International Franchise Association
56th Annual Legal Symposium
May 5-7, 2024

In-House Counsel Intensive (for In-House lawyers only)

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PRACTICAL ADVICE FOR IN-HOUSE COUNSEL

INTRODUCTION

The role of the in-house counsel is to help business leaders navigate the grey areas that result from a constantly changing legal landscape. This requires that you stay informed about developments in many areas of law that could apply to your company and industry, and then translate that knowledge into understandable and practical approaches to emerging issues. This paper provides some historical legal background, as well as recent legal developments, in a wide variety of areas applicable to in-house counsel for franchisors and franchisees. We have also provided some practical approaches and commentary that will help you navigate situations that commonly arise in franchised businesses.

EMPLOYMENT AND JOINT EMPLOYER

A. Significant employment legal concepts in franchising

For decades, workers and franchisees, though under some degree of control of a third party – an employer or franchisor – were almost universally considered different under the law. Workers were considered employees and not independent contractors when the employer exercised sufficient control. Franchisees, on the other hand, were considered independent contractors, not employees, although the franchisor was expected to exercise a significant degree of control over the franchise operations. The idea that a franchisee (and franchisee's employees) would be an employee of the franchisor (i.e., "misclassification") or that franchisee's employees would be jointly employed by the franchisor (i.e., "joint employment") were not serious considerations, so long as care was taken by the franchisor to not exercise too much control of the day-to-day operations.

Over the last 10 to 15 years, the worries about misclassification and joint employment that had been largely academic concerns by franchise lawyers became reality. Massachusetts cases in 2006 and 2010 involving the Coverall franchise system held the franchisee to be an employee of the franchisor under state's ABC test (discussed below).[1] These cases successfully challenged the commonly accepted notions that franchises and employee were different and potentially ushered

[1] Coverall N. Am, Inc. v. Comm'r of the Div. of Unemployment Assistance, 447 Mass. 852, 857 N.E.2d 1083 (2006). *Awuah v. Coverall North America, Inc*., 707 F.Supp.2d 80 (D. Mass. 2010).

in a wave of other cases challenging the independent contractor relationship. At about the same time, the political landscape changed, resulting in more political acceptance to breaking down the traditional distinctions between independent contractors and employees, to greater regulation of businesses typically franchised, and to easing of the standards to unionize. For example, when California Governor Gavin Newsom signed Assembly Bill 5, codifying the ABC test in California law rather than the long-used judicially developed test, the legislature and Governor signaled their support for both finding more workers to be employees and signaled the Governor's his future support of easier efforts to unionize.

> "Assembly Bill 5 is landmark legislation for workers and our economy. . . . Assembly Bill 5 is an important step. A next step is creating pathways for more workers to form a union, collectively bargain to earn more, and have a stronger voice at work. . . ."[2]

Governor Newsom went on in his statement to say that he will move forward to "[step] in where the federal government has fallen short and granting workers excluded from the National Labor Relations Act the right to organize and collectively bargain."[3]

i. Trends in Employment Case Law

As noted above, the determination of whether a worker is an independent contractor or employee was historically based on common law and judicially constructed rules. The magnitude of the significance of the current trend toward ABC-type tests rather than a test that looks at control of the means and manner of accomplishing the result desired (plus a multi-factor test) should be viewed first from the state of the law pre-ABC test.

California, for example, had a multi-factor test, the Borello test, that was articulated in *S. G. Borello & Sons, Inc. v. Department of Industrial Relations.*[4] The primary test is the right to control the manner and means of accomplishing the result desired, modified by a long list of secondary factors. For more than seven decades, some form of the multi-factor common law test was used in California to separate independent contractor and employment relationships. California developed a different test for determining whether there was an employment relationship with an entity that had not directly hired the worker. In *Martinez v. Combs,*[5] strawberry pickers on a farm sued the companies that purchased the strawberries from their employer after

[2] Governor Gavin Newsom, signing statement, September 18, 2019
[3] *Id.*
[4] 48 Cal. 3d 341, 769 P.2d 399 (1989).
[5] 49 Cal. 4th 35, 231 P.3d 259 (2010).

their employer failed to pay them. In *Martinez,* the California Supreme Court held that the strawberry buyers had not hired, fired, or supervised the strawberry pickers and, therefore, were not their employers.

The franchise relationship added an additional wrinkle to the analysis. Once franchisors gave up control over the franchisees' employees, California courts have respected the franchise model and insulated franchisors from typical claims by franchisee employees. The franchise model was specifically addressed in *Patterson v. Domino's Pizza, LLC.*[6] The California Supreme Court concluded that a franchisor is liable for the actions of franchisees' employees "only if it has retained or assumed a general right of control over factors such as hiring, direction, supervision, discipline, discharge, and relevant day-to-day aspects of the workplace behavior of the franchisee's employees."[7] Thus, until 2018, California courts applied the Borello test multi-factor test to determine if there was an independent contractor relationship, the *Martinez v. Combs* test to determine whether an "irregular working arrangement" qualified as an employment relationship, and the so-called Patterson Gloss articulated in *Patterson v. Domino's Pizza, LLC*.

In 2018, in *Dynamex Operations West, Inc. v. Super. Ct. of Los Angeles,* California law was changed to adopt the ABC test from Massachusetts.[8] Then in 2020, California Assembly Bill 5 ("AB-5") codified the *Dynamex* ABC test for purposes of the California labor code.[9] California Labor Code §2775 provides:

> (a) (1) *For purposes of the provisions of this code* and the Unemployment Insurance Code, *and for the wage orders* of the Industrial Welfare Commission, a person providing labor or services for remuneration shall be considered an employee rather than an independent contractor unless the hiring entity demonstrates that all of the following conditions are satisfied:
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> (A) The person is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact.

[6] 60 Cal. 4th 474, 333 P.3d 723 (2014).
[7] Patterson v. Domino's Pizza, LLC, 60 Cal. 4th 474, 497-98 (2014).
[8] Dynamex Operations West, Inc. v. Super. Ct. of Los Angeles 4 Cal. 5th 903 (2018)
[9] California, Illinois, Massachusetts, New Hampshire, and New Jersey have each adopted a version of the ABC test.

(B) The person performs work that is outside the usual course of the hiring entity's business.

(C) The person is customarily engaged in an independently established trade, occupation, or business of the same nature as that involved in the work performed.

. . .

(3) If a court of law rules that the three-part test in paragraph (1) cannot be applied to a particular context based on grounds other than an express exception to employment status as provided under paragraph (2), then the determination of employee or independent contractor status in that context shall instead be governed by the California Supreme Court's decision in *S. G. Borello & Sons, Inc. v. Department of Industrial Relations* (1989) 48 Cal.3d 341 (*Borello*).

Although the legislative adoption of the ABC test in the California Labor Code includes numerous exemptions, none address franchising.

Over the last several years, we have seen a number of cases address the ABC test in franchising or franchising-like circumstances. Below is a brief discussion of the cases.

In *Vazquez v. Jan-Pro Franchising Int'l, Inc.*[10] the Ninth Circuit reversed the district court's decision and remanded *Vazquez* for further proceedings. Initially, the district court concluded that, because there was no direct contractual relationship between Vazquez and Jan-Pro, the *Martinez v. Combs* test applied. The district court had accordingly applied the *Martinez* test with the Patterson Gloss, concluding that there was no employment relationship between Vazquez and Jan-Pro. The Ninth Circuit began its analysis with a review of the *Dynamex* decision, which it believed had clarified and expanded the meaning of "suffer or permit" in wage order cases. The court concluded that, under *Dynamex*, a "hiring entity" "'suffers or permits' a putative employee to work if the hiring entity cannot overcome the 'ABC test.'"

The *Vazquez* court gave an example where Company A contracts with Company B for services, and Company B then enters into agreements to perform work. Ordinarily, Company A would not be liable for misclassification of third-party workers because *Company B* would be the

[10] Vazquez v. Jan-Pro Franchising Int'l, Inc., 923 F.3d 575, 579 (9th Cir.), *reh'g granted, opinion withdrawn*, 930 F.3d 1107 (9th Cir. 2019), *and on reh'g*, 939 F.3d 1045 (9th Cir. 2019), *certified question answered*, 10 Cal. 5th 944, 478 P.3d 1207 (2021), and *opinion reinstated in part on reh'g*, 939 F.3d 1050 (9th Cir. 2019)

"agent of any misclassification." However, where Company A "*designed and implemented the contractual framework*" then Company A is the "agent of misclassification" and may be directly liable under the ABC test. The court concluded that, "as a doctrinal matter, Jan-Pro could be Plaintiffs' employer under the ABC test even though it is not a party to any contract with Plaintiffs."[11] The court saw no reason why the test for employee status must necessarily be the same in wage order cases and vicarious liability cases. The court concluded that "the franchise context does not alter the *Dynamex* analysis, and the district court *need not* look to *Patterson* in applying the ABC test."[12] *Vazquez* instructed the district court to consider whether Jan-Pro's business model "relies on unit franchisees continuously performing services."[13] In analyzing Prong B of the ABC test, the district court was to consider how the franchised business described itself. To help that analysis along, the court noted that Jan-Pro's websites and advertisements say it is in the business of cleaning. The court was dismissive of claims that Jan-Pro was in the franchising business.

Curry v. Equilon Enterprises, LLC [14] analyzed a licensing arrangement between Equilon and its licensee.[15] Curry, who had been hired by the licensee, brought a misclassification claim against Equilon. The court held that Equilon "was not in a position to terminate Curry or hire a different person to perform the tasks Curry performed."[16] There was, therefore, no employment relationship between Curry and Equilon. The court determined that the ABC test was meant to resolve the issue of "whether employees were misclassified as independent contractors. . . [I]t does not appear that the Supreme Court intended for the 'ABC' test to be applied in joint employment cases."[17] The *Curry* court concluded that the ABC test was *not* meant to apply to the relationship between Curry and Equilon. The court also analyzed the facts under the ABC test and determined that Equilon met none of the prongs of the ABC test.

In *Moreno v. JCT Logistics, Inc.*,[18] a non-franchise misclassification case, a truck driver had been hired by more than one of several related trucking companies. The court viewed the case as a joint employment claim. The *Moreno* court was uncertain as to the relationship between the

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[11] *Id.* at 596 .
[12] *Id.* at 595 (emphasis added)
[13] *Id.*
[14] 23 Cal. App. 5th 289, 293, 233 Cal. Rptr. 3d 295, 297 (2018), *as modified on denial of reh'g* (May 18, 2018), *review denied* (July 11, 2018).
[15] *Id.* at 316, fn. 1.
[16] *Id.* at 311.
[17] *Id.*
[18] No. EDCV172489JGBKKX, 2019 WL 3858999 (C.D. Cal. May 29, 2019).

various defendant parties and, therefore, could not tell whether there was a primary employer responsible for the plaintiff's basic wage and hour claims. The court felt that, if there was no primary employer, the reasoning of the court in *Curry* should not apply. The *Moreno* court concluded that the *Dynamex* ABC test now applies to *all* employers, including joint employers.

In *Henderson v. Equilon Enterprises, LLC*,[19] the court considered the same type of relationship in a misclassification claim. It also concluded that the ABC test "does not fit analytically with and was not intended to apply to claims of joint employer liability."[20] The court held that the test for irregular relationships under *Martinez* still governed, and the burden for establishing an employment relationship remained with the putative employee.

In *Salazar v. McDonald's Corp*.,[21] employees of McDonald's franchisees claimed to also be McDonald's direct employees. The court in *Salazar* understood that "Plaintiffs are [the franchisee's] employees," determining that "the relevant question is whether they are also McDonald's employees."[22] The district court in *Vazquez* had taken the same approach, but the Ninth Circuit in *Vazquez* had disregarded the issue of whether there was a putative primary employer. The court found "no evidence that McDonald's had the requisite level control over Plaintiffs' employment to render it a joint employer under the principles set forth in *Martinez*, *Curry*, and other applicable California precedents."[23]

In *Cruz v. MM 879, Inc*.,[24] Merry Maid franchisees claimed that the ABC test should be applied to their relationship with their franchisor. The court disagreed, citing *Salazar, Curry* and *Henderson* as "well-reasoned decisions" holding that *Dynamex* was irrelevant to the question of whether a franchisor was a joint employer of a franchisee's employees. The court ruled that, as in *Curry,* no parties claimed to be misclassified independent contractors. The court ruled that it was obligated to follow the rulings of the state's intermediate appellate courts in *Curry* and *Henderson* and dismissed the claims against Merry Maid.

Matco Tools franchisees brought a class action asserting that they had been misclassified as independent contractors. The franchisor sought to invoke the Patterson Gloss, but the court refused, distinguishing *Patterson* on the basis that *Patterson* was a vicarious liability case. The

[19] 40 Cal. App. 5th 1111, 253 Cal. Rptr. 3d 738 (2019).
[20] *Id.* at 1125.
[21] 944 F.3d 1024 (9th Cir. 2019).
[22] *Id.* at 1032.
[23] *Id.*
[24] No. 115CV01563TLNEPG, 2020 WL 6938843, *3 (E.D. Cal. Nov. 25, 2020).

court further cited *Vazquez* for the proposition that "the franchise context does not alter the *Dynamex* analysis."[25] The court also held that "the term 'hiring entity' does not create a separate threshold inquiry into whether the ABC test applies at all to a particular entity.

In *Salinas v. Cornwell Quality Tools Co*.,[26] a tool maker that distributed tools through a franchised distribution network was sued for misclassification of its franchisees. Nearly all of Cornwell's sales were made by franchisees. The first issue addressed was whether the ABC test or the *Borello* test applied. The franchisor cited California Labor Code § 2775(b)(3), which allows a court to apply the *Borello* test if the court determined that the ABC test could not be applied. The court declined to rule that the ABC test could not be applied. On summary judgment, the court, interpreting the evidence in a manner most favorable to the defendant found there were triable issues of fact on the A element, as to whether Cornwell reserved the requisite degree of control and direction over its dealers. The court also refused summary judgment on the B element, because a reasonable jury could conclude that Cornwell's business was manufacturing and wholesaling professional quality tools, rather than direct sales of products to end-user consumers.

ii. California's Legislative Intervention – Employment Trends

The Fast Act

In September 2022, Governor Newsom signed AB 257, the Fast Food Accountability Standards Recovery Act (the "Fast Act"). The Fast Act was the product efforts of multiple labor organizations to unionize the restaurant industry in California or create a government mandated system to essentially unionize a sector of workers. The Fast Act's stated purpose is to establish a "Fast Food Sector Council" and set industry-wide standards on minimum wage, working hours, and working conditions to promote the "health, safety, and welfare" of fast-food workers in California, including by ensuring their wages align with the cost of living. The Fast Act covered virtually all counter service restaurants that were part of a chain of 100 or more establishments nationally.

Of great concern to the franchise industry was the act's initial inclusion of a joint liability provisions, which made ever franchisor covered by the Fast Act a joint employer and liability for

[25] *Fleming v. Matco Tools Corporation, et al.* 384 F.Supp.3d 1124 (Cal.N.D. 2019)
[26] No. 519CV02275FLASPX, 2022 WL 16735359 (C.D. Cal. Oct. 17, 2022).

labor code violations. In addition, indemnification by the franchisee for violations was made unenforceable by virtue of the statute. These provisions were removed shortly before the statute was passed by the legislature.

In short order, the Fast Act was the subject to a referendum campaign that led to the legislature passing AB 1228. AB 1228 provided that it would replace the Fast Act if the referendum was withdrawn by January 1, 2024. The referendum was withdrawn and AB 1228 became law.

AB 1228

AB 1228, the Fast Food Franchisor Responsibility Act, applies to "National Fast Food Chains"— a set of limited-service restaurants consisting of more than 60 establishments nationally that share a common brand, or that are characterized by standardized options for decor, marketing, packaging, products and services. They are primarily engaged in providing food and beverages for immediate consumption on or off premises, where patrons generally order or select items and pay before consuming, with limited or no table service. Limited service restaurants include, but are not limited to an establishment described by NAICS 722513 (limited-service restaurant). The definition of limited service restaurant in AB 1228 excludes bakeries and restaurants located inside a grocery store. Other exemptions, mainly based on the location of the restaurant, are pending at the California legislature.

AB 1228 creates the Fast Food Council within the Department of Industrial Relations, which has limited authority compared to the Fast Food Council that was to be established by the in the now-repealed FAST Act. The Fast Food Council may also adjust the hourly minimum wage each year pursuant to specific parameters, and may set forth requirements, limitations and procedures for adopting and reviewing fast food restaurant health, safety, and employment standards (subject to the various administrative procedures).

AB 1228 increases the minimum wage for employees of Fast Food Restaurant Employees to $20 per hour, effective April 1, 2024. Thereafter, the Fast Food Council may increase the minimum wage on an annual basis by no more than the lesser of one of the following, rounded to the nearest ten cents: 3.5% or the percentage increase in the Consumer Price Index.

Labor unions secured an exemption, so that a collective bargaining agreement may supersede AB 1228, if the agreement expressly provides for the wages, hours of work and working

conditions of the employees as well as a regular hourly rate of pay not less than 30 percent more than the "state minimum wage." The notable win for the franchise industry was that the final version of AB 1228 did not include the joint liability for franchisees' violation of various employment and labor laws.

AB 1076

Although AB 1076 seemingly would be inapplicable to the franchise relationship because it expressly applies to employees, the provisions of the law with respect to the enforceability of non-competes in employment agreements may extend to the terms of franchise agreements. These provisions may include terms in some franchise agreements that require a franchisee to enter into a restrictive covenant agreement (non-compete, non-solicit, etc.) with a worker.

The amendments to California law adopted by AB 1076, which are supposed to mirror what the legislature deemed to be California's existing ban on non-competes in employment contexts. California is not alone on this type of ban, but, as discussed below, goes further than some other states. Minnesota,[27] California,[28] North Dakota,[29] Oklahoma,[30] and Washington, D.C.[31] ban non-competes in some form with respect to employees. Other states, such as Illinois, Maryland, Oregon, and Virginia have limited the application of restrictions to lower earning workers.[32]

The new provisions of California law void any noncompete agreement (which may include non-solicitation clauses that are not tied to the protection of trade secrets and some employee non-solicitation agreements) no matter how narrowly drafted. The amended provisions of California law provide: "Any contract that is void under this chapter is unenforceable regardless of where and when the contract was signed." The ban applies "regardless of whether the contract was signed and the employment was maintained outside of California." Additionally, employers are affirmatively prohibited from entering into noncompetition agreements (existing law established that noncompetition agreements were void against public policy, but there was no affirmative

[27] Minn. Stat. Ann. § 181.988.
[28] Cal. Bus. & Prof. Code § 16600.
[29] N.D. Cent. Code Ann. § 9-08-06.
[30] Okla. Stat. Ann. tit. 15, § 217.
[31] D.C. Code Ann. §§ 32-581.01 – 32-581.05.
[32] Ivy Waisbord, *Prohibitions on Non-Compete Agreements for Low-Wage Works,* ABA PRACTICE POINTS, https://www.americanbar.org/groups/litigation/committees/business-torts-unfair-competition/practice/2022/prohibitions-on-non-compete-agreements-low-wage-workers/ (last visited Aug. 3, 2023).

prohibition) or from attempting to enforce a noncompetition agreement. Franchisors should be mindful of provisions in agreements or manuals that require non-compete agreements to be signed by franchisee employees.

iii. Labor and Employment – The Federal Gloss

NLRB Joint Employer Rule

On October 27, 2023, the NLRB published a final rule addressing the Standard for Determining Joint-Employer Status (the "Joint Employer Rule"). The final rule establishes that, under the National Labor Relations Act, two or more entities may be considered joint employers of a group of employees if each entity has an employment relationship with the employees, and if the entities share or codetermine one or more of the employees' essential terms and conditions of employment. The Joint Employer Rule was vacated by a federal district court in Texas on March 8, 2024. It is important to have a brief discussion of the Joint Employer Rule, notwithstanding that it was vacated, if the NLRB looks to resurrect the Joint Employer Rule in some form.

The final rule rescinds and replaces the 2020 final rule that was promulgated by the prior Board and which took effect on April 27, 2020. The Joint Employer Rule considers the alleged joint employers' authority to control essential terms and conditions of employment, whether or not such control is exercised, and without regard to whether any such exercise of control is direct or indirect. The Joint Employer Rule considers the following seven factors when determining the essential terms and conditions of employment:

1. wages, benefits, and other compensation;
2. hours of work and scheduling;
3. the assignment of duties to be performed;
4. the supervision of the performance of duties;
5. work rules and directions governing the manner, means, and methods of the
6. performance of duties and the grounds for discipline;
7. the tenure of employment, including hiring and discharge; and
8. working conditions related to the safety and health of employees.

If an alleged employer has the authority control at least one of these terms or conditions, joint employer status can be found. Authority to control a term or condition can be found if an alleged joint employer maintains authority to control essential terms and conditions of employment but has not yet exercised such control. Similarly, the required authority can be found indirectly if an intermediary or third party has the authority.

If joint employer status is found then it will be required to bargain over those particular essential terms and conditions as well as all other mandatory subjects of bargaining that it possesses or exercises the authority to control.

Department of Labor Independent Contractor Rule

On January 9, 2024, the Department of Labor (DOL) announced a six-factor test for determining whether a worker is an employee or an independent contractor under the Fair Labor Standards Act (FLSA) (the "DOL Rule"). The DOL Rule adopts a six-factor economic interest test to determine whether a worker qualifies as an independent contractor. The DOL expressly declined to adopt an ABC test. The six factors of the DOL Rule are:

1. opportunity for profit or loss depending on managerial skill;
2. investments by the worker and the potential employer;
3. degree of permanence of the work relationship;
4. nature and degree of control;
5. extent to which the work performed is an integral part of the potential employer's business; and
6. skill and initiative.

These factors, however, are not exhaustive. The analysis utilizes a totality-of-the-circumstances economic reality approach, which allows consideration of other relevant, but not named, factors, which "in some way indicate whether the worker is in business for themselves." Where the worker is dependent on the employer for work, they will not qualify as an independent contractor under this rule.

The DOL Rule has no effect on other laws—federal, state, or local—that use different standards for employee classification. The FLSA does not preempt any other laws that protect

workers. Businesses must comply with all federal, state, and local laws that apply and ensure that they are meeting whichever standard provides workers with the greatest protection.

Franchisors should examine the terms of their agreements and standard operating procedures through the lens of the DOL Rule. In addition to the six factor test, franchisors should ask themselves:

- Does the franchise system in question require a franchise to make entrepreneurial decisions or capital investments suggesting operation of an independent business?
- Does the franchisor set the franchisee's schedule, supervise their performance, or control the economic aspects of the relationship?
- Is the function that the franchisee performs critical, necessary, or central to the franchisor's principal business?
- Is the franchisee dependent on training from the franchisor to perform the work? Is the worker using specialized skills in connection with business-like initiative?

iv. Wage Issues

Under the Fair Labor Standards Act (FLSA), employers must provide overtime pay to employees at one and one-half times an employee's regular pay rate for every hour the employee works beyond 40 hours in a workweek, unless the employee falls within a specified exemption. Under current U.S. Department of Labor (DOL) regulations, exempt employees include executive, administrative, professional, and computer employees who perform certain duties, and earn at least $684 per week ($35,568 annually). Highly compensated employees who perform office or nonmanual work and are paid a total annual compensation of $107,432 are also exempt.

The DOL Wage and Hour Division published a notice of proposed rulemaking that would increase the standard salary level and the highly compensated employee total annual compensation threshold for an employee to be exempt from the overtime requirements of the FLSA. This proposed overtime rule — Defining and Delimiting the Exemptions for Executive, Administrative, Professional, Outside Sales and Computer Employees — would (1) increase the standard salary level requirement for executive, administrative, professional, and computer employees from $684 to $1,059 per week ($55,068 annually); (2) increase the annual salary threshold requirement for highly compensated employees from $107,432 to $143,988; and (3) automatically raise these salary thresholds every three years based on current earnings data.

MARKETING AND CURRENT TECHNOLOGY

A. Data Ownership and Control

In a franchise system, most consumer data is typically collected by a website or mobile application controlled by the franchisor to ensure the customer has a uniform brand experience and to centralize data collection and sharing for efficiency.[33] The franchisor then uses and shares the data with franchisees and others for the benefit of the entire franchise system.[34] Often times, the franchisors require the franchisees to collect information for the franchisor's use, in addition to data the franchisee collects on their own.[35] Franchisees generally prefer to own their customer data and use it to market to their customers, and may resist franchise agreements that give franchisors control of such data.[36] But to the extent that a franchise relationship vests in the franchisor contractual control over the franchise operations, the plaintiff may seek to impute legal liability for alleged data privacy and security issues at the franchise level to the franchisor. This exposure can be significant as the number of customer records grows. So franchisors in industries that collect large amounts of customer data through reservation systems or customer-facing websites or apps, such as the hotel and restaurant industries, generally attempt to control the customer data and work with franchisees to align on effective marketing approaches. This is done in part to reduce liability under the privacy laws,[37] and in part to ensure a consistent customer experience.

When both the franchisees and the franchisor collect and use customer data, or when that data is exchanged between them, all parties will need to ensure that they are in compliance with the applicable federal and state laws that establish privacy and security policies.

B. Use of AI

Artificial intelligence ("AI") is computer systems that are designed to replicate human intelligence, AI systems can learn, reason, and make decisions on their own, as well as quickly generate content such as images and videos based on simple prompts. This emerging functionality

[33] https://www.franchisewire.com/data-privacy-compliance-for-franchise-systems-in-2023/
[34] Id.
[35] Id.
[36] Id.
[37] https://www.dorsey.com/newsresources/publications/2008/03/protecting-personal-data-in-franchise-systems-ne__#:~:text=Franchisor%20Concerns,franchisors%20control%20of%20such%20data.

makes these systems attractive to franchisor marketing departments and enterprising franchisees who want to creatively market their locations.

AI is here to stay and has now been adopted by more than one third of businesses in the United States.[38] It has the potential to transform how companies approach many aspects of their businesses, including marketing and promotion of products and services. We more fully address the potential uses of AI in franchised businesses, as well as security and privacy considerations raised by its use, later in this paper.

C. Direct to Consumer Marketing Franchisors and franchisees both understand the growing importance of reaching customers with relevant messages that build brand loyalty and spur purchases of goods and services, and successful advertising strategies benefit both franchisors and franchisees. Contests and sweepstakes are often promoted to drive traffic to mobile apps, and new forms of advertisement are centered around automated text messages along with digital platforms, such as the social media application TikTok.

Promotions, Sweepstakes and Contests. Promotions, sweepstakes, and contests are regulated at both the federal and state level. A sweepstake is a promotion where prizes are given to individuals at random, while a contest is promotion that awards prizes based on skill. Sweepstakes and contests are regulated by the Federal Communications Commission (FCC), the FTC, and the U.S. Postal Service. The FCC's Contest Rules require that radio and television broadcast licensees disclose on air any material terms of any contests that they broadcast.[39] In 2015, the FCC expanded this rule by allowing the broadcasters to disclose material contest terms either on air, or on the internet.[40] If the latter, then the written disclosure must be on the station's website, the licensee's website, or any website that is readily accessible to the public if neither the individual station nor the licensee has its own website.[41] In addition, the station must also have a conspicuous link or tab to the material contest terms on its website's homepage, periodically announce on air the availability of material contest terms on the website, identify the web address

[38] https://www.bclplaw.com/en-US/events-insights-news/2023-state-by-state-artificial-intelligence-legislation-snapshot.html
[39] 47 C.F.R. § 73.1216.
[40] *Id*.
[41] *Id*.

where the terms are posted, and maintain material contest terms on the website for at least thirty days after the contest has concluded.[42]

The FTC's Telemarketing Sales Rule requires that telemarketing calls used to promote a contest or sweepstakes contain certain disclosures such as: the odds of winning; a statement that no purchase or payment is required to win the prize or to participate in the promotion; a statement that any payment will not increase the person's chances of winning; instructions on how to participate, or an address or local or toll-free telephone number to which the customers may write or call for information on how to participate; and all material costs or conditions to receive or redeem the prize.[43]

Several states also have additional bonding and filing requirements. The bonding requirement protects consumers in that it guarantees payment of the prizes offered. For example, Florida regulations require a sponsor to post a bond and register any sweepstake for consumer products or services at least seven days before the start of the sweepstake if the total value of the prize is over five thousand dollars.[44] Similarly, New York regulations require that a sponsor post a bond and file a statement with the secretary of state at least thirty days before any sweepstakes for consumer products, if the value of the prize is over five thousand dollars.[45] Although Rhode Island does not have a bond requirement, it does have a registration requirement for "retail business" promotions if the total value of the prizes offered is more than five hundred dollars.[46] Moreover, certain states such as Colorado, Florida, Maryland, North Dakota, and Washington expressly prohibit entry fees.[47]

Text Messaging – TCPA. In 1991, Congress enacted in 1991 the Telephone Consumer Protection Act (TCPA) in an effort to address a growing number of telephone marketing calls.[48] The TCPA restricts the making of telemarketing calls and the use of automatic telephone dialing systems and artificial or prerecorded voice messages, and applies to common carriers as well as to other marketers.[49] In *Facebook, Inc. v. Duguid*, 592 U.S. 395, 399 (2021), the Supreme Court held

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[42] *Id*.
[43] 16 C.F.R. § 310.3(a)(1).
[44] FLA. STAT. ANN. § 849.094.
[45] N.Y. GEN. BUS. LAW § 369-e.
[46] 11 R.I. GEN. LAWS § 11-50-1.
[47] *See* COLO. REV. STAT. § 6-1-803; FLA. STAT. § 849.094(2)(e); MD. COM. LAW § 13-305(b); N.D. CENT. CODE § 53-11-02(1); WASH. REV. CODE § 9.46.0356.
[48] FEDERAL TRADE COMMISSION, FCC ACTIONS ON ROBOCALLS, TELEMARKETING, https://www.fcc.gov/general/telemarketing-and-robocalls.
[49] Id.

that the TCPA bars automated texts and calls *only* to randomly or sequentially generated telephone numbers.[50] Accordingly, businesses that contact consumers by using actual telephone numbers acquired by the advertiser could not be liable for communications to consumers under the TCPA.

In *Turizo v. Subway Franchisee Advert. Fund Tr. Ltd.*, a Florida federal court rejected the Subway Franchisee Advertising Fund's motion to dismiss a putative class action alleging its sales text messages violated Florida Telephone Solicitation Act (FTSA).[51] The court held that Supreme Court's decision in *Facebook, Inc. v. Duguid* did not bar the plaintiff's claims because the FTSA does not narrowly define an autodialer to randomized or sequential number similar to the TCPA.[52] Further, *in 2022, Beverly DeShay v. Keller Williams Realty, Inc.*, the plaintiff filed a class action complaint against the defendant Keller Williams Realty, Inc. for the alleged violations of the TCPA by making unsolicited, pre-recorded calls to consumers without their consent.[53] On April 2023, a Florida state court granted final approval to a $40 million settlement agreement.[54]

Franchisors and franchisees must know and understand the TCPA. To the extent the franchisor outsources marketing to third parties, the franchisors engaging third parties must know and understand the TCPA standards.

Social Media Use Issues - TikTok. Franchise brands should leverage their social media platforms in order to create opportunities to engage with their consumers. Social media has given businesses, especially franchises, new ways of advertising their product or services. The advantages of social media include lower costs and the ability to quickly distribute advertisements. Adverting through the social media application, TikTok, is quickly becoming a popular advertising strategy.

TikTok is a mobile application where users can post, share and watch short-form videos. In terms of downloads, TikTok has been the top app in the United States for each quarter since 2021, and the top app worldwide in the first quarter of 2022.[55] TikTok's "For You" feed allows

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[50] Facebook, Inc. v. Duguid, 592 U.S. 395, 399 (2021)
[51] Turizo v. Subway Franchisee Advert. Fund Tr. Ltd., 603 F. Supp. 3d 1334, 1338 (S.D. Fla. 2022)
[52] Id. at 1343.
[53]https://www.realtytcpa.com/home/2589/DocumentHandler?docPath=/Documents/DeShay_v_Keller_Williams_Realty_Complaint.pdf
[54] https://www.realtytcpa.com/home/2589/DocumentHandler?docPath=/Documents/Final_Approval_Order.pdf; see also https://www.realtytcpa.com/home/2589/DocumentHandler?docPath=/Documents/Deshay_v_Keller_Williams_Settlement_Agreement.pdf
[55] Lauren Forristal, *TikTok Was the Top App by Worldwide Downloads in Q1 2022*, TECHCRUNCH (Apr. 26, 2022), https://techcrunch.com/2022/04/26/tiktok-was-the-top-app-by-worldwide-downloads-in-q1-2022/.

users to scroll through short videos uploaded by other creators. The videos that end up on each user's "For You" feed are based on the users' previous activity history. Accordingly, TikTok's algorithm gives every video a chance to go viral regardless of the creator's popularity.[56]

Franchises can advertise by directly uploading their own videos on TikTok that could potentially land on millions of users' feeds. For example, Crumbl is a gourmet cookie franchise that started in October 2017 and grew to over two hundred stores in over thirty states, with franchisees opening eighty-four stores in 2020 alone.[57] The franchise uses its social media accounts in order to reveal its weekly cookie flavors to its 2.7 million Instagram followers and 5.7 million TikTok followers.[58] The franchise claims that it does not advertise its franchising program and everything has simply been word of mouth.[59]

ARTIFICIAL INTELLIGENCE

A. What is AI or Artificial Intelligence?

There are many different definitions, which are certainly subject to change as AI continues to develop, but a basic definition is "software and/or hardware that can learn to solve complex problems, make predictions or undertake tasks that require human-like sensing (such as vision, speech, and touch), perception, cognition, planning, learning, communication, or physical action."[60]

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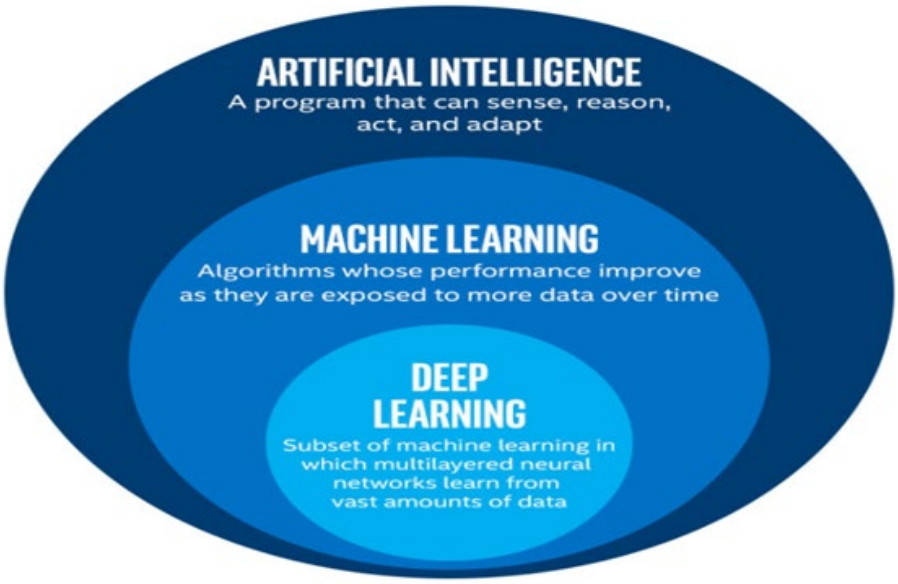
[56] Zarnaz Arlia, *TikTok's Takeover Of Marketing And Commerce In 2022*, FORBES (Feb. 23, 2022), https://www.forbes.com/sites/forbescommunicationscouncil/2022/02/23/tiktoks-takeover-of-marketing-and-commerce-in-2022/?sh=66d913015b4f.

[57] Laura Michaels, *Inside the Craze at Fast-growing Franchise Crumbl Cook*ies, FranchiseTimes (Oct. 27, 2021), https://www.franchisetimes.com/franchise_news/inside-the-craze-at-fast-growing-franchise-crumbl-cookies/article_e29c5860-31da-11ec-9667-83789573129c.html.

[58] *Id*.

[59] Ben Coley, *Crumbl Cookies Rises from Emerging Brand to Category Leader*, QSR (Sep. 21, 2021), https://www.qsrmagazine.com/exclusives/crumbl-cookies-rises-emerging-brand-category-leader.

[60] U.S. Department of Commerce's National Institute of Standards and Technology (NIST), *U.S. Leadership in AI: A Plan for Federal Engagement in Developing Technical Standards and Related Tools* (Aug. 9, 2019), available at https://tinyurl.com/2w93d6dp



[61]

Traditional AI typically focuses on rule-based or statistical approaches and may not possess the same creative or context-aware capabilities as generative AI. The latter distinguishes itself from its traditional counterpart by its ability to generate human-like text and content based on patterns learned from vast amounts of data, allowing it to perform more human-like language tasks. In the words of ChatGPT (Chat Generative Pre-trained Transformer), generative AI works by "leveraging deep learning algorithms to generate new content based on patterns it has learned from a large dataset. It operates by understanding the underlying structure and features of the input data, such as text, images, or audio, and then using this understanding to produce new, similar content. In the case of text generation, for example, the model learns the statistical relationships between words and phrases in its training data, allowing it to predict and generate coherent and contextually relevant text. This process involves iterative training on vast amounts of data, refining its ability to generate content that resembles human-produced output."

[61] Gugatharsan Sivalingam, *An Introduction to Machine Learning*, MEDIUM (Jun. 20, 2020), https://tinyurl.com/4ddxcas6

B. Potential Uses of AI by Franchise Companies

The potential for integrating AI into daily business is an exciting development for franchise companies. ChatGPT, alone, is estimated to have reached 100 million monthly active users just two months after launch, making it the fastest-growing consumer application in history.[62] Several companies have been investing in AI technologies for assistance with daily business functions, such as marketing automation, customer service, product development and franchisee training. For example, Chipotle is testing an AI-powered robot, Chippy, to make its tortilla chips and its website features an AI chatbot called Pepper than can field consumer questions and complaints. Taco Bell and KFC are using AI for help with inventory by introducing a system called "Recommended Ordering" to predict and recommend how much product managers should order every week. Starbucks is using AI to help with pricing decisions and making its mobile app more personalized by giving consumers tailored recommendations, and White Castle is one of several chains using AI to take drive-thru orders.[63] These are just a few of the customer-facing possibilities. AI also is being used by franchise companies' in-house legal departments to assist with tasks, such as reviewing and abstracting leases and franchise agreements and confirming insurance compliance by franchisees.

Marketing Automation

Franchise companies of all sizes are already using AI (generative AI in particular), to create personalized marketing materials tailored to the preferences and interests, at the franchisor level, of prospective franchisees, and, at the franchisee level, of consumers of franchised outlets. Franchisors can analyze data for prospective franchisee leads and conversion rates to maximize its resources in targeting new prospective franchisees. AI can also generate content for email campaigns, social media posts, system websites, advertisements and other promotional materials based on consumer demographics, past interactions and purchasing behavior. Franchise companies operating in multiple regions or countries can leverage AI for localization and translation of marketing materials, menus, signage, and other content. AI-powered language models can accurately translate text and adapt marketing messages to resonate with local cultures, customs, and preferences. By analyzing data from multiple franchised outlets, generative AI can

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[62] Krystal Hu, *ChatGPT sets record for fastest-growing user base – analyst note*, REUTERS (Feb. 2, 2023, 10:33 AM), https://tinyurl.com/48r3fus8

[63] Joe Guszkowski, *How big restaurant chains are using artificial intelligence,* RESTAURANT BUSINESS (Aug. 31, 2023), https://tinyurl.com/3u2pa3wt

identify trends and insights to allow franchisors to optimize use of marketing dollars and improve consumer engagement at the franchised outlets. AI algorithms can curate user-generated content, testimonials, and reviews from multiple franchised outlets to create authentic and compelling narratives. Further, by automating content creation processes, generative AI enables franchise companies to maintain a consistent and active online presence, driving brand awareness and consumer engagement. As discussed below in this Section, these potential uses of AI, especially with respect to testimonials and reviews, can run afoul of federal and state laws, including consumer protection laws.

Customer Service

Franchise companies have already begun using chatbots powered by generative AI to provide instant customer support and answer frequently asked questions on websites, mobile apps and via text messages. Using AI-powered chatbots should improve response times and enhance the overall consumer experience. By continuously learning from consumer interactions, generative AI can refine its responses and adapt to evolving consumer needs and preferences.

Product Development

Generative AI can allow franchise companies to use market trends, customer feedback and historical information to generate new ideas for products by market. AI algorithms can analyze customer reviews, surveys, and social media conversations to identify emerging preferences and unmet needs. Even more astonishing, generative AI is able to simulate product variations and conduct virtual product testing, enabling franchise companies to refine products even before launching.

For example, McDonald's plans to use artificial intelligence and cloud technology to enhance its restaurant operations by working with Google Cloud to create hotter and fresher food.[64] In fact, McDonald's opened its first automated restaurant in Fort Worth, Texas as a test restaurant.[65] Customers place their orders at a kiosk and can pick up their orders on a shelf (rather than through a counter worker), or can pick up their orders at the store's dedicated Drive-Thru Express Lane, where it will be delivered via conveyor belt.[66] A McDonald's spokesperson claimed

[64] Cara Tabachnick, *McDonald's plans to add about 10,000 new stores worldwide by 2027; increase use in AI*, CBS NEWS (Dec. 6, 2023, 12:45 PM) https://tinyurl.com/yzbad9rm
[65] Kristin Houser, *McDonald's opens its first automated restaurant in Texas*, FREETHINK (Jan. 4, 2023) https://tinyurl.com/y5u4n759
[66] *Id.*

that the crew members are all focused on making and packaging orders rather than taking or delivering them.[67]

Training and Onboarding

The training and onboarding of franchisees are critical and core responsibilities for franchisors. Generative AI can assist franchisors in creating interactive training materials, simulations, and virtual reality experiences. AI generated training modules can simulate real-world scenarios, allowing employees to practice skills, procedures, and customer interactions from a classroom. International franchisees can attend classroom training virtually without having to fly across the world. By providing a more immersive learning experience with the assistance of AI, franchisors can improve the training and onboarding process.

In-House Legal Department Functionality

While consumer-facing use of AI may be getting most of the attention, in-house legal departments are also finding ways to leverage AI technologies effectively to optimize operations. In addition to the legal requirements applicable to AI use in general, legal departments have the additional challenge of having to comply with state ethical bar rules, such as confidentiality, privacy, and the proper supervision of nonlawyers. Not to mention, ChatGPT, Bard and other AI-based technologies are still in development and have been found to produce errors. Several legal departments and firms are engaging in limited use of AI while those errors are addressed. In the interim, legal departments are finding ways to introduce generative AI to help with some of their everyday mundane tasks, such as reviewing and abstracting leases and franchise agreements, confirming insurance compliance by franchisees, drafting default notices and other franchisee correspondence and internal company presentations.

C. Legal Implications and Laws Impacting Use of Generative AI

According to The Council of State Governments, over the past five years, 18 states have enacted 30 bills that focus on regulating the design, development and use of AI.[68] While these laws primarily focus on ensuring data privacy and accountability, franchise companies using AI

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[67] *Id.*

[68] *See* Rachel Wright, *Artificial Intelligence in the States: Emerging Legislation*, THE COUNCIL OF STATE GOVERNMENTS (Dec. 6, 2023), https://tinyurl.com/yckbf79x (the following states have enacted legislation: California, Colorado, Connecticut, Delaware, Illinois, Indiana, Iowa, Louisiana, Maryland, Montana, New York, Oregon, Tennessee, Texas, Utah, Vermont, Virginia and Washington).

also need to be aware and address the following issues, especially if AI is used system-wide and could have a substantial impact on the franchise system:

Copyright and Patent Protection and Ownership

In cases where generative AI is used to create marketing materials, product designs, training modules, or other intellectual property, questions may arise regarding whether the franchisor or the AI developer holds the rights to these creations. Written agreements between parties can usually address ownership rights in intellectual property; however, in the case of materials developed using generative AI, such as ChatGPT, ownership of "output" as between users and OpenAI is addressed in the company's terms of use, which provides that the user owns the output.[69] The terms of use also require users to represent and warrant that the user has all rights, licenses and permissions needed to provide the "input" for the generative AI services. OpenAI's terms of use also grant a license from users to OpenAI to use the input and output for the generative AI services, which means the information shared with ChatGPT is stored on the web and can be shared with others.

While OpenAI's terms of use provide that users own the output, this may not always be the case. Therefore, it is important for users to review the service provider's terms and conditions to understand who owns the intellectual property created through use of generative AI. If the terms and conditions do not explicitly provide that the user is the owner of the output created by the generative AI services, then franchise companies may not be the owner of the intellectual property resulting out of the use of AI technology to help design a company logo, product name or marketing materials.

In addition, according to Section 306 of the Compendium of U.S. Copyright Office Practices, the "U.S. Copyright Office will register an original work of authorship, provided that the work was created by a human being."[70] The U.S. Copyright Office "will not register works produced by a machine or mere mechanical process that operates randomly or automatically without any creative input or intervention from a human author."[71] Recently, in April 2024, the United States Patent and Trademark Office (USPTO), recognizing the likelihood that AI will be used to prepare and prosecute patent and trademark applications, issued guidance[72] to inform

[69] *Terms of Use*, OPENAI (Nov. 14, 2023), https://tinyurl.com/mmryuybv
[70] U.S. COPYRIGHT OFFICE, COMPENDIUM OF U.S. COPYRIGHT OFFICE PRACTICES § 306 (3d ed. 2021).
[71] COMPENDIUM (THIRD) § 313.2.
[72] 89 FR 25609.

practitioners and the public of the important issues that patent and trademark professionals, innovators, and entrepreneurs must navigate while using AI in matters before the USPTO. Further, at least one U.S. court has decided the issue of whether AI can be the author for copyright purposes. In *Thaler v. Perlmutter*,[73] the U.S. District Court for the District of Columbia upheld the Copyright Office's rejection of a copyright application relying on the longstanding principle that copyright law protects only works of human creation. Proprietary intellectual property is fundamental to every franchise system. If a franchise system is unable to register intellectual property important to the system, then it will undoubtedly face competitive problems. Franchise companies must (i) evaluate the importance of copyright registration to AI-generated content for its business, (ii) be careful before sharing information with AI technology that is available on the open web, and (iii) also develop company policies concerning permitted and prohibited uses of AI.

Privacy Laws

Generative AI relies on large datasets, which can include personal information, to train models and generate content. Franchise companies must ensure compliance with applicable data protection regulations, such as the European Union's General Data Protection Regulation ("GDPR") and California's Consumer Privacy Act ("CCPA"). Similar to collecting consumer information at a point of sale, franchise companies must implement comprehensive data protection measures to avoid violating data privacy laws and potential reputational damage. AI-driven products or services could be vulnerable to security breaches or hacking, leading to access to sensitive consumer information. Accordingly, in utilizing generative AI, franchise companies must ensure that sensitive information is protected from authorized access, breaches and misuse.

Antitrust

Franchise companies may understandably want to use generative AI to assist with pricing strategies, market analysis and to analyze competitor strategies or offers; however, using AI in this fashion can lead to unintentional antitrust and competition law risks. Franchise companies must avoid using AI to engage in anticompetitive practices, such as price-fixing or market manipulation, which could harm consumers or stifle competition. If AI is used to assist with pricing strategies, such as analyzing nearby competitor offers or fluctuating demand in the area to be able to modify prices or implement "surge pricing" then it could lead to heightened scrutiny by governmental authorities and consumers. If AI is used in this manner, the franchise company should maintain a

[73] *Thaler v. Perlmutter*, No. CV 22-1564 (BAH), 2023 WL 5333236 (D.D.C. Aug. 18, 2023).

transparent AI algorithm and be prepared to provide explanations on how the AI system operates and the decision-making processes to refute possible challenges by governmental authorities or consumers, as well as avoid potential reputational damage.

General Liability

As AI systems become more autonomous and make decisions that impact business operations and consumer interactions, questions arise regarding liability and legal responsibility. Franchise companies may be held liable for the actions of AI-driven chatbots, recommendations, or predictions that result in harm to consumers or third- parties. As examples, generative AI systems may perpetuate or amplify biases present in the training data, leading to unfair or discriminatory outcomes, which could violate consumer protection laws. AI systems could be used to manipulate consumers by, for example, providing false information about products or services, which could violate laws against deceptive advertising. Further, if AI systems are used to implement surge pricing, the strategies could unfairly exploit consumers by charging different prices based on factors such as location, which could lead to violations of price discrimination and unfair trade practices, in addition to the antitrust risks discussed above. Lastly, if AI is used by franchise companies in regulated industries, such as healthcare or real estate brokerage, the systems may fail to comply with industry-specific regulations. If the AI system is developed "in-house" avoiding liability resulting from use of the AI system may not be possible unless opt-ins or waivers are utilized. However, if a third-party develops the AI system, then the franchise company must ensure the third-party developer implements the appropriate measures to comply with applicable laws, as well as maintains sufficient insurance and properly indemnifies the franchise company for any negligence or failure to comply with laws in the AI system's performance.

D. Global AI-Specific Legislation

Recently, in March 2024, on the same day the European Parliament adopted the EU AI Act, Utah became the first state in the U.S. to enact a statute specifically governing private-sector AI usage.[74] The new statute was incorporated into Utah's consumer protection statutes. Under the new law, if a business or natural person uses generative AI to interact with an individual in

[74] Reena Bajowala and Arda Goker, *Utah Enacts First AI-Focused Consumer Protection Legislation in US*, GREENBERG TRAURIG (Apr. 2024) https://tinyurl.com/2p8r4byk

connection with commercial activities regulated by Utah's Division of Consumer Protection, it must clearly and conspicuously disclose to the individual that he or she is interacting with generative AI and not a human. This requirement applies only if the individual interacting with the generative AI prompts or asks the generative AI to disclose whether the individual is interacting with a human. The Utah law also sets forth more restrictive disclosure obligations on persons providing the services of "regulated occupations" such as clinical mental health, dentistry, and medicine. Further, the Utah law establishes liability for inadequate/improper disclosure of generative AI use and creates the Office of Artificial Intelligence Policy to administer Utah's AI program.

In addition, the European Union, Brazil and Canada have each enacted or proposed regulations on AI. According to the European Parliament, the European Union's Artificial Intelligence Act ("EU AI Act") "aims to ensure that fundamental rights, democracy, the rule of law and environmental sustainability are protected from high risk AI, while boosting innovation and making Europe a leader in the field."[75] On December 8, 2023, the European Parliament and Council reach political agreement on the EU AI Act (and was subsequently adopted by the European Parliament on March 13, 2024),[76] which has been touted as the first of its kind in the world. Under the law, applications of AU are assigned three risk categories: (1) applications that create unacceptable risk and therefore are banned; (2) applications that are high-risk due to their potential harm to health, safety, fundamental rights, environment, democracy and the rule of law; and (3) applications with limited risks that are not explicitly banned or listed as high-risk, which are generally unregulated.

Meanwhile Canada is among the several countries around the world that have introduced laws to govern the development and use of AI. The Canadian legislation, known as the Artificial Intelligence and Data Act ("AIDA"),[77] is intended to help foster the development of responsible AI in Canada. Similar to the EU AI Act, the AIDA adopts a risk-based approach to regulating AI.

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[75] *Artificial Intelligence Act: deal on comprehensive rules for trustworthy AI*, EUROPEAN PARLIAMENT, Sep. 12, 2023, available at https://tinyurl.com/39r73h7f.

[76] *Artificial Intelligence Act: MEPs adopt landmark law*, EUROPEAN PARLIAMENT, Mar. 13, 2024, available at https://tinyurl.com/mrt2d2se

[77] *Bill C-27: An Act to enact the Consumer Privacy Protection Act, the Personal Information and Data Protection Tribunal Act and the Artificial Intelligence and Data Act and to make consequential and related amendments to other Acts*, GOVERNMENT OF CANADA, Nov. 27, 2023, available at https://tinyurl.com/4n9mkpx7.

The government's companion document[78] outlines the many of the government's plans with the AIDA and the types of AI systems that would be considered "high-impact" under future regulations. According to the companion document to the AIDA, key factors to be examined in determining which AI systems would be considered "high impact" include: the risk of harm to health and safety, or adverse impact on human rights; severity of potential harms; scale of use; the nature of harms or adverse impacts that have already taken place; the extent to which it is not reasonably possible to opt-out from the system; imbalance of economic or social circumstances or age of impacted persons; and the degree to which risks are already regulated under another law. According to the Canadian government, AI systems that can recommend online content to influence human behavior, expression and emotion on a large scale are of interest due to their potential impacts.

Using AI to scan resumes and rank job applicants or to post online content recommending food options, including to teenagers, would likely be deemed high-risk and high-impact and subject to specific legal requirements in the EU and Canada. Accordingly, franchise companies using AI or planning to use AI should assess their (and their vendors') level of compliance of the AI systems with the soon to be formally adopted new laws.

E. Considerations for Successful use of AI

It's inevitable that AI will become a mainstay tool for franchise companies to use for assisting with daily business functions. Many companies have already begun testing or using AI in their businesses, and the remaining franchise companies will not be far behind. In order to help ensure successful use of AI in their franchise business, companies can take several actions, such as:

1. **AI Policies**. Adopt an AI policies for both franchisor employee use and franchisee use. These policies should clearly define permitted and restricted uses of AI as well as educate users of the capabilities and limitations of AI technologies. AI policies can be included in the system's operations manual to provide maximum flexibility. The franchisor-level policies should

[78] ARTIFICIAL INTELLIGENCE AND DATA ACT (AIDA) COMPANION DOCUMENT (2023) available at https://tinyurl.com/3r9dacnm

also address risk management, contingency plans and response strategies for any problems that could likely arise.

2. **AI System Governance**. First, franchise companies should ensure high-quality data is available for training AI models. Second, franchise companies should ensure that AI-generated content adheres to ethical standards and aligns with brand values and guidelines. Franchise companies can implement regular audits and employ bias detection tools to help identify and address biases in generative AI systems. Content moderation, human oversight, and quality assurance processes can help prevent the dissemination of harmful or inappropriate content generated by AI algorithms. Franchise companies can implement robust data governance practices, such as designating an executive to oversee the company's use of AI, to maintain data integrity, security, and compliance with regulations.

3. **Individual Consent**. Although currently not required in most US jurisdictions, franchise companies may want to consider obtaining informed consent when collecting and utilizing personal information for generative AI applications and include ownership rights in applicable terms and conditions. To do so companies will need to explain how the AI system operates and the potential impacts on the consumer. User-friendly consent mechanisms and opt-in/opt-out choices will allow consumers to make informed decisions about their information, with the hopeful additional benefit of building trust in the franchise companies' use of AI. Plus, individual waivers should be considered where appropriate, especially if testing an AI system, to help limit potential liability.

4. **Privacy and Security**. As discussed above, franchise companies must prioritize the privacy and security of customer information when utilizing generative AI. Transparent privacy policies and information handling practices, and compliance with data privacy laws are some of the ways franchise companies' can successfully implement generative AI into their system while safeguarding customer privacy.

5. **Insurance**. Franchise companies should review their insurance coverage to ensure it covers use of AI. New polices may need to be obtained or coverage increased to address new risks associated with implementing AI into the franchise system.

6. **Contractual Protection**. Franchise companies should review their forms of franchise agreement to confirm existing terms are sufficient to provide protections needed in using AI. Franchisee insurance requirements should also be reviewed, while including broad

indemnities in franchise agreements and third-party software supplier agreements can help to address potential monetary loses in the event AI is improperly or unlawfully used. However, the reputation risks to franchise companies are great so franchise companies should adopt all of these recommended actions in this section and not rely on contractual protections.

7. **Education**. Franchise companies, especially in-house legal departments and executives tasked with overing the company's use of AI, must stay informed of relevant laws, regulations, and industry standards governing the use of AI, especially in regulated sectors.

By leveraging AI technologies effectively while keeping the legal requirements in mind, franchise companies can drive innovation, optimize operations, and deliver superior customer experiences across their franchise networks. Franchise companies can successfully navigate the legal risks associated with AI by adopting appropriate policies, contracts and safeguards, and collaborate with legal experts to stay informed of evolving legal regulations.

NEGOTIATION OF FRANCHISE AGREEMENTS

The concept of parity is largely unrealistic in franchise agreements. If, however, the franchisor is willing to engage in a discussion about terms of the franchise agreement, negotiation can result in a franchise agreement that is better suited to the individual franchise relationship than the form franchise contract contained in the Franchise Disclosure Document (FDD). But no matter how extensive the negotiations might be, keep in mind that based on the nature of the franchise relationship, the agreement will still be in the franchisor's favor when considering the relative obligations of the parties, the remedies available to them, and the need for franchisor controls to protect the system. This maybe even more true when dealing with larger more sophisticated franchise systems. When larger franchisees broach the possibility to changes to the agreement, the typical imbalance of "power" is still very different than negotiating a typical business contract, but now the parties may have comparable leverage.

Notwithstanding the foregoing, negotiation is a process, and can benefit both parties without substantial changes to the franchise agreement in the following ways:

A. It brings greater clarity to and understanding of the parties' expectations.
B. It can uncover terms in the agreement that were contrary to the parties' understanding and expectations for the deal.

C. Franchisors and their counsel are in a position to better understand the prospective franchisee and determine the fit of the individual or entity for the franchised business and the system.

A franchisor and its counsel spend considerable time and money preparing a franchise disclosure document, franchise agreement, and related documents to offer prospective franchisees. These agreements are drafted and vetted to develop and maintain a successful brand and system. The importance of consistency across the system should not be discounted – and this consistency benefits both sides. Of course, this reasoning begs the question: why negotiate at all?

Many franchise companies take a "take it or leave it" attitude with negotiations for a franchise agreements. Others are open to negotiation on certain terms. A number of considerations and factors determine a franchisor's willingness to change the terms of its standard franchise agreement, and how hard a prospective franchisee can push for such changes.

A. THE FACTORS

1. State Relationship Laws - In addition to the states regulating the offer and sale of franchises, a number of states regulate the franchise relationship – limiting the franchisor's ability to terminate, not renew, disapprove transfers, or in some instances negotiate other changes to the franchise agreement. In essence, certain states have done some negotiating for the franchisee.[79]

2. Start-Up Franchisors - A business at the beginning stage of franchising may be willing to make more concessions in an effort to close its first deals. Often business owners with a successful concept are blinded by dollar signs when a potential franchisee is the first to suggest the concept of franchising. Start-up franchisors should be wary of giving away the farm in exchange for some up-front fees. Franchisors must keep in mind that these first franchisees will be a part of what hopefully will become a larger system over time. Once franchisors concede certain terms, however, it can be much more difficult to gain that leverage back and institute more protective terms going forward.

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[79] *What States Have Franchise Laws?*, FRANCHISE OPPORTUNITIES, (June 28, 2022) https://www.franchiseopportunities.com/blog/franchise-business-resources/what-states-have-franchise-laws (listing the following states as having franchise relationship laws: Alaska, Arkansas, California, Connecticut, Delaware, Hawaii, Idaho, Illinois, Indiana, Iowa, Maryland, Michigan, Minnesota, Mississippi, Nebraska, New Jersey, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin).

3. Established Systems - An established franchise system usually has a proven concept that has achieved a certain level of success, and that success is contingent upon the franchisor's ability to maintain consistency throughout the system. Additionally, in contrast to and early-stage franchisor, a larger system will often have more leverage than its prospective franchisee (although this may not be the case with respect to a master franchisee or area developer in some instances, as discussed below). A prospective franchisee is in much more of a "take it or leave it" position with a large, established system and often willing to forego the ability to negotiate in exchange for the rights to a successful brand and proven concept. But this dynamic may change with a larger franchisee.

4. Multi-Unit Franchisees and Area Developers - As franchisees become more sophisticated over time, the leverage may shift, even if only slightly. Successful multi-unit operators are more likely to successfully negotiate changes to significant terms in franchise agreements, like royalty rates, minimum royalties, and territorial protections. Similarly, depending on a franchisor's desire to enter a certain market, area developers with a presence and ability to quickly ramp up in new areas may gain certain concessions to which franchisors might otherwise not concede.

5. International Expansion - International franchise agreements are more commonly subject to negotiation. Rarely, if ever, is a franchisor able to adhere to a "take it or leave it" approach with international prospects. Even franchisors that have such an approach to domestic development are faced with a negotiation process that requires building consensus among various parties in the international context. Although a detailed analysis of the art of international negotiation is beyond the scope of this paper, it is important to emphasize that parties to an international franchise agreement need to consider a number of factors, unique to the international setting, when negotiating it. The experience and positional power of the prospective franchisee, the local market, applicable laws and regulations, legal nuances, and cultural differences all add interesting and challenging dimensions to international contract negotiations.

B. TYPICAL APPROACHES TO FRANCHISE AGREEMENT TERMS

1. Grant of Rights - The grant of rights section is the core of the franchise agreement, as it encompasses what the franchisee is authorized to do (and just as critical, what the franchisee is prohibited from doing), where the franchisee is authorized to conduct business, whether the

rights are exclusive and what rights are reserved to the franchisor. It is imperative that the sales team and legal team have the same understanding and unified approach and message regarding the language in this section. The negotiations generally occur concerning the scope of territory, limitations of franchisee rights and reservation of franchisor rights.

2. Exclusive or Non-Exclusive Territory - Few areas of the franchise agreement generate more conversation and concern in the development and negotiation phase than the description of the territory; specifically, the scope of the territory and whether it is exclusive. From the franchisor's business perspective, the territory provision exemplifies the difficult balance that it must strike when considering the attractiveness of the franchise offering versus the need to reserve control and flexibility over the expansion of the brand (whether that is through additional outlets or alternative channels of distribution). More established brands may be able to offer less by way of territorial protection than those brands just beginning to franchise.

3. Reservation of Rights - The reservation of rights provision is a critical compliment to the grant of rights section, and often the area that at times may generate a good amount of discussion and negotiation. A franchisor should identify clearly the *franchisor's* territory, expansion and distribution rights, even in the context of a franchise agreement that does not grant an exclusive territory to the franchisee. The rights typically reserved by franchisors focus on the operation of competing businesses (whether by the franchisor or an affiliate, or another franchisee) and alternative methods of distribution (methods used to offer products or services to the franchise system's consumers that are different than the method used by the franchises of the system). Franchisors should have a well thought out strategy related to future business needs, and plan for the known with specific details. Just as important, a franchisor should incorporate language that allows for some flexibility in unknown areas. Similar to the grant of exclusivity, franchisors are well served by detailed and express provisions when faced with claims of encroachment by a franchisee.

In an attempt to avoid claims, the franchise agreement should speak to acceptable/unacceptable proximity. If this section is left ambiguous, it could lead to problems between the franchisor and franchisee about whether the franchisor breached the terms of the agreement by opening an outlet on the perimeter of the franchise's territory.

4. Infringement of Trademarks - Most franchisors take great care when drafting clauses concerning the infringement of their trademarks, given the importance of those marks to

their systems. It is typical for a franchisor to maintain control over the handling of actions with respect to trademark infringements and to expressly provide how quickly the franchisee is expected to notify the franchisor of any infringement of the trademarks and it is rare to have negotiation on this point.

Although much of the language related to infringement of trademarks is not negotiable, franchisees should take care to analyze how and if a challenge to the trademarks, or a change to the trademarks, affects them and their business. Particularly, if the franchisor is new and/or key trademarks are not yet well established (or not yet registered), franchisees will want to push for language to ease uncertainty and protect their interests.

5. Initial Fees and Continuing Royalties - Although initial fees and continuing royalties are critical economic terms of a franchise agreement, these provisions are not often heavily negotiated absent a special circumstance (e.g., a franchisor needs help in a new territory or the prospective franchisee wants to develop a number of units or act as an area developer). The "market" rates for initial franchise fees are typically tied to the franchise system's specific industry, and generally include the costs of start-up services to be provided by the franchisor, as well as the right to open the franchised business. Initial franchise fees may vary depending upon the length of the franchise agreement term. Franchise agreements with longer terms typically have higher initial fees, since there is usually some exclusivity (however limited it may be) associated with the grant of franchise rights.

6. Renewal Term - There are generally four approaches that the parties can take to the renewal provisions:

1. The franchisor might prohibit renewal of the franchise agreement.
2. The franchisee may have the right to renew, but only under certain conditions and upon the approval of the franchisor.
3. Renewal might be automatic upon expiration of the initial term.
4. The parties might agree that the agreement is perpetual ("evergreen").

Franchisor attorneys should consider applicable state laws when drafting the renewal provision and considering if changes should be made in the context of negotiation, as this is an area where the law may place certain restrictions on nonrenewal of a franchise agreement. From the franchisor perspective, the considerations related to state laws is more of a drafting tip than a

negotiating issue, as most state laws will be favorable to the franchisee. From a franchisee perspective, attorneys should know the details of the applicable laws, so that they can request appropriate changes on behalf of their client. Although the law should trump the contract at the time of renewal, franchisees are best served to have the appropriate language included in the contract, as too often parties rely on the contractual language.

A renewal fee can vary greatly, sometimes as a fixed amount, while other times an amount that can fluctuate. It is not uncommon for the renewal fee, if any, to be tied to the then-current initial franchise fee, so that it can increase over time, which may be important when renewal will take place many years in the future. The negotiation surrounding the renewal fee may be a time for franchisee attorneys to leverage the relationship. If things are going well between the franchisee and the franchisor such that the franchisee wishes to renew and the franchisor approves without issue, why should a fee be charged to merely continue business "as usual"?

7. Refurbishment or Replacement

Franchise agreements commonly include a modernization provision, which is included by franchisors to permit them to adapt and change the business over time to stay current in the marketplace. After all, most franchise agreements span a considerable period of time relative to other business arrangements, and franchisors don't want to be restricted to when and where they can implement changes to existing units. The obligation generally involves the franchisee's commitment to upgrade the premises throughout the franchise agreement term, or as triggered by a particular event, such as renewal or transfer. The franchisor should be mindful of this clause so that the general image of the trademarks is being adequately preserved and improved throughout the term of the franchise agreement. If this clause is absent or inadequately drafted, the franchisor might risk not being able to require that franchisees keep their locations up to standard, or their brand competitive and relevant to the consumer, which in turn might end up damaging the goodwill of the overall franchise system.

8. System Modifications

One could argue, and no matter how long the argument goes, there may be no answer as to which is more important, products/supplier designations or system modifications. System modifications relate to the overall operation of the franchise system and how the system operates in terms of processes, appearance, products and services offered, or anything and everything related to the actual franchise system. Typically, throughout a franchise agreement, are numerous

references to the right to change the system from time to time at the sole discretion of the franchisor. The right to system modifications may be even more critical for a startup franchisor who is "learning" its way through the franchise process.

On the other hand, a franchisee who reads the franchise agreement may wonder, how do I enter into an agreement that allows for the other party to make any and all changes that it wishes on the spur of the moment to which I, the franchisee, would then be obligated to implement without having any basis for what the change may mean in terms of cost (time and money) and relevance to the business that supposedly I bought years ago? Can there be a middle ground in this area? Arguably a franchisee could request that any fundamental material changes:

- be "reasonable" in nature;
- not have a dramatic/significant monetary effect on its operations;
- have a lead in time for changes to be implemented;
- not to be mandated if a franchisee is in its last one or two years of the remaining term of the franchise agreement;
- not be implemented until the franchisor demonstrates to the franchisees the benefits of such; and/or
- not occur more often than every number of years.

9. Advertising

The advertising provisions run the gamut from the requirement of monies to be paid into a national advertising fund operated and controlled by the franchisor or its affiliate to and including, the requirement for franchisees to spend certain dollars on regional advertising and/or local advertising and at times, in conjunction with advertising cooperatives. Some systems allow for offsets, such as if there is an advertising cooperative, then the amounts paid into the cooperative count toward local and regional advertising and sometimes even count toward the national advertising fund. In analyzing what the pros and cons of negotiating or modifying advertising provisions, like all provisions, depends on the exact arrangement. In general, advertising is another one of those areas that franchisors do not necessarily want to negotiate or modify.

First, there is a sense that advertising requirements should be equal for all franchisees and therefore, franchisor does not want to negotiate or modify the requirements for one or two

franchisees. However, in a start-up situation, there is more likelihood to negotiate the advertising and for such to be based upon certain threshold standards. Secondly, if advertising is to be required in the new system, franchisee may request that the advertising dollars be targeted to the franchisee's general geographic area, rather than the typical national sole discretion advertising which allows the franchisor to advertise in any manner it so desires and not have to target any specific geographic area.

10. Restrictive Covenants

These provisions provoke an ongoing debate as to whether or not there should be such a provision in the agreement and if so, to what extent is it to be enforced. The debate among franchisees is between (a) those that are on their way out who do not want a restrictive covenant and (b) those that are within the system that want a restrictive covenant to protect themselves from the former franchisees.

Transfer by the Franchisee – Transfer provisions are often the subject of negotiation, and they raise a number of the same issues as renewal. While the franchisor may want to impose an exhaustive list of conditions to the approval of a transfer, practitioners should keep in mind that these transfer restrictions are limited by certain state laws. Many franchisees will lobby to add language that the franchisor cannot unreasonably withhold consent to a franchisee's proposed transfer, which is actually required by some states (making it a bargaining chip for franchisors). Obviously, franchisors have a strong interest in maintaining qualified and capable franchises in their system and will want an unfettered ability to approve (or deny) the transfer of the franchised business. Notwithstanding this interest, franchisees may have some leverage in this area. The ability to transfer the agreement is the only way the franchisee can liquidate its investment if needed. Furthermore, although ideally the franchise agreement will continue between the franchisor and the original operators, it is not realistic to assume there will never be issues or instances when the agreement will need to be transferred in order for the business to stay successful, or even survive; or as a mechanism for a franchisee to extricate itself from the system for whatever reason.

Right of First Offer or Right of First Refusal - Franchisors will often include a right of first refusal or, less common, a right of first offer to purchase the franchisee's business prior to any proposed transfer. Franchisees often argue that such a right actually depresses the value of the business – since it makes it less certain that a potential purchaser can actually close on the

transaction – i.e., if it's a good deal, the franchisor may take it. Negotiating to remove the right of first refusal is likely a losing battle for most (if not all) franchisees, but certain limitations on such rights may be agreeable to the franchisor. Franchisors will usually include:

- the ability to review the proposed transfer documents;
- a right to follow up with additional information requests;
- the right to negotiate with the prospective buyer regarding the terms of the deal without it being deemed a rejection of the offer;
- the right to substitute cash for in-kind payments by the proposed buyer; and
- a reasonable period of time to review and approve or reject the offer.

Franchisees and franchisors alike would be well advised to establish even an informal procedure for handling the right of first refusal that allows the franchisee to raise a potential transaction informally with the franchisor. Timing is often difficult when trying to coordinate closing a transaction while complying with the franchisor's right of first refusal.

11. Events of Default and Right of Termination

Termination provisions, like transfer and renewal, are crucial to a franchisor's ability to control the system. Franchise agreements typically include a lengthy list of conditions that constitute an event of default under the agreement. Typically there are distinctions between events of default that can be cured after notice to a franchisee, and those that allow a franchisor to terminate the agreement immediately upon notice to a franchisee (or in some instances even without notice). Franchisee counsel may argue that allowing a franchisor to terminate without notice or providing very short cure periods could put a franchisee at serious risk for a technical default. Franchisor counsel will likely counter that consistent cure periods and remedies are important for managing the overall system, and that agreeing to modify termination provisions not only puts the franchise business at risk, but it also creates an undue administrative burden on a franchisor.

12. Right of a Franchisee to Terminate

While Franchisee counsel may seek to negotiate a contractual termination right for their clients, they should proceed with caution. Often franchisors will agree to include a termination provision, but it may actually end up limiting a franchisee's common law rights to terminate upon a franchisor's material breach. These termination provisions often include:

(a) allowing termination only if the franchisee is not itself in breach of the agreement;

(b) requiring the franchisee to give notice to the franchisor of the franchisor's default; and

(c) allowing the franchisor a cure period.

In such instances a franchisee would be better served if the franchise agreement remained silent on the matter.

13. Guaranty by Franchise Owners

There has been some debate among practitioners as to whether or not personal guaranties actually provide any real additional benefit above and beyond the obligations of agreement. As one practitioner noted, "Unless performance of the personal guarantee is itself secured by a perfected first security interest in valuable collateral, it is no more valuable than the net worth of the guarantor, and can be broken in a bankruptcy proceeding, if the guarantor is willing to endure the cost and downstream consequences of a personal bankruptcy." This argument, however, assumes that a franchisee is not taking advantage of the situation and withholding royalties or breaching obligations with the knowledge that it has no personal responsibility. Also, while this argument may be compelling to seek to limit the payment obligations of a guarantor, a franchise agreement guaranty typically covers performance obligations (including maintaining confidential system information and restrictions on competition), and indemnification for claims brought by third parties as a result of the franchised business' activities.

Although a personal guaranty of both performance and payment obligations is both reasonable and customary in most instances, franchisors in some very limited circumstances may be amenable to negotiating dollar caps on guarantor liability, as well as time limits that allow the personal guaranty to burn off during the initial phase of the franchise relationship (when the risks are particularly high).

14. Cross-Default

If a franchisee operates more than one unit or is a party to multiple agreements with the franchisor, providing a cross default provision can serve as an effective "stick" rather than "carrot" approach to compliance. Similar to a general release, cross default provisions may present a significant risk for multi-unit operators or area developers and franchisees may try to negotiate or remove this provision altogether. Most franchisors are not likely to concede this point.

Franchisors can argue that such a provision allows them to more effectively control the standards of all of their locations and franchisees should not be able to pick and choose agreements with which they must comply. Moreover, franchisees should be able to allocate sufficient resources to all of their locations and units.

TRANSFERS INVOLVING PRIVATE EQUITY GROUPS

Issues with transfers to private equity groups can be significantly different than a transfer to a non-private equity group – your "typical" (or not so much anymore) stand-alone franchise.

A. Advantages

Approving the transfer of multiple franchised units to PE Groups can provide certain advantages to the franchisor and the buyer:

Unit Growth

If the proposed transfer does not already include development rights or the right of first refusal to acquire certain markets, or the right to close certain locations, then the PE Group buyer will most likely negotiate heavily with the franchisor to include such rights in the terms of the consent to transfer.

The contractual right and obligation to develop more units is generally considered a benefit to both the franchisor and the PE Group. Most franchisors, even mature brands, never cease looking for growth in units, as well as in topline revenue, and franchisors typically view a well-funded PE Group as financially positioned to develop units quicker than smaller franchisees. Because of these perceived advantages, franchisors are often more than willing to grant additional development rights to well-funded PE Group transferees.

In connection with new-unit development, franchisors should also be prepared to negotiate with the PE Group a defined list of closures either by mutual termination or non-renewal. While PE Group buyers may be willing to purchase under-performing units as part of a large portfolio, they most likely will not want to continue to operate such units if unit-level economics cannot be turned around so that the PE Group meets its internal financial performance requirements.

Cash Flow; Same Unit Sales Growth

One of the biggest advantages to PE Groups of multi-unit transfers is the resulting, immediate cash flow. While PE Groups have deep financial resources, it is more beneficial to have

immediate cash flow from established units versus the time it takes to develop and build the business one unit at a time, or even many at a time. Transfers involving PE Groups often involve a large number of units, sometimes in the hundreds. Given that PE Groups are generally experienced business managers and sophisticated investors with aggressive financial goals, franchisors typically enter into these transactions with the belief that these well-funded buyers will make the investments necessary to increase same-unit sales.

Operations Efficiencies

Typically, when PE Groups decide to invest in mature businesses/brands, they acquire multiple units where operations can be scaled for efficiency. The financial backing of such buyers brings comfort to franchisors that not only will ongoing operations be well-funded, but also that such franchisees will require less hands-on support from the franchisor, permitting the franchisor to reduce overhead or redirect such resources to other operators.

B. Potential Challenges

1. Loss of System Control

Typically, the more units a franchisee has (or is acquiring), the more bargaining power it has not only on the front end, but also during its tenure as a franchisee, which may reduce the franchisor's ability to enforce system standards and make certain brand decisions. Ultimately, if a PE Group does not want to comply with a system standard or system change, or if its relationship with the franchisor becomes strained, it can become very difficult for the franchisor to enforce compliance, because the franchisor's leverage is greatly reduced. Defaulting and terminating the franchise agreements for a large number of units, which may be in the hundreds, typically is not feasible. Doing so would significantly reduce the franchisor's revenue, has the potential of damaging the brand, and may result in lengthy and expensive litigation.

2. Resistance to Capital Expenditures (the X Factor)

The franchisor and the franchisee can gain certain efficiencies when one franchisee operates a large number of units. However, when the franchisor imposes image or other brand standard changes that require capital expenditures, the more units a franchisee has, the bigger the financial impact. What may be considered a relatively low expenditure for one or two units now becomes very significant for the lesser number of units.

3. PE Groups' Financial Performance Metrics

All PE Groups impose financial performance requirements on the operators of the business. The pressure to meet these performance requirements may cause the operators to delay changes franchisors are requiring the system to make, using the leverage described above to limit the franchisor's willingness to enforce its own requirements. Additionally, if the PE Groups' financial performance requirements are not consistent with industry standards, then budgetary restrictions placed on operations to ensure the required return on investment can create negative issues, such as inadequate staffing, training, and repair and maintenance of facilities; which, in turn, has the potential of creating a downward spiral of negative same-unit sales, reduced cash flow, even tighter budgets, and slowed, reduced, or no development of new units.

4. Not Too Big to Fail

In the worst-case scenario, a PE Group franchisee could file for bankruptcy. Obviously, the more units owned by the PE Group, the bigger the potential for negative repercussions throughout the system. In markets where units are permanently closed, the brand will most likely be damaged in the eyes of the consumers in that market. Such brand damage has the potential of negatively impacting other franchisees, especially those that are in close geographic proximity to the closed units. Even if the brand does not experience direct, negative impact in the communities where the affected units are located, the negative publicity that will accompany a large-scale bankruptcy can create an unfavorable opinion in the financial community, which may devalue the brand.

C. Processes, Structures and Other Considerations

1. Franchisor's Internal Processes and Due Diligence

As this often results in franchisors accepting deals that can create significant issues and risk in the long run, the franchisor's business and legal teams should consider drafting general, internal guidelines designed to make the process of conducting transfers to PE Groups as efficient as possible. It is important for all parties that interact with the proposed PE Group transferees to understand the initial due diligence that will need to be conducted and the business and legal terms that will need to be negotiated between the parties in order to complete such a transfer.

During the franchisor's initial due diligence, discussions with the proposed PE Group buyer should include the following, not only as they relate to the proposed transaction, but also as they relate to other entities that will have ownership in the franchisee entity:

(1) organizational structure,

(2) list of other brands owned by the PE Group and/or specific proposed owners of the franchisee entity,
(3) operations/management structure,
(4) debt and capital structure, and
(5) vision for growth and the future.

Transferees should also be made aware early on that while the franchisor may be amenable to modifying certain of its guaranty, confidentiality, non-competition, and transfer provisions, these obligations will not be waived entirely.

2. Operations/Management Structure

As part of their due diligence, franchisors should ask the PE Group transferee to describe its proposed, above-unit level leadership and management structure; its plan for selection, integration, and replacement of personnel currently operating the units to be acquired; and any changes it anticipates making to the existing core executive and management teams. If the franchise agreement requires that an individual be designated as a lead operator who is accountable for unit-level performance, development of new units, and compliance with system and brand standards and has the authority to legally bind the franchisee entity this person should be identified early in the due diligence process.

3. Debt and Capital Structure

The PE Group transferee should provide the franchisor with a detailed description of the sources of financing the transferee is planning to use to fund the purchase price, including the proposed post-transaction debt and equity structure, and the PE Group's long-term plan and guiding philosophy with respect to the appropriate debt-to-equity ratio and interest coverage ratio for the business.

The PE Group should provide the franchisor its plan/model for sources and amounts of anticipated re-investment into the business being acquired, specifically noting projected expenditures for building upgrades/refreshes; equipment replacement and additions; technology upgrades and additions; and operational enhancements, including staffing and training.

4. Possible Modifications to Standard Franchise Agreement Provisions

While franchisors are often eager to consent to the transfer of multiple units to a PE Group, doing so may mean that the franchise agreements will require significant amendments to provisions relating to change of control, key persons, guaranties, confidentiality and

noncompetition covenants, financial metrics, restrictions on public offerings/securities, and restrictions on transfers. PE Group transferees should be made aware in the early stages of negotiation that while it is anticipated that the PE Group will want to negotiate these franchise agreement provisions, such provisions typically will not be waived outright.

5. Change of Control/Key Person

Most franchise agreements require franchisees to identify a key person and provide franchisors approval rights not only as to the initial Key Person but also to any future key person(s). Additionally, franchise agreement transfer provisions and possibly other provisions relating to the management of the units may be triggered when there is a change of control, which is most likely defined as a change of a certain percentage of ownership interests (which may be 50% or less), or a change in the key person.

Possible modifications include:

(a) Change Ownership Requirements for key persons.

(b) Change Ownership Percentage Triggers for Transfer Provisions.

(c) Reserve Consent Rights.

(d) Add Restrictions for Changes to key persons.

6. Confidentiality and Non-competition Covenants

Negotiations around these covenants can be lengthy. Typically, a PE Group will want as few Obligors as possible to be bound by such covenants, with Passive Investors being excluded entirely. Many PE Groups own large portfolios with franchised units from multiple industries and brands. As a result, PE Groups may wish to limit such covenants so that (a) they are not in breach of the agreement as soon as the agreement is signed and (b) they and their investors are not limited from investing in other concepts. In most cases, the Key Person, and possibly some or all Obligors, do not have visibility into the identities of all investors, especially those considered Passive Investors. Therefore, if a franchisor requires all Obligors and Passive Investors to be bound by its confidentiality and non-competition covenants, most likely, the deal will not close. As a result, Franchisors should balance their obligations to protect the brand and the system with the reality of which of the franchisee's parents, affiliates, and owners will actually receive confidential information and be involved in the operation of the franchisee's business.

7. Financial Metrics

The purchase of a large portfolio of franchised units is typically financed, in part, by a credit facility (versus a standard loan a more traditional franchisee may use to fund a purchase). A credit facility is a type of loan made in a business or corporate finance context. It provides funding to the borrowing business over an extended period of time so that the borrower does not have to reapply for a loan every time it needs money. A credit facility provides an avenue for a company to take out an umbrella loan for the purpose of generating capital over an extended period of time. A PE Group may be reluctant to provide the franchisor with a copy of its credit facility, but this requirement is critical.

If any of the owners of the franchisee entity are also owners of a portfolio of units that operate under a different franchisor's concept, the credit facility should be reviewed carefully to determine if any of the ratios or other terms of the credit facility cross reference or cross-default to any other credit arrangement the PE Group or its affiliates, subsidiaries, etc. or to the performance of a different portfolio of units. Franchisees should be required to represent that a true and correct copy of the credit facility was provided to the franchisor.

TRANSFERS TO FAMILY MEMBERS

As franchise owners develop succession plans, they often plan to transfer their businesses to their children or other family members. However, in some instances, such as in a divorce or a death or disability where the franchise is transferred due to a court order, such transfers may not be pre-planned.

On one hand, family businesses that get passed from one generation to the next often are operated by some of the most successful and dedicated franchise owners in a system. On the other hand, sometimes the heir or transferee doesn't want to run the family business or simply isn't qualified to do so, potentially posing a risk to their business, as well as the franchisor's brand.

Franchisors, in drafting their franchise agreements, should create a balance between facilitating transfers to family members, while retaining ultimate control over who can become a franchise owner in order to protect the brand.

1. Advantages

So long as the proposed transferee possesses the necessary qualifications, transfer of a franchised business to a family member can be beneficial to all parties, providing a franchisor

with additional comfort that a successful franchise will continue to operate for another generation and a franchise owner with the comfort that they are able to pass down something of value to their children. Those who inherit the family business often grow up in the business, having significant on-the-job training before assuming ownership. Where a family member has been trained and intimately involved in the operation of a franchise, such a transition can be seamless. The transition to a new owner may even reinvigorate a lagging franchise, as the new owners bring fresh enthusiasm and implement new ideas.

Franchisors often encourage or facilitate such transfers by eliminating transfer fees for transfers to family members and simplifying or eliminating other required transfer conditions. The inclusion of special provisions for family transfers in a franchise agreement can be a selling point for franchisors.

2. Disadvantages

Unfortunately, not all transfers to family members go well, whether planned or unplanned. Often, though the existing franchise owner may want to transfer their business to their children or other family members, the intended owners aren't interested in taking over the business, aren't truly committed to operating the business, or aren't qualified to do so. In such cases, a franchisor may not want to continue being in business with the proposed transferee.

3. Handling Transfers to Family Members

While a franchisor should consider making it easier to transfer an asset to family members as part of a succession plan, it is important for the franchise agreement to provide the franchisor with the ultimate right to approve the transfer of the franchise or a controlling ownership interest in the franchisee entity to a family member, requiring each proposed franchise owner to still satisfy the franchisor's minimum requirements. However, as noted in Section II.D.4. above, some state laws restrict the ability of franchisors to limit transfers to heirs in the case of the death or disability of a franchise owner.

In the event that the new franchise owner cannot meet the franchisor's qualifications or satisfy any applicable conditions, the franchise agreement should provide for a reasonable period of time (generally, three to six months) to allow the original owner's executive, administrator, personal representative, or trustee to have the opportunity to transfer their ownership rights to acceptable third parties. During such period, the franchisor should have the right, but not the obligation, to step in and manage the business for a reasonable fee so that it remains in operation

until it can be transferred. If the franchise owner's representatives are ultimately unable or unwilling to transfer the ownership interests in the franchise to a qualified franchisee, the franchisor should retain the right to terminate the franchise agreement.

MULTIBRAND FRANCHISEES

The value of a franchise to a franchisee can be significantly enhanced when the franchisor grants the franchisee an exclusive right (or some kind of protective right) to conduct the franchised business within a certain market, and thereby protect (to a certain extent) the franchisee from competition from the franchisor and other franchisees in the same franchise system. In some franchised businesses, such rights are not only beneficial but are considered crucial to enable the franchisee to open the new business and have the best opportunity to fully develop it over time, thereby maximizing the sales, revenue, and growth potential that is the essence of the franchise opportunity itself. In others, there are no such protections.

However, when a franchisor engages in other forms of business or utilizes alternative or indirect methods of doing business in the same markets in which its franchisees operate, the franchisor and franchisees may find themselves competing for the same customers and resources. Common examples of this include instances when a franchisor:

(a) acquires a competitor that is already present in or expanding into the marketplace;

(b) develops a new and different brand that competes in the same industry or sector as the franchised business; and/or

(c) utilizes alternative channels of distribution for its products or services.

These different types of competition are collectively referred to as "indirect competition" in this paper for convenience.

A. ISSUES RELATED TO COMPETITION WITHIN A BRAND

1. Territory and Encroachment

As a general rule, exclusive territories are very important to franchisees. Franchisees often deem it essential to have protection from unfair competition by the franchisor and other franchisees

because they see their financial success as being dependent on the physical location of their business and its marketplace, or at least a protected area for doing business. Consequently, prospective franchisees tend to focus on these protections in their franchise agreements, and existing franchisees can be quick to raise claims when there are actual or perceived violations of their territorial rights by franchisors.

In the traditional example, when a franchisor grants an exclusive territory for a franchised business at a physical retail location (the proverbial "brick-and-mortar store") the franchisee's rights and protections are typically determined by four principal elements in a protected territory clause in the franchise agreement. Those elements are:

(a) the scope – i.e., the types of activities that the franchisee has an exclusive right to conduct and/or the activities that the franchisor is prohibited from engaging in or permitting others to engage in;

(b) the market – i.e., the geographic territory or marketplace in which the rights or restrictions apply;

(c) the duration – i.e., the time period in which the rights or restrictions apply; and

(d) the limitations – i.e., the rights reserved by the franchisor to engage in activities that might otherwise violate the other parameters above.

2. Scope - The scope of business activities in a protected territory clause can either be set forth in the affirmative, with statements that *grant the franchisee* exclusive rights to conduct specific business activities under the franchisors' trademarks or using the franchisor's system; or in the negative, with statements that *restrict the franchisor* from conducting or granting anyone else the right to conduct specific business activities under the franchisors' trademarks or using the franchisor's system; or a combination of both.

3. Market - In a traditional protected-territory clause, the marketplace covered by the clause is based on a specified geographic area. In more advanced clauses that geographic area may be expanded to cover certain types of indirect or alternative sales methods that cross geographic boundaries, such as internet-based sales made to customers in the territory, sales made outside the territory that are delivered to customers within the territory, and alternate channels of distribution that are within or have some other nexus to the territory.

Normally franchisors and franchisees will agree on geographic areas that are defined by either a "radius" or "metes-and-bounds" description, but it can be anything definable.

Protected territory clauses based on "radius" provide the franchisee with an exclusive territory that is a geographic circle, with a specified midpoint and radius extending as specific distance. The radius could be a little as 300 feet (about the length of a city block) or as much as several miles (covering large portions of counties or states). Often a map or diagram of the protected radius is attached to the franchise agreement as an exhibit for clarity.

However, radius territories have drawbacks. Although they may seem clear on paper, they can be less ideal in practical application. The first drawback is that it may be awkward to apply a circular boundary in certain populated areas. For example, a circular territory may be quite awkward to apply in a downtown city area that is organized around perpendicular city blocks, as it could create a dividing line that runs through buildings and creates odd corners that are prone to dispute.

Another drawback is the inconsistency that can arise from a franchise program utilizing a standard radius. For example, if the radius is measured by straight line over hilly or mountainous topography, the surface land area actually covered might be quite large and materially different than other protected territories with the same radius. In some businesses this could matter (such as pest control franchises where land surface area may be directly pertinent to the service provided), whereas in others it may not matter much (such as educational tutoring franchises, in which population demographic is a more pertinent metric to the service provided).

Metes-and-bounds descriptions provide an alternative to radius descriptions. In a metes-and-bounds clause the protected territory is an enclosed geographic area with a defined boundaries on all sides that are readily identifiable with reference to maps and/or coordinates. As with radius territories, it is wise for the franchise agreement to contain an exhibit with a map or diagram of the territory to ensure a meeting of the minds with precision. However, as with radius territories, metes-and-bounds descriptions can have pitfalls.

A key shortcoming and a trap for the unwary in a metes-and-bounds description can arise when a boundary line is tied to a political border (like a county line), an artificial barrier (like a highway), or a natural barrier (like a river), which can move over time at no fault of the parties.

4. Limitations - An essential part of every protected territory clause is the list of rights the franchisor reserves for itself, which inherently operate to limit the rights granted to the franchisee. This is where the franchisor's ability to engage in indirect and alternate forms of competition, or arguably competitive practices, are enumerated. The purpose is not necessarily (or

not merely) to carve exceptions out of the franchisee's protected territory, but rather to ensure a meeting of the minds, resolve ambiguities, and prevent disputes in *the application* of the franchisee's protections as to different kinds of business practices that the franchisor may engage in and which could evolve over time.

A standard reservations of rights clause usually has two components:

(a) a list of the specific business activities that would constitute *or may potentially constitute* indirect competition by the franchisor; and

(b) an umbrella clause reserving to the franchisor any and all rights that are not expressly granted to the franchisee.

5. State Statutory Protections Against Encroachment – Franchisees may assert claims for encroachment under various state statutes including industry-specific statutes (such as those regulating motor vehicle dealership and potentially hotel franchises), statutes of general application (such as deceptive and unfair trade practice laws and antitrust laws), and franchise relationship laws.[80]

ISSUES RELATED TO OPERATING, ACQUIRING, OR DEVELOPING COMPETITIVE BRANDS

Today, there is a significant increase in the number of organizations that leverage franchising as a way to scale groups of brands. This business model, to own and develop multiple franchise brands under one holding company or franchise conglomerate, was originally popularized by the Dwyer Group franchise holding company in 1981, which owned several extremely successful franchise systems including Aire Serv, Glass Doctor, The Grounds Guys, Mr. Appliance, Mr. Electric, Mr. Rooter (Drain Doctor in the UK and Portugal), and Rainbow International. This business model allows established franchisors to develop and grow additional brands much more efficiently and to scale such brands at a faster rate. Also, the model allows a franchise conglomerate or multi-brand franchisor the opportunity to multi-purpose its franchise resources, staff, and leadership team.

[80] FLA. STAT. § 817.416(2)(a); HAW. REV. STAT. § 482E-6; IND. CODE § 23-2-2.7-1; IOWA CODE §§ 523H.1, 537A.10(6); MINN. STAT. § 80C.14 Subdiv. 1; MINN. R. 2860.4400; WASH. REV. CODE § 19.100.180(2)(f); WIS. STAT. § 135.03.

Large franchise holding companies and franchise conglomerates have to make sure to properly manage and address both the encroachment issues and the system operations issues that are bound to pop up from time to time caused by the strain on franchisor-franchisee relationships when these large organizations introduce new competitive brands to their portfolios.

. *Territory/Encroachment Issues*

Franchisees will bring actions against their franchisors when they believe other franchisor-owned brands are intruding on their territory, whether the competing brands operate in the same or a different market segment. Franchisees planning to bring an encroachment claim against their franchisor need to understand there are many factors considered by courts in determining whether a franchisee is entitled to recovery.

One of the most significant cases dealing with the issue of franchise encroachment is *Scheck v. Burger King Corp.*[81] In this case, the defendant franchisor ("Burger King") permitted a restaurant located within close proximity from the plaintiff franchisee's ("Scheck") store location to be converted into a competing Burger King franchise. The franchise agreement at issue expressly denied the plaintiff franchisee any territorial exclusivity, providing that the license is "for the described location only and does not in any way grant or imply any area, market or territorial rights proprietary" to the franchisee. The court found that "the express denial of an exclusive territorial interest to the franchisee does not necessarily imply a wholly different right to the franchisor, that being the right to open other proximate franchises at will regardless of their effect on the franchisee's operations." Under the covenant of good faith and fair dealing, Scheck was "entitled to expect that Burger King will not act to destroy the right of the franchisee to enjoy the fruits of the contract."[82]

. *Competition With Other Brands Owned by Franchisor*

The economic effects of a franchisee's competition with other franchisor-owned brands involves layers of economic analysis. Decisions on pricing, on quality, on retail efforts, and on other inputs all may affect profits not only of the franchisor and franchisee making such decisions, but also the profits of the other brands in the franchise portfolio. Concerns that existing franchisees

[81] Scheck v. Burger King Corp., 798 F. Supp. 692, 695 (S.D. Fla. 1992).

[82] Peter C. Lagarias and Edward Kushbell, *Fair Franchise Agreements from the Franchisee Perspective*, 33 FRANCHISE L.J. 3, 14 (2013); *see Scheck*, 756 F. Supp. at 549 (citing Photovest Corp. v. Fotomat, 606 F.2d 704, 728 (7th Cir. 1979)).

face when a franchisor operates, acquires, or develops competitive brands within its franchise system include:

- Increased market competition from their own franchisor, which may lead to reduced market share, decreased customer traffic, and potential financial losses for franchisees;

- Cannibalization of sales among multiple competitive brands' franchise locations as customers may be divided between the various brand options, resulting in reduced sales volumes and profitability for individual franchisees;

- Allocation of resources between the existing brands and the newly introduced or acquired competitive brands. If resources are skewed towards new brands, it can create a disadvantage for existing franchisees; and

- Stressed business relationship between the franchisor and existing franchisees, as franchisees may begin to question the franchisor's loyalty and commitment to their success.

The mere fact a franchisor is consolidating other brands/franchise systems under a single portfolio does not inherently result in a net-negative for franchisees. Franchisees may be able to reap certain benefits from such consolidation, including:

- Franchisors achieving economies of scale, thus allowing franchisees to pay less for third-party products and services;

- Becoming a part of cross-brand loyalty programs that carry a large customer base;

- Access to more sophisticated and effective franchise management teams; and

- Access to state-of-the-art franchisee management support systems.

Despite some possible benefits, the idea of a franchisor folding new brands into its franchise portfolio to compete with its existing franchise brands, whether in the same or a different market, unsurprisingly concerns existing franchisees.

Same Market Segment

Market segmentation is a business practice that brands use to divide their target market into smaller, more manageable groups of people based on common ground they share to optimize marketing, advertising, and sales efforts. Particularly when brands are directly competing in the same market segment of a given field. Fear of losing a competitive advantage, while also facing competition within their territory from what can be perceived to be their franchisor, causes many franchisees to seek legal remedies for encroachment. Addressing these territorial issues begins first with the express and implied contractual rights between the parties. Generally, litigation on this matter has fallen into three categories:

(1) where the franchisee has no territorial protection against competition from its own brand;
(2) where the franchisee has territorial protection against an identified brand in its contract; and
(3) where the franchisee has territorial protection based on the type of business without regard to brand identification.

Different market segment

Although a franchise holding company or franchise conglomerate may think it clever to create silos within its franchise portfolio to safeguard itself against territorial disputes, there are numerous instances of franchisees bringing encroachment actions against their franchisor for operating brands in completely different market segments.

Market Saturation.

Introducing multiple competitive brands into the same market segment may lead to market saturation, resulting in diminishing returns for all brands. Franchisors need to conduct thorough market research and feasibility studies to determine if the market can sustain multiple brands without oversaturation.

Separate and Distinct Administrative Functions or All for One

Franchisors should consider what aspects of their managerial and administrative functions they want to share with their newly acquired and developed brands. While some system operations work best remaining specialized for an individual franchise or brand, others can benefit from the efficiencies created by synthesizing tasks across a franchise portfolio.

Marketing and Advertising Issues – Overlap or Separate

Marketing and advertising within a franchise portfolio with competing brands can be difficult, especially when each competing brand has its own unique marketing plan and advertising strategies. Some challenges and issues franchisors should consider when formulating their marketing plans include:

- Brand Differentiation and Market Positioning. Franchisors should develop effective strategies to ensure that each brand has its own unique identity, target audience, and value proposition in order to market and sell its products and/or services.

- Local Market Preferences. Different markets may have unique customer preferences and competitive landscapes. Franchisors should establish a framework that allows franchisees to tailor marketing efforts to their local markets while maintaining overall brand recognition and presence.

- Co-op Advertising. Franchisors commonly establish cooperative advertising programs or co-op funds, where franchisees contribute to a pool of funds which are then used for regional or national marketing initiatives. Managing co-op advertising programs can be complex, as franchisors need to ensure transparency and fair allocation of funds throughout the entire franchise system.

- Marketing Fund Management. Franchisors are typically responsible for managing the marketing funds contributed by franchisees. This includes budgeting, planning, and executing marketing initiatives that drive brand awareness and customer engagement.

Marketing and advertising franchise brands should be collaborative among the franchisor and franchisees of each brand to ensure that each brand and franchisee is being afforded the best opportunity to succeed.

CONSIDERATIONS IN PURCHASE AND SALE OF A FRANCHISE COMPANY There are a litany of issues and potential problems associated with an acquisition of a franchise company, many of which are not found in the purchase and sale of other businesses. This chapter provides a general overview of some of the special considerations and issues to address

when purchasing or selling a franchise company. It focuses on the unique issues in connection with mergers and acquisitions of franchise companies including issues relating to franchise-specific laws, potential causes of action available to franchisees, key provisions to examine when reviewing franchise agreements, franchise disclosure issues with respect to the transaction, and drafting considerations.

A. FRANCHISE COMPANIES' ASSETS AND LIABILITIES ARE UNIQUE

1. NATURE OF A FRANCHISOR'S ASSETS

Although standard acquisition checklists used in a non-franchise acquisition are still valuable, attorneys should supplement them to reflect the additional unique assets and liabilities of a franchise company. Intellectual property is often a franchise system's key asset. Because franchisors operate in dozens of industries, it is not practical to compile a single checklist of all the intellectual property found in franchise systems; however, the following assets are likely to be relevant to most transactions:

- trademarks and service marks;
- copyrights and copyrightable assets, including unique software, manuals and training materials, prototype blueprints, and advertising;
- patents;
- licenses and contractual rights, including agreements with suppliers, national accounts, and franchisees;
- domain names;
- trade secrets;
- internet agreements; and
- customer information (franchisees, and customers of franchisees).

2. NATURE OF FRANCHISOR'S LIABILITIES

On the liability side, franchise agreements impose obligations that may not be reflected on a balance sheet. Further, the franchise regulatory environment poses risks and liabilities that other businesses do not encounter. These liabilities are not considered liabilities under generally accepted accounting principles. For example, there are the obligations franchisors undertake in long-term agreements with franchisees, which may not all have been entered at the same time and may contain some different provisions. The possibility of violations of the laws and regulations

that govern franchise sales and relationships with franchisees may pose significant potential liabilities. Beyond legal liabilities, the franchisor's relationship with its franchisees, key suppliers, national accounts, and franchisee associations must be analyzed carefully to determine the true value of the business.

The presence of a franchisee community differentiates franchising from most other businesses. Franchisees often band together, either informally or formally through groups such as franchisee associations, and these groups can carry significant legal and practical power to influence the terms of an acquisition, as well as its post-closing success.

Absent a franchisee association, or direct contact with franchisees, a thorough review of the franchise files might be necessary to uncover correspondence involving common issues with franchisees.

B. INFORMATION ACCESS – BEYOND THE TYPICAL DUE DILIGENCE

One of the critical components of a franchise acquisition is accessing information about the existing franchisees. Future expansion of the business, or contraction, will in large part be dictated by the seller's existing franchisees. Are they interested in expanding, and if they are not, how will they react to significant expansion in their markets (assuming they do not have exclusive territories)? Will they provide validation to future franchisees? Are they themselves in financial difficulty and likely to contract in the future?

The obvious starting place in learning about the existing franchisee population is to talk with them. However, as discussed earlier, many sellers will be reluctant to allow would-be buyers to speak to their franchisees. In a small system, it may be practical to review each of the seller's franchise agreements and each franchisee's file, but in a larger system, it will be impractical to review more than a representative sampling. The sampling, however, should be of multiple agreements and files of each type of franchisee (i.e. single unit, multi-unit, area developer, and master franchisee (sub-franchisor)) to make certain that the buyer has reviewed a good cross section of the franchisees. In addition, larger systems often have franchisee associations (franchise advisory councils and/or independent franchisee associations), and a careful review of the minutes of those meetings, and correspondence between the franchisor and the association(s) will often provide great insight into the issues that need further review.

C. DISCLOSURE AND REGISTRATION ISSUES

Disclosure and registration laws are intended to provide disclosure to prospective franchisees with important information concerning the franchise. Therefore, it is particularly important to determine whether and how the impending transaction should be disclosed under these laws if the franchisor intends to sell new franchisees before the sale is closed. Disclosure guidelines do not specifically address disclosure obligations with respect to the pending sale of a franchise system. However, they do require disclosure of certain information about any parent company of the franchisor. Moreover, a number of state franchise disclosure laws include a requirement not to omit any material information from the disclosure document, and several of these statutes address actual changes in a franchisor's ownership or management control as constituting a material event requiring disclosure. A failure to timely disclose the existence of a potential sale to a prospective franchisee could also lead to a claim of common law fraud for negligent misrepresentation.

Unfortunately, there is no bright line as to when a transaction must be disclosed. Thus, no hard and fast rule can be adopted for when a sale must be disclosed, and common sense and the particular circumstances should dictate. Similarly, when the buyer also sells franchises, these same considerations apply to its disclosure document. Among the considerations are (a) at what point the transaction is more likely than not to occur; and (b) what effect the transaction will have on the operation of the business and the disclosures currently contained in the franchise disclosure document.

D. Exploratory Stage

The parties to a business combination usually begin their negotiations with informal discussions during which they explore each other's intentions and sincerity. In the context of a franchise acquisition, the parties can use this exploratory stage to create mechanisms for solving the practical problems discussed earlier. With counsel's assistance, they can, and should, establish procedural rules to safeguard the interests of both parties during the project's three principal phases: the period during which the buyer formulates a concrete purchase proposal, ending with the negotiation and execution of an agreement in principle or letter of intent; the more intensive diligence stage, which culminates with the signing of a definitive agreement; and the period between the signing of the definitive agreement and closing.