a tool is designed to pull summaries out of narrative sequences of events or make assumptions about the perspectives of participants in any narratives, users should ensure to verify the underlying information before taking specific action based on the tool’s output. As ChatGPT itself notes, it does not have true human “understanding”:

What It Can and Can’t Do

-  **Can:** Understand context, generate human-like text, write code, answer questions, simulate conversation, summarize info, etc.
-  **Can’t:** Access real-time info unless connected to the web (like I can be!), truly understand like a human, or remember things long-term unless you tell it to (like via custom instructions or memory).

4. Other Considerations and Risks

There are numerous other considerations that may go into the evaluation of the output of an AI tool. The potential legal risks are beyond the scope of this paper, including the confidentiality and data security concerns outlined above as well as copyright infringement in the data set or outputs. In particular, if the AI tool collects or processes customer or employee data, franchisors must ensure compliance with applicable laws such as Canada’s *Personal Information Protection and Electronic Documents Act*, the European Union’s *General Data Protection Regulation*, the *California Consumer Privacy Act*, and other sector-specific regulations.³⁴ This may include implementing data processing agreements with third-party vendors, providing clear privacy notices, and

³⁴ See: <https://www.osler.com/en/insights/updates/leveraging-ai-in-franchising-opportunities-and-legal-considerations/>.

outlining franchisee responsibilities regarding consent and data handling. Additionally, franchisors should thoughtfully assess the IP risks associated with AI, including the potential misuse of their own IP when training third-party models, and the risk that AI-generated outputs may infringe on third-party rights.³⁵

Some AI tools present the further risk of hallucinations or other misinformation finding its way into outputs. Depending on the use of the tool, franchisors may also need to assess any potential bias in the data sets or in the human fine-tuning that was applied to the foundation model to create guardrails around certain questions or responses.

For all of these reasons, franchisors should be particularly careful if they use an AI tool to make any representations to prospective or current franchisees, especially if any such outputs will be made in an FDD that can be the subject of significant liability. For example, in the six Canadian provinces that specifically regulate franchising,³⁶ a material deficiency in a disclosure document can provide franchisees with a statutory rescission right for two years after entering into the associated franchise agreement. While this rescission right is theoretically limited to situations where the franchisor has failed to provide a franchise disclosure document³⁷, Canadian courts have increasingly determined that certain deficiencies are so material that they are “fatal”, and the disclosure document that was provided is not considered to have been a disclosure document at all. The Canadian rescission remedy is severe: all agreements related to the franchise are rescinded, and the franchisor must effectively return the franchisee to the position they were in prior to entering the franchise agreement.³⁸ The financial exposure to the franchisor can be very substantial for even a single rescission. Outside of the rescission remedy, if a franchisee suffers a loss because of a “misrepresentation” contained in the disclosure document or a statement of material change or because of the franchisor’s failure to comply in any way with the disclosure requirements under franchise legislation, the franchisee has a statutory right of action for damages. These risks require that Canadian franchisors carefully scrutinize any tool that might make

³⁵ *Ibid.*

³⁶ Ontario, Alberta, Prince Edward Island, New Brunswick, Manitoba and British Columbia. Saskatchewan will soon be added to this list.

³⁷ See, for example, Section 6(2) of Ontario’s *Arthur Wishart Act (Franchise Disclosure)*, 2000, SO 2000, c 3 (the “**AWA**”).

³⁸ More specifically, if a franchisee validly rescinds the franchise agreement, within 60 days (30 days in Alberta) of the effective date of rescission, the franchisor or the “franchisor’s associate”, as the case may be, must: (a) refund to the franchisee any money received from or on behalf of the franchisee, other than money for inventory, supplies or equipment; (b) purchase from the franchisee any inventory purchased pursuant to the franchise agreement at a price equal to the purchase price paid by the franchisee; (c) purchase any supplies and equipment that the franchisee had purchased pursuant to the agreement at a price equal to the purchase price paid by the franchisee; and (d) compensate the franchisee for any losses incurred in acquiring, setting up and operating the franchise less the amounts of the purchase expended on the repurchase requirements. See, for example, Section 6(6) of the *AWA*.

representations to prospective, renewing or resale franchisees (whether in a disclosure document or otherwise).

In the United States, this is also a concern for AI tools that will be used for franchise development, such as chatbots and messaging platforms that may be used by prospective franchisees to understand the franchise opportunity and to learn about the franchisor's system. First, it is currently an open question whether such tools would—under certain circumstances—be construed as franchise “brokers” or “sellers” that must be registered before use in those states that have such requirements.³⁹ More important, under the FTC Rule, franchisors are generally restricted from discussing certain information, such as generally limiting any “financial performance representations” to information disclosed in Item 19 of the franchisor's current FDD.⁴⁰ Further, numerous state statutes—not to mention common law doctrines of fraud and negligent misrepresentation—prohibit franchisors from providing untrue or misleading information to prospective franchisees, and those statutes generally provide franchisees with a private cause of action to enforce their protections.⁴¹ Therefore, franchisors must take care that any franchise development tools will comply with these requirements and restrictions. This will include proper maintenance of data sources, such as, for example, restricting AI chatbot tools' information to the current FDD (and testing to make sure that is the case), rather than allowing it to draw information from outdated FDDs that could be incorrect or misleading under the circumstances.

5. Approach to Review

So how does a reviewer apply the information above to a particular output review? If the reviewer knows how the tool works and what its limitations are, it is far easier to spot potential areas of concern. For example, is the use of the AI tool relying on a specific type of reasoning? Is it relying on a large language model to answer questions that will not reasonably be within its training data (or a derivative thereof)? Is it conducting normative evaluations of job or loan candidates? The more the reviewer knows about how a tool functions, the more purposive they can be about reviewing any output.

³⁹ See, e.g. N.Y. Comp. Code. R. & Regs. Tit. 13 § 200.11 (New York); RCW 19.100.140 (Washington). Further, the North American Securities Administrators Association, Inc. (“NASAA”) has recently requested public comments for a proposed model franchise broker registration act that could be applied to regulate brokers and sellers in other states. N. Am. Sec. Admin. Ass'n, Request for Public Comment: Franchise Broker Act, (May 13, 2024), *available at* https://www.nasaa.org/wp-content/uploads/2024/05/Request-for-Public-Comment-Franchise-Broker-Act_5-13-2024.pdf.

⁴⁰ See 16 CFR § 436.1(e).

⁴¹ See, e.g. Cal. Corp. Code §§ 31201, 31301 (California); HAW. REV. STAT. §§ 482E—5(b), 9(b)-(c) (Hawaii); 815 Ill. Comp. Stat. Ann. §§ 705/6, 26 (Illinois); Ind. Code Ann. §§ 23-2-2.5-27, 28 (Indiana); Md. Code Ann., Bus. Reg. § 14-227 (Maryland); Mich. Comp. Laws Ann. §§ 445.1505, 1531 (Michigan); Minn. Stat. §§ 80C.13, 17 (Minnesota); N.Y. Gen. Bus. Law §§ 687, 691(1) (New York); N.D. CENT. CODE §§ 51-19-11, 12 (North Dakota); OR REV. STAT. § 650.020(1), (3) (Oregon); R.I. GEN. LAWS §§ 19-28.1-17, 21 (Rhode Island); S.D. CODIFIED LAWS §§ 37-5B-25, 49 (South Dakota); VA. CODE ANN. §§ 13.1-563, 571 (Virginia); Wash. Rev. Code §§ 19.100.0170, 190(2) (Washington); Wis. Stat. §§ 553.41, 51(1) (Wisconsin).

Conclusion

The main takeaway from this paper's survey of the uses of AI in franchising should be an appreciation of the breadth of possible uses. Nearly anything is possible. Nevertheless, franchisors must still do their due diligence on potential new tools and any prospective service providers. With the advent of AI tools in the market, service providers did an effective job of creating an "arms race" environment that forced many businesses to quickly decide on their approach to AI and how to maintain any competitive advantage. However, with the benefit of time and a maturing pool of AI tool providers, franchisors should take the time to explore the market and find the tool that meets their needs. While this may be an "off the shelf" option, franchisors should consider the potential to customize the tool for their particular requirements.

To summarize the practical and legal considerations that franchisors should keep in mind when creating or acquiring an AI tool, we will divide the "takeaways" into their respective places on our "timeline" of AI implementation.

Deciding to Purchase an AI Tool

In deciding to purchase an AI tool, each franchisor and franchise system will have specific practical and legal considerations that take precedence. Nevertheless, the majority of concerns are likely common across various franchise systems, and we recommend franchisors keep the following general principles in mind:

- ***Know What You Want:*** Who will be using it? What goes in and comes out of the tool? Will it be internal or external? Who owns what? What do you need it to do? What is simply "nice to have"?
- ***Know What Resources You Need:*** What's the cost? What's the opportunity cost? What training will be required? What equipment will be required and how much of an obstacle is integration? What role do you need a service provider to play? A detailed project plan and budget will set you up for success.
- ***Contract Carefully:*** Ensure you control data ownership, recognize any legal risks, and protect yourself appropriately.

Implementing an AI Tool

When the franchisor moves into the implementation stage for the chosen AI tool, franchisors should keep the following general principles in mind:

- ***Know What Your Franchise Agreement Says:*** What are you allowed to do? What does the system change or IT language say? What does your renewal language allow? How are technology costs addressed? How strong is your confidentiality provision?

- **Know the System Impact:** How will the tool integrate with the existing systems? How will the rollout be structured? How will costs be allocated? How will franchisees react?
- **Develop an AI Policy:** Ensure you have a flexible but enforceable policy and update it regularly.

Using an AI Tool

Finally, while acknowledging the diversity of potential AI tools and needs, we wish to highlight the following three main takeaways for when a franchisor (or any of its authorized users in a franchise system) is using an AI tool:

- **Experiment:** New AI tools are being developed and improved every day. Maintain a policy of constant experimentation and testing to determine how various tools can improve your business.
- **Know the Tool Inside and Out:** Avoid the “black box” effect by understanding how the tool functions. This will not only improve tool outputs, but it will improve your ability to review such outputs and consequently lower any associated risk.
- **Human Vigilance:** Review all AI-generated content with its capabilities and limitations in mind. Consult internal and external legal teams to ensure the risk inherent in the fluid AI environment is being appropriately managed.

Indulge! AI is an incredible tool with limitless potential. However, you must ensure that you understand the specifics of your tool, its impact on key relationships, data ownership and flows, the regulatory environment, and the risk balancing in any associated contracts. Franchisors already know how to evaluate the introduction of new technologies into the complex collection of relationships that comprise franchise systems. Similarly, legal teams already know how to negotiate the risk balancing in any technology contracts with service providers. While artificial intelligence introduces some unique tools and possibilities—and some new risks—the fundamental approach to determining key performance metrics and return on investment remains the same. Provided franchisors do not shy away from the complexities underlying artificial intelligence and apply the same rigor to AI tools as they do to other technologies, the opportunities are too enticing to avoid.