

International Franchise Association
55th Annual Legal Symposium
May 7-9, 2023

Franchising in the Age of Digitization, Robotics and Automation

Rebecca Valo
Cassels Brock & Blackwell
Toronto, Canada

Jason M. Murray
K&L Gates LLP
Miami, Florida

Jim Cagle
McDonald's Corporation
Chicago, Illinois

Donald P. Wray, Jr.
Domino's Pizza LLC
Ann Arbor, Michigan

Table of Contents

- I. INTRODUCTION 1
 - A. Recent Trends and Emerging Technology 2
 - B. Franchise Challenges and Tech-Based Solutions..... 3
 - 1. Marketing 4
 - 2. Human Resources and Labor 5
 - 3. Operational Efficiency 6
 - 4. Franchise Growth..... 7
 - 5. Consumer-Facing Solutions 8
- II. CURRENT & EMERGING CHALLENGES 10
 - A. Geo-Political Issues 11
 - B. Inflation and Economic Uncertainty 13
 - C. Supply Chain Disruptions 13
 - D. Data Security and Privacy 14
- III. INTRODUCTION & IMPLEMENTATION OF TECH SYSTEM CHANGES 16
 - A. Good Faith and Fair Dealing 16
 - 1. The American Perspective 16
 - 2. The Canadian Perspective 18
 - 3. The International Perspective..... 19
 - B. Best Practices for Technological Changes in a Franchise System 19
 - 1. Best Interests of the System 20
 - 2. Franchisee Buy-In and Relationship Management..... 21
- IV. CONTRACTUAL CONSIDERATIONS 23
 - A. Key Consideration: Does the Contract Permit the Change? 24
 - 1. System Modification Provisions..... 24
 - 2. Data Security and Privacy Provisions 27
 - 3. Capturing Fees..... 32
 - B. Other Tips and Best Practices..... 32
- V. CONCLUSION 33

I. INTRODUCTION

We are all familiar with the phrase innovate or die. Indeed, we are perhaps even more familiar with those companies that failed to innovate – think, Kodak, Borders, and Blockbuster¹. But what exactly is innovation? There are countless ways to define innovation, but in the franchise context it is often thought of as a method to disrupt the market or challenge competitors, and as a way to enhance an organization's processes and technologies².

Since franchised systems usually encompass geographically dispersed, independent entities allied for the purpose of engaging in business, the franchise model is particularly amenable to sustaining innovation. The necessity of consistency across units means that franchises are a great host for virtuality, automation, and variety of emerging technology. Beginning with early back of house solutions, such as the implementation of intranets, and consumer-facing technologies, such as the use of digital menus and signage, franchised businesses have been increasingly relying on new and innovative technologies to attract franchisees, facilitate growth, lower costs, and improve operations. In today's technological landscape, more and more franchisors are relying on artificial intelligence (AI), machine learning (ML), and robotics to operate and manage their businesses.

While technology has increased efficiency and profitability for franchisors, certain facets of the franchise business model and the accompanying legal schemes create unique challenges. A franchisor seeking to innovate its business must approach the implementation of new technology with great care and remain mindful of internal constraints, such as contractual and legal considerations, and external challenges, such as social, political, and economic issues. It is essential for franchisors to understand the nuances of system change implementation, including the unique nature of the franchisor-franchisee relationship in light of the legal duties of good faith and fair dealing.

This paper explores the use of innovative technologies in the franchise context. Beginning with a brief overview of the types of technologies relied on by franchisors, this paper will explore the various contexts in which such technology is used, and its utility. Next, this paper will consider current and emerging challenges to the implementation of new technologies. Finally, through the lens of the franchisor-franchisee relationship and its contractual and legal implications, this paper will provide practical advice and best practices for implementing technological system changes in the franchise context.

¹ Poonkulali Thangavelu, *Companies that Failed to Innovate and Went Bankrupt*, INVESTOPEDIA (Dec. 30, 2022), <https://www.investopedia.com/articles/investing/072115/companies-went-bankrupt-innovation-lag.asp>

² Michael Boyles, *Innovation in Business: What it Is & Why It's So Important*, HARVARD BUSINESS SCHOOL ONLINE, <https://online.hbs.edu/blog/post/importance-of-innovation-in-business>.

A. Recent Trends and Emerging Technology

Largely considered to be the most influential technology for businesses in recent years, AI utilizes data collection, computational techniques and output systems to perform tasks that may otherwise require intelligence and autonomous decision-making ability.³ These developments have already become commonplace in private spaces, with many consumers already adopting AI in their homes through popular smart home devices such as Amazon's Alexa and Apple's Siri.⁴ While the definition is broad, AI can refer to a system's ability to perform tasks that are usually associated with human reasoning, such as identifying data sets.^{5,6} AI is developed through the use of algorithms designed to iteratively learn from data and improve the program's performance through continued usage.⁷

Machine learning, which is a branch of AI, focuses on the collection and use of data and sophisticated algorithms to imitate – and of course, improve – the way humans learn. Many innovative products, from self-driving cars to Netflix's recommendation engine, are dependant on ML. ML is essential for innovators to gain key insights, make classifications, and predict behaviours and outcomes.⁸ Recently, the infusion of AI and ML in roles traditionally held by frontline employees has attracted significant attention, including in the franchising context.⁹

³ Stefano Puntoni et al., *Consumers and Artificial Intelligence: An Experiential Perspective*, 85 J. MARKETING 131, 132 (2021).

⁴ Kate Letheren et al., *Black, white or grey magic? Our future with artificial intelligence*, 36 J. MARKETING MGMT. 216, 217 (2020).

⁵ Pablo J. Olmo Rodriguez, *Artificial Intelligence Law: Applications, Risks & Opportunities*, 90REV. JUR. UPR 701, 703 (2021).

⁶ A bipartisan bill presented by the House of Representatives in December 2017 listed the following examples of AI technology:

(A) Any artificial systems that perform tasks under varying and unpredictable circumstances, without significant human oversight, or that can learn from their experience and improve their performance. Such systems may be developed in computer software, physical hardware, or other contexts not yet contemplated. They may solve tasks requiring human-like perception, cognition, planning, learning, communication, or physical action. In general, the more human-like the system within the context of its tasks, the more it can be said to use artificial intelligence.

(B) Systems that think like humans, such as cognitive architectures and neural networks.

(C) Systems that act like humans, such as systems that can pass the Turing test or other comparable test via natural language processing, knowledge representation, automated reasoning, and learning.

(D) A set of techniques, including machine learning, that seeks to approximate some cognitive tasks.

(E) Systems that act rationally, such as intelligent software agents and embodied robots that achieve goals via perception, planning, reasoning, learning, communicating, decision making, and acting.

⁷ Pablo J. Olmo Rodriguez, *Artificial Intelligence Law: Applications, Risks & Opportunities*, 90:3 REV. JUR. UPR 701, 703 (2021). Note: An algorithm may be considered as a step-by-step set of operations to be performed, or a type of formula. Algorithms are increasingly prevalent if not omnipresent in the daily lives of people in countries with developed economies, being used in the military, business, finance, manufacturing, science, communications, media, transportation, medicine, entertainment, and virtually every other facet of economic and social life.

⁸ *What is Machine Learning?* IBM, <https://www.ibm.com/topics/machine-learning> (last visited Apr. 14, 2023).

⁹ Jochen Wirtz et al., *Brave new world: service robots in the frontline*, 29 J. SERV. MGMT. 907, 908.

As further discussed below, many franchised restaurants that depend on frontline service have begun adopting AI technology as part of the customer interaction. The AI technology can create some degree of automated social presence at the services encounter, making the consumers feel as if they are in the company of another social entity.¹⁰ While these frontline AI interfaces can be programmed locally, they can also access data from a wide range of other sources, pulling from the internet, collective organizational knowledge bases and its customer relationship management systems which may contain customer backgrounds, preferences and transaction data.¹¹ If combined with biometrics, facial and voice recognition systems, these technologies can go so far as to identify the customer and provide customized and personalized service.

AI solutions have also created opportunities for large advances in operational efficiency. AI entities do not learn in the same way humans do and acquiring knowledge and learning can be instantaneous and system wide.¹² For example, service robots can store millions of scenarios and determine a response based on what the optimal result would be given all the factors present.¹³ Compare this to a human worker, who may read a manual that offers them the optimal solution to several common scenarios but is still far from covering every scenario possible. Additionally, even if each scenario was covered, a human does not have the same “memory” and would be unable to “store” each scenario and the appropriate response. Humans are conditioned to learn and retain when they *experience* certain situations – it is untenable to experience every scenario possible. This is exacerbated when any sort of change is enacted – the codified knowledge is now out of date. While updating an AI entity is both immediate and cost-effective, humans would need to learn how to interact with the new system, which may take a considerably longer amount of time.

Frontline AI technologies benefit from significant economies of scale. Every incremental “head” added does not add any cost beyond the parts itself (and speakers, cameras and microphone systems have become increasingly inexpensive).¹⁴ Traditional employees are not scalable in this sense and every additional individual added requires both tangible (i.e., uniform) and intangible costs (i.e., training). Additionally, service robots are predictable and provide homogenous service interactions to each customer, behaving identically from one person to the next and are not subject to fatigue induced error.¹⁵ Given these examples, it is evident that AI can offer several significant benefits in the franchise space.

B. Franchise Challenges and Tech-Based Solutions

Technology has offered solutions to a variety of challenges in the franchise context. In addition to facilitating operational efficiency through centralized systems and automated

¹⁰ *id.* at 909.

¹¹ *id.*

¹² *id.* at 910.

¹³ *id.*

¹⁴ *id.* at 912.

¹⁵ *id.* at 910.

processes, emerging technology has allowed franchisors to better understand their businesses at all levels. Through the use of AI and information technology, franchisors can gather vital information about their franchisees and consumers. Through automation and robotics, franchisors are able to streamline operations and reduce costs.

Franchisors have been increasingly relying on technology to understand and meet the needs of franchisees and consumers. With AI, franchisors can better communicate with franchisees to mitigate operational challenges, increase satisfaction and retention, and attract new franchisees. AI has also allowed franchisors to better understand the consumer, allowing them to accurately identify target demographics, attract new demographics, and maintain a competitive edge. Robotics and automation have streamlined operations at the franchisee level, improved efficiency, and reduced costs. This section explores the ways in which franchisors are relying on technology to improve their business and solve challenges in marketing, human resources, operations, franchise growth, and consumer relations.

1. Marketing

In 2021, the market for AI in marketing was estimated at 15.84 billion U.S. dollars, with a projected increase to more than 107.5 billion by 2028.¹⁶ Marketing professionals have used AI to analyze large quantities of data, allowing them to identify target audiences, personalize campaigns to the individual consumer, predict conversion rates and other consumer behaviour, and deliver well-timed marketing content to consumers.¹⁷ AI and predictive analytics allow franchisors to efficiently and accurately identify the ideal target group for their business, as well as identify new segments of their target groups based on certain characteristics.¹⁸ This process, known as target segmentation, allows franchisors to identify many specific types of consumers, rather than grouping them into broad categories.¹⁹ Franchisors can then use this data to deliver marketing tailored to each consumer's specific needs.

With the enormous volume of valuable information obtained by AI systems, franchisors can distinguish between consumers based on specific needs and characteristics. In this way, consumers are no longer grouped under broad categories, such as "vegetarian". Instead, franchisors are able to further segment target consumers into highly specific groups. For instance, vegetarians can be further categorized based on characteristics such as specific diets (ovo-vegetarian, lacto-vegetarian, vegan, etc.) and specific motivations (religious, cultural, social, health-related reasons, etc.). Franchisors can then use this data to deliver marketing tailored to each consumer's specific needs—a health-conscious vegan receives a targeted social media ad featuring products that complement and enhance their lifestyle, or a socially conscious consumer receives a personalized ad about the franchisor's most recent charitable initiative.

¹⁶ *How to leverage AI in marketing: three ways to improve consumer experience*, DELOITTE, <https://www2.deloitte.com/si/en/pages/strategy-operations/articles/AI-in-marketing.html> (last visited Apr. 14 2023).

¹⁷ *id.*

¹⁸ *id.*

¹⁹ *id.*

AI and predictive analytics can also help franchisors predict consumer behaviors and responses to advertising. This allows businesses to further refine marketing communications so as to establish relationships with consumers on their terms.²⁰ Franchisors can deliver advertisements and communications in the individual's preferred format and at the ideal time. Further, through integrated Wi-Fi marketing, data can be collected at each franchise location, allowing franchisors to deliver geographically specific targeted advertising.²¹ For franchise owners, integrated Wi-Fi marketing can not only predict consumer behavior, but help change it. Franchisors can drive regular customer promotions to increase time in store locations, encourage occasional customers to visit more frequently, bring back "lost" customers, and increase awareness through location specific social media engagement.²² AI and predictive analytics allow businesses to increase marketing success by making data-driven decisions.

2. Human Resources and Labor

Labor is often an area of particular importance for franchised businesses. A recent study conducted by the International Franchise Association (IFA) revealed that labor is the most important concern facing franchised businesses, with 87% of franchisors reporting that their franchisees have had difficulty filling job openings.²³ Further, over 80% of these franchise businesses have identified labor challenges as a cause of constrained growth.

The IFA's research also identified innovative strategies implemented by franchisors to mitigate labor concerns. These strategies included using AI in recruitment, investing in digital advertising, and creating automated application processes. Artificial intelligence has been used by businesses to reduce recruiting timelines, lower costs, improve employee experience, and increase employee retention.²⁴ AI is particularly suited to sourcing and screening candidates as it can collect large volumes of data from a variety of sources, including social media profiles, previous online employment records, and educational qualification. This data is then used to improve ranking and filter the pool of candidates to those best suited for each position.²⁵ Further, this method can be used to identify passive candidates, who may be more desirable because of their satisfaction with their current positions.²⁶ Some tech start-ups are taking AI in recruitment a step further by specializing in AI interviewing software. These programs simplify the interviewing process using pre-set questionnaires and recorded videos, thereby reducing the

²⁰ *id.*

²¹ Stephen Gould, *How Franchisees Can Use Technology to Change Consumer Behaviour*, ENTREPRENEUR (Feb. 24, 2023) <https://www.entrepreneur.com/franchise/how-franchisees-can-change-consumer-behavior-with-this-tech/444815>.

²² *id.*

²³ INT'L FRANCHISE ASS'N, IDENTIFYING AND ADDRESSING TODAY'S LABOR TRENDS: A 2023 STUDY ON TRENDS IN FRANCHISING (2023), https://www.franchise.org/sites/default/files/2023-02/2023%20Labor%20Survey%20Draft_V2.7%20%28002%29.pdf.

²⁴ Barbara Van Pay, *How Artificial Intelligence is Reinventing Human Resources*, ENTREPRENEUR (Sept. 30, 2018), <https://www.entrepreneur.com/en-ae/technology/how-artificial-intelligence-is-reinventing-human-resources/320763>.

²⁵ *id.*

²⁶ *id.*

recruitment timeline and cutting costs. By developing and delivering customized information, data, and resources in a digestible format, AI can make talent acquisition more efficient and effective.²⁷

Recruitment is not the only area in which AI has been used to improve human resource practices. Some franchisors have utilized these technologies to train employees, create schedules, analyze employee performance, and manage employee relations.²⁸

3. Operational Efficiency

Automation is increasingly prevalent across industries. Growing labor, social, and economic concerns have led businesses to rely more heavily on AI and robotics. In 2018, Boston Pizza – one of Canada’s largest casual dining franchises – implemented advanced technological upgrades to its back of house and front of house operations.²⁹ These changes included a guest management platform which accurately and efficiently seats customers, manages tables, waitlists, and reservations, and stores all customer information in a digital database.³⁰ The franchise also implemented back of house software which aids in the flow of the kitchen with advanced routing, timing on orders, and dashboard reporting.³¹ In May 2018, the franchise had implemented this technology in more than 100 locations, but many questions remained as to its effectiveness and practicality. However, by 2021, and following a difficult year for restaurant franchises globally, Boston Pizza reported rapid growth through 2020, with a 20% increase in unit growth.³² The brand also reported that it is on track to double in size by 2023.³³ Insiders are attributing the franchise’s resilience in large part to its implementation of innovative technology.³⁴

Some franchisors have taken automation a step further through the use of robotics. Domino’s Pizza – a global franchise with locations in more than 90 international markets – is implementing commercial autonomous delivery through the use of a delivery robot with specialized temperature-controlled compartments and advanced navigation and spatial technology.³⁵ This is not the first time the franchise has attempted this change, though in earlier attempts the technology was still far from autonomous, as the vehicles needed to be remotely operated by engineers. Today, the technology is available in

²⁷ R. Geetha & D. BhanuSree Reddy, *Recruitment through Artificial Intelligence: A Conceptual Study*, 9 INT’L J MECHANICAL ENGINEERING 63, 64 (2018).

²⁸ *id.* at 69.

²⁹ *Boston Pizza Overhauls its Restaurant Technology with ConnectSmart Kitchen and DineTime Platforms*, CAN. FRANCHISE ASS’N (May 2, 2018), <https://cfa.ca/franchisecanada/boston-pizza-overhauls-its-restaurant-technology-with-connectsmart-kitchen-and-dinetime-platforms/>.

³⁰ Diana L. Repack & William F. Repack, *A Case Study of the Adoption and Use of Information Systems Technology in a Business-Format Franchise*, 23 IRMJ 17, 18 (2010).

³¹ *id.*

³² Ryan Reeves, *How Boston’s Pizza Restaurant & Sports Bar is Using Tech to Accelerate National Growth*, HOSPITALITY TECHNOLOGY (Jul. 26, 2021) <https://hospitalitytech.com/how-bostons-pizza-restaurant-sports-bar-using-tech-accelerate-national-growth>.

³³ *id.*

³⁴ *id.*

³⁵ *Dom – Autonomous Delivery Vehicle*, DOMINO’S, <https://www.dominos.com.au/about-us/technology/dom> (last visited Apr. 14, 2023).

Houston, Texas, and customers are only able to place orders for robot delivery on specific days. While the success of this endeavour is yet to be determined and many practical considerations remain, this attempt appears promising as Domino's and its tech partner, Nuro, were the first to receive approval from the US Department of Transportation.³⁶

Franchisors are also relying on new technology to improve training programs. Franchisee and employee training is rapidly digitizing, creating a need to improve engagement with training materials. After all, it is much easier to ignore a pre-recorded video than it is to ignore a human instructor. To solve this issue, franchisors are relying on a process known as "gamification".³⁷ These training programs are app-based and employ game design elements to deliver training content. Gamified training keeps trainees engaged through friendly competition and small rewards or tokens.³⁸ While this technology may appear frivolous, its effectiveness is anything but. An independent survey of 500 businesses across the United States showed that 78% of workers are using games-based motivation at work, with 91% saying that these systems improve their work experience by increasing engagement, awareness, and productivity.³⁹

4. Franchise Growth

Innovation has been shown to have a direct impact on franchise growth. Global research exploring the impact of technology in this context demonstrates that the use of modern technology in franchising leads to faster expansion, while lower use of technology slows expansion.⁴⁰ Early technological trends showed franchisors increasingly relying on information and communications technology to attract new franchisees. These innovations were generally limited to user-friendly websites and targeted advertising. Today, while franchisor websites remain an essential element of attracting franchisees, the role of technology in franchise growth is more complex.

Franchisors seeking to expand are using advanced AI to attract new franchisees. Similar to the use of AI in the marketing context, franchisors are able to deliver effective targeted advertising to potential franchisees.⁴¹ AI's advanced data collection capabilities means that franchisors can better identify their target demographic of franchisees, understand

³⁶ *id.*

³⁷ Don Daszkowski, *Six Ways Technology Will Transform Franchise Businesses In 2020*, Forbes (Dec. 30, 2019) <https://www.forbes.com/sites/forbesbusinesscouncil/2019/12/30/six-ways-technology-will-transform-franchise-businesses-in-2020/?sh=7bb6f6992ede>.

³⁸ BADGEVILLE, *Gamification Improves Work Experience for 91% of Employees, Increases Productivity Across U.S. Companies (Press release)*. PR NEWswire (Aug. 6, 2015) <https://www.prnewswire.com/news-releases/gamification-improves-work-experience-for-91-of-employees-increases-productivity-across-us-companies-300124915.html> [<https://web.archive.org/web/20171107003553/https://www.prnewswire.com/news-releases/gamification-improves-work-experience-for-91-of-employees-increases-productivity-across-us-companies-300124915.html>]

³⁹ *id.*

⁴⁰ Suzana Stefanović & Milica Stanković, *The Role Of ICT And The Internet In The Development Of Franchise Systems*, 52 ECON. THEMES 409.

⁴¹ Ademola Adekunbi, *Five Innovative Ways To Implement Automated Marketing For Improved Sales*, ENTREPRENEUR (Aug. 11, 2019) <https://www.entrepreneur.com/en-ae/marketing/five-innovative-ways-to-implement-automated-marketing-for/337876>.

their needs, and deliver highly effective customized marketing. AI can also take this a step further by “scoring” leads. This allows franchisors to accurately determine which potential franchisees are viable, and which have a low potential of converting.⁴²

Competitive franchises are making innovation a priority in a variety of contexts, including designing franchise locations with flexibility for future technology. This forward-thinking approach makes innovative franchises far more attractive to prospective franchisees, who are looking for an operationally efficient business investment with long-term potential for success and a robust plan for growth.

5. Consumer-Facing Solutions

Perhaps the most important aspect of a business, customer experience has the power to improve brand loyalty, customer satisfaction, and increase revenues.⁴³ Customer experience is not only important for businesses, but for customers too – 64% of consumers consider customer experience to be more important than price when deciding whether to make a purchase.⁴⁴

Customer-facing technology in franchising has come a long way from manual cash registers and paper menus. The prevalence of AI in this context is projected to increase significantly, with 95% of customer interactions expected to be AI-powered by 2025.⁴⁵ This technology, in tandem with automation, allows franchisors to optimize efficiency while prioritizing the consumer experience at all stages of the interaction.

Common examples of consumer-facing innovations which increase efficiency and improve the consumer experience are self-serve technology and digital payment methods.⁴⁶ This technology also has the added benefit of reducing labor costs. In restaurant franchises, customers are able to order and pay independently, leading to faster turnover and higher profits. Self check-outs and automated kiosks are also available in retail franchises, offering solutions to the increasingly challenging brick-and-mortar customer experience.⁴⁷ As more and more businesses implement self-service technology, the self check-out market is expected to continue to grow, reaching an estimated \$7.8 Billion by 2027.⁴⁸

⁴² *id.*

⁴³ Jack Flynn, *25 Must-Know Customer Experience Statistics [2023]: The Benefits Of A Positive Customer Experience*, ZIPPAA (Oct. 19, 2022) <https://www.zippia.com/advice/customer-experience-statistics/>.

⁴⁴ *id.*; SITEL GROUP, *CX Appeal: What is the Role of Customer Experience in Purchasing Decisions?*, FOUNDEVER (last visited Oct. 12, 2021).

⁴⁵ *AI Will Power 95% Of Customer Interactions by 2025*, FINANCE DIGEST, <https://www.financedigest.com/ai-will-power-95-of-customer-interactions-by-2025.html> (last visited Apr. 14, 2023).

⁴⁶ Don Daszkowski, *Six Ways Technology Will Transform Franchise Businesses In 2020*, FORBES (Dec. 30, 2019) <https://www.forbes.com/sites/forbesbusinesscouncil/2019/12/30/six-ways-technology-will-transform-franchise-businesses-in-2020/?sh=7bb6f6992ede>.

⁴⁷ *Could self-checkout be a triple threat winner?*, NCR (Jan. 13, 2023) **Error! Hyperlink reference not valid.** <https://www.ncr.com/blogs/retail/adopting-self-checkout>.

⁴⁸ GRANDVIEW RESEARCH INC., *Self-checkout Systems Market Size Worth \$7.8 Billion by 2027 | CAGR: 13.3%: Grand View Research, Inc*, PR NEWswire (Aug. 16, 2020) <https://www.prnewswire.com/news->

While self check-outs have been criticized as creating certain challenges for customers⁴⁹ – indeed, many of us still shudder at the phrase “unexpected item in the bagging area” – new technology has improved these systems drastically since their early days. Today, these kiosks automatically recognize and scan items, allowing customers to check out with ease and reducing wait times.⁵⁰ While studies show that more customers – about 60% – prefer human contact over self-service kiosks, 70% of consumers still expect companies to offer a self check-out service.⁵¹ Further, digital payment methods, such as Apple Pay and Google Wallet, are increasingly common across franchise businesses. With more ways to pay, franchisors can increase turnover and attract more customers.

Some franchisors are improving the customer experience by bringing goods and services to the palm of the consumer’s hand. More and more franchises are introducing their own mobile apps to deliver services and goods to customers quickly, while others rely on third-party delivery apps, such as Uber Eats, Skip the Dishes, and DoorDash.⁵² By making shopping easier, franchisors are able to increase revenues and attract new customers.

AI and ML are also used to make loyalty programs more effective and attractive to customers. While a considerable 74% of customers may buy a product based on a positive customer experience alone, 80% are more likely to buy when brands offer experiences personalized to them.⁵³ Franchisors can use data analytics to deliver the right discounts and offers at the optimal time. AI-powered chatbots can also be used to resolve 80% of customer concerns quickly and effectively – often within the first interaction.⁵⁴ Indeed, it’s entirely imaginable that the likes of ChatGPT could soon be used to handle customer requests and inquiries, assist with orders, reservations and marketing, collect and respond to customer feedback, and more.

releases/self-checkout-systems-market-size-worth-7-8-billion-by-2027--cagr-13-3-grand-view-research-inc-301041734.html.

⁴⁹ Wilfred Chan, *Unexpected Item: How Self-Checkouts Failed to Live Up to Their Promise*, GUARDIAN (Dec. 17, 2022) <https://www.theguardian.com/business/2022/dec/16/self-checkout-us-retail-walmart>.

⁵⁰ Isabel Cameron, *4 Stand-Out Examples of Innovative In-Store Tech*, CHARGED (Aug. 26, 2022) <https://www.chargedretail.co.uk/2022/08/26/4-stand-out-examples-of-innovative-in-store-tech/#:~:text=Uniqlo's%20self%2Dcheckout&text=The%20automated%20system%20uses%20radio,attached%20to%20each%20Uniqlo%20item>.

⁵¹ Jack Flynn, *25 Must-Know Customer Experience Statistics [2023]: The Benefits Of A Positive Customer Experience*, ZIPPPIA (Oct. 19, 2022) <https://www.zippia.com/advice/customer-experience-statistics/>; *Word of Mouth Marketing in 2021: How to Create a Strategy for Social Media Buzz Skyrocket Referral Sales*, BIGCOMMERCE, <https://www.bigcommerce.com/articles/ecommerce/word-of-mouth-marketing/#word-of-mouth-marketing-statistics> (last visited Apr. 14, 2022).

⁵² Don Daszkowski, *Six Ways Technology Will Transform Franchise Businesses In 2020*, FORBES (Dec. 30, 2019) <https://www.forbes.com/sites/forbesbusinesscouncil/2019/12/30/six-ways-technology-will-transform-franchise-businesses-in-2020/?sh=7bb6f6992ede>.

⁵³ Jack Flynn, *25 Must-Know Customer Experience Statistics [2023]: The Benefits Of A Positive Customer Experience*, ZIPPPIA (Oct. 19, 2022) <https://www.zippia.com/advice/customer-experience-statistics/>.

⁵⁴ *id.*

II. CURRENT & EMERGING CHALLENGES

The franchise business model carries unique challenges for technology implementation and adoption. Unlike conventional non-franchising business, franchisors do not have an employer-employee relationship with their franchisees. A franchise system's ability to unilaterally affect changes and mandate use is limited by the nature of their relationships with franchisees and the terms and condition of their franchise agreements. Because of this unique relationship, franchisors and franchisees must navigate competing expectations and priorities. A franchisor, often a large corporation, has certain needs and expectations for implementing technology to achieve and maintain growth.⁵⁵ A franchisee, on the other hand, may be an independent businessperson, often with a small business mentality. While a franchisor's priorities extend beyond the individual franchisee to the system as a whole, a given franchisee is more concerned with the practicality of running their own individual unit or units.⁵⁶ As such, individual franchisees may be more reluctant to allocate time away from running their business in order to learn and understand new technology.⁵⁷ In addition, while technology and automation can reduce costs over time, these innovations often require a significant initial investment. These contrasting priorities can pose challenges to the growth and success of a franchise system, as well as to the franchisor-franchisee relationship.⁵⁸

Individual franchisees may also have their own ideas about what technologies they need and how they should use them.⁵⁹ In fact, there may also be times where tech-related innovation in a franchise system actually originates from the franchisees. These situations compounds the challenge of implementing new technology as franchisees' perspectives on the utility of a given initiative has a significant impact on their willingness to accept it.⁶⁰ Studies have shown that individuals are less likely to use a new technology if they believe there may be negative consequences, such as reduced productivity, while they are learning to use it.⁶¹ Given that franchisees may be reluctant to dedicate time for training on new technology, they may perceive its implementation as an impediment to productivity, particularly where the technology is especially novel or complex. It's important that franchisors remain aware of, and sensitive to, the fact that building a compelling business case, a thorough communication strategy and seeking franchisee buy-in will require considerable time, patience and effort.

Several factors external to the franchisor-franchisee relationship compound the challenges faced by franchisors when implementing new technology. Geo-political issues, such as the COVID-19 pandemic and the war in Ukraine, supply chain disruptions,

⁵⁵ Diana L. Repack & William F. Repack, *A Case Study of the Adoption and Use of Information Systems Technology in a Business-Format Franchise*, 23 IRMJ 17, 18 (2010).

⁵⁶ *id.*

⁵⁷ *id.* at 19.

⁵⁸ *id.* at 18.

⁵⁹ *id.* at 19.

⁶⁰ *id.* at 19; R. Agarwal & J. Prasad, *The Role of Innovation Characteristics and Perceived Voluntariness in the Acceptance of Information Technologies*, 28 DECISION SCI. 557 (1997).

⁶¹ Diana L. Repack & William F. Repack, *A Case Study of the Adoption and Use of Information Systems Technology in a Business-Format Franchise*, 23 IRMJ 17, 19 (2010).

and inflation all impact the success and ease of affecting a franchise system change. A franchisor looking to improve operations, reduce costs, and facilitate growth must be particularly mindful of the current state of the global sociopolitical climate and its potential implications on the franchise system. These factors, in light of overarching data security and privacy considerations, must be navigated with great care.

A. Geo-Political Issues

In consideration of today's globalized economy, the likelihood of a franchise's supply chain operating within only one country's borders is rapidly decreasing. As such, franchisors should be aware of and consider the potential impacts of geo-political issues on the franchise system. Particularly in the context of new technologies, where nearly all computers rely on rare earth metals mined and refined in a handful of regions, franchisors looking to update the franchise system may face issues such as scarcity, sanctions, or logistical difficulties. For example, China, one of the leading global manufacturers of semiconductors,⁶² is facing a number of geopolitical challenges, including a semiconductor shortage,⁶³ the continuing COVID pandemic and the aftereffects of China's Zero-COVID policy;⁶⁴ and U.S. sanctions on its semiconductor, advanced computing, and technology industries.⁶⁵ Today, the impact of government imposed sanctions, particularly in connection with Russia, may also have very real impact and consequences on the sourcing of both products and vendors for any international franchise system. Franchisors evaluating whether to implement new technologies would do well to consider the roadblocks of sourcing and acquiring new technologies, including the underlying components, as in the semiconductors example. This is especially important in cases where the suppliers of technology utilize remote services for support, hosting or other similar services. Franchisors should ensure they understand the complete picture around technical design, processes, and data flows.

In addition to considering where physical components of new technologies may come from, franchisors should scrutinize software and code that the physical components may rely on. As the world becomes increasingly reliant on technology, such technology can also become the target of bad-faith actors. In November 2022, Reuters reported that thousands of apps on Google and Apple's online stores contained code developed by a

⁶² *Semiconductor Manufacturing by Country 2022*, WORLD POPULACE (Sept. 25, 2022)

<https://worldpopulace.com/semiconductor-manufacturing-by-country/>.

⁶³ See Kevin Stankiewicz, *Intel CEO Now Expects Chip Shortage to Last into 2024*, CNBC (Apr. 29, 2022) <https://www.cnbc.com/2022/04/29/semiconductor-shortage-intel-ceo-says-chip-crunch-to-last-into-2024.html>; see also Michael Alexander et al., *Semiconductor Shortage 2023: A different kind of trouble ahead*, ROLAND BERGER (Nov. 9, 2022)

<https://www.rolandberger.com/en/Insights/Publications/Semiconductor-Shortage-3-2022.html>.

⁶⁴ Laura Dobberstein, *China's semiconductor and IC imports have slumped. Why on Earth could that be?*, Microsoft Start (Mar. 9, 2023) <https://www.msn.com/en-us/money/markets/chinas-semiconductor-and-ic-imports-have-slumped-why-on-earth-could-that-be/ar-AA18oylR>.

⁶⁵ BUREAU OF INDUS. & SEC, OFFICE OF CONG. & PUB. AFFAIRS, COMMERCE IMPLEMENTS NEW EXPORT CONTROLS ON ADVANCED COMPUTING AND SEMICONDUCTOR MANUFACTURING ITEMS TO THE PEOPLE'S REPUBLIC OF CHINA (Oct. 7, 2022) <https://www.bis.doc.gov/index.php/documents/about-bis/newsroom/press-releases/3158-2022-10-07-bis-press-release-advanced-computing-and-semiconductor-manufacturing-controls-final/file>.

Russian technology company falsely holding itself out as a U.S. company.⁶⁶ The concern, as noted in the report, is that the company may be compelled by the Russian government to turn over user data to domestic security agencies.⁶⁷

Similarly, in 2021, American intelligence agencies and private cybersecurity investigators looked into whether Czech software company JetBrains was “breached and used as a pathway for Russian hackers to insert back doors into the software of an untold number of technology companies.”⁶⁸ JetBrains’ customers include 79 of the Fortune 100 companies as well as SolarWinds, the company based in Austin, Texas whose network management software was involved in allowing hackers into government and private networks in 2020.⁶⁹ A joint report of the Department of Justice and the Department of Homeland Security issued in March 2021 found that foreign government-affiliated actors, including Russia, targeted vendors’ cybersecurity and supply chain vulnerabilities leading up to the 2020 election.⁷⁰ It could therefore be the case that compromises in software and coding vendors for the 2020 election may well have been present in such vendors’ software and coding for other customers as well.

Further, geo-politics may impact more than a franchise’s supply chain or technologies. Businesses often look to social media as a means of advertising to younger demographics, and franchises are no exception. However, the international community raised concerns in recent years over TikTok, the popular social media app owned by the Chinese company ByteDance, because of potential cybersecurity and national security threats.⁷¹ By downloading the app on their devices, users may be creating access points for ByteDance and the Chinese government.⁷² Similarly, franchises looking to advertise on the popular social media platform may unknowingly expose themselves to vulnerability and exploitation. Franchises trying to gain or maintain market share control via social media should be cautious when using apps such as TikTok without a careful vetting of what exactly is being downloaded. Similarly, franchise systems looking to update any legacy technologies, such as point of sale (POS) systems, should understand exactly what software or hardware would be implemented.

⁶⁶ James Pearson & Marisa Taylor, *EXCLUSIVE Russian software disguised as American finds its way into U.S. Army, CDC apps*, REUTERS (NOV. 16, 2022) <https://www.reuters.com/technology/exclusive-russian-software-disguised-american-finds-its-way-into-us-army-cdc-2022-11-14/>.

⁶⁷ *id.*

⁶⁸ Nicole Perlroth, David E. Sanger & Julian E. Barnes, *Widely Used Software Company May Be Entry Point for Huge U.S. Hacking*, NEW YORK TIMES (Jan. 6, 2021) <https://www.nytimes.com/2021/01/06/us/politics/russia-cyber-hack.html>.

⁶⁹ *id.*

⁷⁰ KEY FINDINGS AND RECOMMENDATIONS FROM THE JOINT REPORT OF THE DEPARTMENT OF JUSTICE AND THE DEPARTMENT OF HOMELAND SECURITY ON FOREIGN INTERFERENCE TARGETING ELECTION INFRASTRUCTURE OR POLITICAL ORGANIZATION, CAMPAIGN, OR CANDIDATE INFRASTRUCTURE RELATED TO THE 2020 US RELATED TO THE 2020 US FEDERAL ELECTIONS, (Mar. 2021) https://www.dhs.gov/sites/default/files/publications/21_0311_key-findings-and-recommendations-related-to-2020-elections_1.pdf

⁷¹ See, e.g., Ivana Saric, *China Could Use Tiktok to Control Users' Devices, FBI Director Says*, AXIOS (Mar. 8, 2023) <https://www.axios.com/2023/03/08/china-tiktok-fbi-director-congress>.

⁷² *Id.*

In short, franchisors should be extremely vigilant when researching and vetting technology vendors. Even if the franchise is not a specific target of hackers or bad actors, it may face exposure through breaches in its vendors' cybersecurity. The best practices to limit this exposure include requiring franchisees to only use vendors with certain levels of security certifications or require franchisees to use only trusted and pre-approved vendors. Franchisors would be wise to consider using various insurance products, including cybersecurity insurance, for the franchise system as a degree of protection in the event of a breach.

B. Inflation and Economic Uncertainty

Inflation is a growing concern for businesses and consumers alike. Recent studies indicate that consumer prices have risen substantially since pre-pandemic times across 44 advanced economies.⁷³ This economic uncertainty is further exacerbated by social and political issues. In Russia, for example, inflation rose steadily throughout the pandemic before surging in the wake of its invasion of Ukraine.⁷⁴

In the franchise context, inflation is a major concern for businesses. A recent report by the IFA analyzed the impact of inflation on the franchise industry and found that 90% of franchisees have experienced a moderate to substantial impact on their business.⁷⁵ Franchisees reported rising fuel costs, labor-related increases, and higher inventory, rent and utility costs as among the most impacted areas. Some franchisees reported as much as a 25% increase in the cost of goods which has reduced net bottom line by almost 50%.⁷⁶ These rising costs not only impact the rate of franchise growth, but also a franchise's ability to invest in new technology and maintain a competitive edge.

C. Supply Chain Disruptions

For most franchise systems, the question is not *whether* their business will face disruption, but rather *when*. Given the recent supply chain disruptions, it has become apparent that an increased level of supply chain resilience is required.⁷⁷ The application of intelligent technologies like AI can help businesses bolster their supply chain resiliency.⁷⁸ This can be done through several mechanisms, including the ability of AI to devise better control mechanisms and identify areas of disruption.⁷⁹ AI can also identify real-time shortages and coordinate immediate solutions. This technology can also proactively generate several different supply chain disruptions and can provide insights

⁷³ Drew Desilver, *In The U.S. and Around the World, Inflation is High and Getting Higher*, PEW RESEARCH CENTER (June 15, 2022) <https://www.pewresearch.org/fact-tank/2022/06/15/in-the-u-s-and-around-the-world-inflation-is-high-and-getting-higher/>.

⁷⁴ *id.*

⁷⁵ INT'L FRANCHISE ASS'N, 2022 FRANCHISEE INFLATION SURVEY (Sept. 15, 2022)

<https://www.franchise.org/franchise-information/franchise-economy/2022-franchisee-inflation-survey>.

⁷⁶ *id.* at 5.

⁷⁷ Sachin Modgil, Rohit Kumar Singh & Claire Hannibal, *Artificial Intelligence for Supply Chain Resilience: Learning from Covid-19*, 33:4 INT'L J. OF LOGISTICS & MGMT. 1246, 1249.

⁷⁸ *id.* at 1250.

⁷⁹ *id.*

on how the chain can be affected by a particular phenomenon over a certain period of time.⁸⁰

AI can also assist with the planning and mapping of the supply chain network itself, using data to track things like stock levels and shelf life, as well as the optimal route to pass these inventories along to the business (and ultimately the consumer).⁸¹ In addition to “internal” tracking, AI can also factor in externalities, such as weather and traffic into these computations without incurring significant costs. This ensures that businesses are able to meet their demands and fulfil promises made to consumers.

These benefits ultimately accrue to the final consumer, as increases in efficiency can result in lower costs and more consistent service, even in-light of changes in external factors. Thus, AI’s advances in predictive capabilities may soon become a requirement for demand forecasting in a dynamic business environment.⁸²

D. Data Security and Privacy

Data security risks have increased across a range of industries due to remote working conditions introduced by COVID-19. Franchised businesses are no exception – their inherently diasporic nature makes the franchise model particularly vulnerable to data security and privacy incidents.⁸³

Even before the pandemic, retail businesses have used AI to collect customer information for the purpose of loyalty programs and customer rewards.⁸⁴ Many retailers also store customer payment information for faster online check out. This information may include names, addresses, birthdays, and banking and credit card information.

This common practice implicates various privacy concerns. First, the low cost of storage implies that data may exist for substantially longer than what was intended.⁸⁵ Second, data may be repackaged and reused for other purposes – particularly ones of which the user was unaware.⁸⁶ Finally, data for a certain individual may contain information about other individuals.⁸⁷ In this sense, innovation functions as a double-edged sword – too much regulation and innovation may be generic and lack customization, too little protection and users may be weary to adopt new technologies due to privacy concerns.⁸⁸

⁸⁰ *id.*

⁸¹ *id.*

⁸² *id.* at 1252.

⁸³ *What do franchisees need to know about cybersecurity and data protection risk mitigation?*, CAN. FRANCHISE ASS’N (APR. 30, 2021) <https://cfa.ca/franchisecanada/q-what-do-franchisees-need-to-know-about-cybersecurity-and-data-protection-risk-mitigation/>.

⁸⁴ Gabriela Barkho, *How Brands are Designing Loyalty Programs with Data in Mind*, MODERN RETAIL (Mar, 13, 2021) <https://www.modernretail.co/retailers/how-brands-are-designing-loyalty-programs-with-data-in-mind/>.

⁸⁵ Thomas Davenport et al., *How Artificial Intelligence Will Change the Future of Marketing*, 48 J. ACAD. MARKETING SCI. 24, 38-39 (2020).

⁸⁶ *id.*

⁸⁷ *id.*

⁸⁸ *id.*

While these innovative systems help to create a better experience for the customer, they also make the retail company a “data goldmine” of customer information.⁸⁹ As reported by the New York Times in 2019, loyalty program data is commonly used by hackers to “impersonate customers” and “tap into separate accounts.”⁹⁰ In the same report, the Times noted significant hacks into the loyalty programs of American Airlines, The Hilton, Marriot, and McDonalds.⁹¹

Although safeguarding personal information is not a new responsibility for franchisors or franchisees, confidential information stored on computer servers is highly susceptible to modern security risks that businesses need to manage responsibly. The same care should extend to AI technologies and an analogous set of principles should be applied by businesses when giving an AI vendor access to their client's confidential data.⁹²

AI systems can be incredibly complex, and all their potential uses may not be completely understood, even by their developers.⁹³ This lack of transparency may pose serious legal and social challenges, exacerbate privacy and security concerns, and complicate our ability to assign responsibility.⁹⁴ The question that one must ask is: who will be held responsible when private data becomes lost, stolen, or used for non-intended purposes, causing harm to individuals, corporations, or even governments?⁹⁵ Thus, commercial AI applications can be a risky proposition – a miscalculation can result in significant financial and legal consequences to AI users, vendors and other stakeholders involved.^{96,97}

⁸⁹ Ros Page, *What are loyalty schemes like Flybuys and Everyday Rewards doing with your data?*, CHOICE (Dec. 20, 2021) <https://www.choice.com.au/consumers-and-data/data-collection-and-use/who-has-your-data/articles/loyalty-program-data-collection>.

⁹⁰ Tiffany Hsu, *Why Rewards for Loyal Spenders Are ‘a Honey Pot for Hackers’*, NEW YORK TIMES (May 11, 2019) <https://www.nytimes.com/2019/05/11/business/rewards-loyalty-program-fraud-security.html>

⁹¹ *id.*

⁹² Pablo J. Olmo Rodriguez, *Artificial Intelligence Law: Applications, Risks & Opportunities*, 90:3 REV. JUR. UPR 701, 719 (2021).

⁹³ *id.* at 709.

⁹⁴ *id.*

⁹⁵ *id.*

⁹⁶ *id.*

⁹⁷ *id.* Rodriguez also highlights a few notable US cases that have dealt with controversies relating to the use of AI:

Cruz v. Talmadge, 244 F. Supp. 3d 231 (D. Mass. 2017): The manufacturers of a G.P.S. system, an arguably semi-autonomous A.I. system, were sued after being injured while riding a bus that struck an overpass. The plaintiffs argue that the bus driver was following directions provided by the A.I. and sought to impose liability under traditional negligence theory, breach of warranty, and strict liability, and asserted facts to prove foreseeability and a feasible alternative design.

Nilsson v. General Motors, No. 3:18-cv-00471 (N.D.Cal. filed Jan. 22, 2018): The plaintiff claimed that an autonomous vehicle, with its back-up driver, drove into his lane and knocked him and his motorcycle to the ground. According to the plaintiff, the self-driving car “suddenly veered back” into his lane causing him injuries that required “lengthy treatment” and forcing him to take a disability leave. G.M. settled the lawsuit with the plaintiff off court, although, according to their defense, a police report found Nilsson at fault for attempting to overtake the lane. Cases like this have risen serious concerns about what is the standard of care that a reasonable person in this and future cases should adhere to.

III. INTRODUCTION & IMPLEMENTATION OF TECH SYSTEM CHANGES

When it comes to technology, innovation does not have to be groundbreaking. It can be something as simple as upgrades to a customer service or features added to an existing product.⁹⁸ Of course, the term “simple” can be misleading. Small upgrades multiplied by an entire franchise system can be both daunting and expensive. The franchisor of Smoothie King (a beverage franchise system), for example, estimates that it can take from four to eighteen months to complete a successful roll out of a franchise system change.⁹⁹ Such changes can also easily reach six figures in costs.¹⁰⁰ Not to mention, all that planning could be for naught if the roll out turns out to be unsuccessful. Thus, it is important that franchised system changes be approached in a careful and precise manner.

A. Good Faith and Fair Dealing

1. The American Perspective

Most US courts have held that an implied covenant of good faith and fair dealing exists in every contract.¹⁰¹ The covenant imposes a duty of fairness and a reasonable standard of care upon contracting parties in performing their express contractual duties. This covenant also obligates any party vested with contractual discretion to exercise that discretion reasonably and in a manner consistent with the reasonable expectations of the parties.¹⁰² While the definition has been particularly difficult for courts to pin down, the duty generally requires that no party will do anything that will destroy or injure the right of another party to receive the benefits of the contract.¹⁰³ What is fair under the circumstances is factually specific and requires a court’s exercise of discretion.

The US has incorporated the common law implied covenant of good faith and fair dealing into statute. The duty is codified in the Uniform Commercial Code and the Restatement (Second) of Contracts.¹⁰⁴ However, unlike the Canadian approach described below, the common law duty of good faith in the US imposes a positive duty of disclosure on contracting parties.¹⁰⁵

⁹⁸ Michael Boyles, *Innovation in Business: What it Is & Why It’s So Important*, HARVARD BUSINESS SCHOOL ONLINE, <https://online.hbs.edu/blog/post/importance-of-innovation-in-business>.

⁹⁹ Rocky Gettys, *How Do You Successfully Roll Out Changes in Your Franchise System*, SMOOTHIE KING (Apr. 10, 2018) <https://www.smoothiekingfranchise.com/articles/resources/executive-insights/how-do-you-successfully-roll-out-changes-in-your/>.

¹⁰⁰ Joe Halpern, *Tech Tools ’22: How 4 Franchise Brands are Leveraging Technology*, 2 FRANCHISE UPDATE 36 (2022) https://www.franchising.com/media/magazines/fum_2022_2.pdf.

¹⁰¹ *Kirke La Shelle Company v. The Paul Armstrong Company et al.*, 263 N.Y. 79, 188 N.E. 163.

¹⁰² *Interim Health Care of N. Illinois, Inc. v. Interim Health Care, Inc.*, 225 F.3d 876, 886 (7th Cir. 2000); *Burger King v. Agad*, 941 F. Supp. 1217, 1221 (N.D. Ga. 1996).

¹⁰³ *Amecks, Inc. v. Southwestern Bell Telephone Company*, 937 S.W.2d 240 (Mo. Ct. App. 1997).

¹⁰⁴ U.C.C. § 1-304; Restatement (Second) of Contracts § 205.

¹⁰⁵ AMERICAN BAR ASS’N, *Good Faith in Canadian Contract Law*, BUSINESS LAW TODAY (Apr. 20, 2016) https://www.americanbar.org/groups/business_law/publications/blt/2016/04/02_kierans/.

Although the implied covenant of good faith and fair dealing applies to all contracts, it has been applied specifically in the franchise context to protect the rights of franchisees and restrain a franchisor's unreasonable exercise of discretion.¹⁰⁶ Further, while the implied covenant cannot replace the express provisions of a franchise agreement, it may shed light on the parties' intentions when there is no express provision and serve as the best method to measure contract performance in franchising.¹⁰⁷

While it is not prohibited for franchisors to make decisions that best suit their business, they remain held to a certain standard which requires them to exhibit candor and engage in good faith when dealing with franchisees.¹⁰⁸ This is particularly important when a franchisor is considering the implementation of tech-based system changes because these modifications can have significant cost and labor consequences for franchisees. Practically speaking, franchisors in the US should be mindful of their disclosure and prioritize honesty and transparency to build trust with franchisees and facilitate the advancement of mutual interests.¹⁰⁹

*In re Sizzler Restaurants Int'l, Inc.*¹¹⁰ indicates that courts are more concerned with the franchisor's rationale and basis for a proposed system change rather than the ultimate success of the system change. In *Sizzler*, a franchisee alleged that Sizzler Restaurants had acted in bad faith when implementing a system-wide change related to its marketing model. Though the franchisee claimed this marketing change was made in bad faith, the court held that the franchisee "failed to establish that Sizzler acted dishonestly or outside accepted commercial practices, or did so with improper motives, or arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties."¹¹¹

Sizzler suggests that there is confusion surrounding what standard applies when a franchisor implements a system-wide change that disrupts its franchisees, particularly when that change may be cost-intensive or paradigm-shifting, such as pivoting to a new marketing model. The franchisee in *Sizzler* argues that Sizzler operated in bad faith, but the court analyzed the "business rationale" of Sizzler prior to ruling that the franchisee failed to establish that the franchisor acted outside of accepted commercial practices a good faith and fair dealing requirement. While Sizzler's business judgment would naturally be considered when analyzing whether the franchisor breached the covenant of good faith and fair dealing, courts and stakeholders in franchise networks would benefit from a clearer understanding of how the concepts of the business judgment rule and the covenant of good faith and fair dealing interact with one another.

¹⁰⁶ *Vylene Enterprises, Inc v. Naugles, Inc.*, 90 F. 3d 1472 (9th Cir. 1996); *In re Van Ness Auto Plaza, Inc.*, 120 B.R. 545 (Bankr. N.D. Cal. 1990) (citing 15 U.S.C. § 1221); *Atlantic Ritchfield Co. v. Razumic*, 390 A. 2d 736, 740-41 (Pa. 1978).

¹⁰⁷ Robert W. Emerson, *Franchise Contract Interpretation: A Two-Standard Approach*, 641 MICH. STATE L. REV. 641, 648-649 (2015).

¹⁰⁸ Robert W. Emerson, *The Faithless Franchisor: Rethinking Good Faith in Franchising*, 24 J. BUS. L. 411, 424 (2022).

¹⁰⁹ *id.*

¹¹⁰ 225 B.R. 466 (Bankr. C.D. Cal. 1998).

¹¹¹ *id.* at 5.

However, while the *Sizzler* court ruled that Sizzler's decision was acceptable under the business judgment rule, courts finding that a franchisor has implemented a system change with little market research or no reasoning will likely find that the covenant of good faith and fair dealing was breached.¹¹²

2. The Canadian Perspective

Six of the ten Canadian provinces have franchise legislation: Alberta, British Columbia, Manitoba, New Brunswick, Ontario, and PEI. Each of these statutes imposes upon parties to a franchise agreement a statutory duty of fair dealing in the performance and enforcement of the franchise agreement. Additionally, all franchise relationships in Canada are bound by the common law duty of good faith (excluding Quebec, where the Civil Code addresses good faith¹¹³), regardless of whether they are governed by the law of one of the six provinces with a statutory duty.

In the franchise context, the duty of fair dealing "includes the duty to act in good faith and in accordance with reasonable commercial standards". The duty of good faith and fair performance is not a free-standing duty. Instead, in any given case, it is measured by examining the parties' mutual objectives as defined in the franchise agreement. Any assessment of a good faith issue therefore must begin with reference to the underlying franchise agreement between the parties, and particularly the specific covenants and obligations that govern the particular topic at issue.¹¹⁴

The Supreme Court of Canada has recently recognized a general duty of good faith within the performance of all commercial contracts that applies equally to the franchise context. The recent trilogy of cases from the Supreme Court in *Bhasin v. Hrynew*, *C.M. Callow Inc. v. Zollinger* and *Wastech Services Ltd v Greater Vancouver Sewerage and Drainage District* (the "*Bhasin* Trilogy") held that parties must act "honestly and reasonably and not

¹¹² See, e.g., *Kazi v. KFC U.S. LLC*, No. 19-cv-3300-RBJ (D.Colo., May 17, 2021) (jury awarded damages of \$792,239 for breach of implied covenant of good faith and fair dealing due to a bad faith exercise of discretion in locating a new outlet too close to the existing franchise, and failing to perform a legitimate impact study in good faith); *Michael D. Bryman, et al. v. El Pollo Loco, Inc.*, *Michael D. Bryman, et al. v. El Pollo Loco, Inc.*, No. MC026045 (Cal. Super. Ct. Aug. 1, 2018) (appeal docketed, *Handlers-Bryman, et al. v. El Pollo Loco*, No. B292585 (Ca. Ct. App. Feb. 5, 2019). (jury verdict of \$8.8 million against the franchisor for violating the implied covenant of good faith and fair dealing when the franchisor placed competing units near franchisee, despite terms in franchise agreement that gave the franchisor that right) (settled on appeal); *Amos v. Union Oil Co. of California*, 663 F. Supp. 1027 (D. Or. 1987) (pivoting from historically standard company practice with little to no research, knowledge of the risks, and lying to the franchisor's dealers about it was found by a jury to breach both implied and contractual duties of good faith and fair dealing).

¹¹³ While Quebec has no franchise specific legislation both the Civil Code of Quebec and the Charter of French Language apply to franchising. Good faith and equity are parts of the civil law in Quebec. "The Civil Code of Quebec recognizes a broad duty of good faith which extends to the formation, performance and termination of a contract and includes the notion of the abuse of contractual rights: see arts. 6, 7 and 1375." *Bhasin v. Hrynew*, [2014] 3 S.R.C. 494, para. 83.

¹¹⁴ Sally L. Dahlstrom, Jennifer Dolman & Caroline B. Fichter, *The Evolution of Litigating Good Faith and Fair Dealing Claims* (Paper delivered at the 43rd Annual Forum on Franchising, October 27-30, 2020), AMERICAN BAR ASS'N at 9.

capriciously or arbitrarily" in the performance of their contractual duties and in the exercise of contractual discretion.

Importantly, the common law duty of good faith is an organizing principle and not a doctrine. These duties do not require a party to forgo advantages flowing from a contract, nor is a party required to subordinate its own interests to those of their counterparty; however, parties must not "lie or otherwise knowingly mislead each other about matters directly linked to the performance of the contract", including with half-truths, omissions and even silence on certain issues. When it comes to exercising contractual discretion, it must be done in a manner consistent with the purpose for which the contractual discretion was granted. When assessing the fairness of a contracting party's use of discretion, the question is not what is fair objectively, but rather what is fair according to the parties' own bargain.

Practically speaking, under both the common law and statutory duty of fair dealing, franchisors will benefit from documenting the business and financial reasons guiding any implementation of system changes and should take care not to actively mislead franchisees in the implementation of such changes. Although the duty of good faith as articulated in the *Bhasin* Trilogy is not new to the franchise context by any means, the analysis provided by the Supreme Court further clarifies the meaning of the good faith obligation and provides general principles equally applicable to franchise agreements.

3. The International Perspective

International rules related to "the duty of good faith and fair dealing" may differ from those found in North America. For instance, as noted by the Institute of Corporate Law and Governance (ICLG), English Law does not have a "general overriding duty of good faith and fair dealing that applies to franchise agreements."¹¹⁵ Thus, the UK and Wales do not recognize a general duty of good faith and fair dealing. The ICLG also notes, however, a developing body of case law "which may be leading the courts to the position where they may be prepared to imply a general duty of good faith and fair dealing." This, of course, is a far cry from the implied covenant of the duty of good faith and fair dealing recognized by most court of the United States¹¹⁶. As such, choice of law and venue provisions for international franchise agreements are extremely important if either party envisions relying on the duty of good faith and fair dealing.

B. Best Practices for Technological Changes in a Franchise System

Innovation can be achieved through design thinking, which involves four stages: clarification, ideation, development, and implementation. As discussed in greater detail below, the ideal way to introduce any tech-based changes to a franchise system is to involve the franchisees in the process. Indeed, while a franchisor may force technological

¹¹⁵ INST. OF CORP. LAW AND GOVERNANCE, FRANCHISE LAW AND REGULATIONS ENGLAND AND WALES 2023 (2022).

¹¹⁶ *Implied Covenant of Good Faith and Fair Dealing*, LEGAL INFO. INST., CORNELL LAW SCH. (2022) https://www.law.cornell.edu/wex/implied_covenant_of_good_faith_and_fair_dealing.

changes pursuant to a franchise agreement, that route may prove to be time-consuming, a relationship strain, expensive, and, in the long run, unsuccessful. Such forced innovation may also result in expensive litigation. Moreover, even an apparent legal victory does not equal certainty.¹¹⁷

Getting franchisees involved in the change process is not just an exercise of diplomacy, but a valuable tool for new ideas. Franchisees represent a network of individuals in different markets with hands on experience with customers¹¹⁸. The knowledge of franchisees is therefore invaluable. The customer data mined from franchise locations with the systems current technology can also be used for new innovative ideas.

Due to the costs associated with system changes, franchisors are encouraged to use pilot programs to test the new innovation. This is because unforeseen problems arising during a pilot program are more easily address in an isolated situation than a system-wide basis.

1. Best Interests of the System

In Canada, the franchise specific *Fairview*¹¹⁹ case provides an excellent approach to risk management in the face of a proposed system change. While *Fairview* dealt specifically with changes to the menu and kitchen equipment, its outcome and findings are still instructive.

The franchisor in *Fairview* orchestrated a thorough franchisee consultation process to receive feedback from franchisees on the proposed system changes. This documented consultation process allowed the franchisor, Tim Hortons, to better understand its franchisees' concerns, affording them the opportunity to make revisions to the proposed changes. Further, Tim Hortons had ample evidence of their efforts to engage franchisees and uphold their duty of fair dealing – both at common law and under the franchise legislation. Invariably this was planned in advance, with input from businesspeople and legal counsel.

The *Fairview* case provides insight into the interpretation of the wording “reasonable commercial standards” when analyzing the duty of good faith imposed by Canadian franchise legislation. *Fairview* informs that a general “economic rationality” or “legitimate interests” test is appropriate for determining if a franchisor upheld their duty of good faith as it relates to the implementation of a system change. In *Fairview*, the court ruled that the changes had been implemented “for perfectly rational business reasons, having regard to [Tim Hortons’] own interests and the interests of its franchisees, with due consideration of the opinions of franchisees...”. To elaborate, just because a system change is not ultimately profitable, does not mean the franchisor breached its duty of fair

¹¹⁷ Peterbrooke Franchising of America, LLC v. Miami Chocolates, LLC, 2022 WL 6635136, *6 (11th Cir. Oct. 11, 2022) (vacating and remanding lower court decision in favor of franchisor in matter involving forced implementation of system upgrades).

¹¹⁸ *id.*; Trevor Ackerman, *Top Five Strategies For Embracing Innovation In The Franchise System*, FORBES (May 4, 2018) <https://www.forbes.com/sites/forbescommunicationscouncil/2018/05/04/top-five-strategies-for-embracing-innovation-in-the-franchise-system/?sh=1ab8dbd4600c>.

¹¹⁹ *Fairview Donut Inc v The TDL Group Corp*, 2012 ONSC 1252, aff'd 2012 ONCA 867.

dealing, so long as the decision was made using 'reasonable commercial standards'. Of course, the obvious inference that follows is that franchisors that make calculated decisions (which account for the impact on franchisees) to promote the profitability of the system as a whole, are unlikely to attract liability for sweeping, system-wide changes on the basis of a breach of good faith.

In the United States, many franchisors have become part of the growing trend of using the "business judgment rule" to evolve their business through proposed system changes and manage the risks associated with possible "second-guessing" of their actions through claims of violation of the implied covenant of good faith and fair dealing.¹²⁰ This trend seeks to protect decisions made by franchisors by establishing the following presumptions: 1) the franchisor acted with disinterestedness and independence in making decisions that affect an individual franchisee or the system as a whole; 2) decisions were made after a reasonable effort to become familiar with the relevant facts; 3) the decision was made in good faith and with a reasonable belief that it was in the best interests of the franchise system; and 4) franchisor did not abuse its discretion.¹²¹ "Promoters of the business judgment rule opine that incorporating the rule in a franchise agreement does not give the franchisor free reign, but rather provides the contracting parties with more clarity on their respective roles and interests and gives franchisors more certainty and confidence that they will not be second-guessed as under the good faith and fair dealing standard."¹²² Because of the appeal to the business judgment rule in franchising, the United States might be said to offer franchisors broader autonomy and flexibility in managing proposed system changes.

2. Franchisee Buy-In and Relationship Management

Once the introduction of a particular innovation is decided, franchisors may want to use market data from its own pilot projects (either at corporate-owned businesses or franchisees who participated in early testing), or from competitors that have already implemented a similar innovation to determine its potential success. This market data can then be used to present the proposed innovation to franchisees. By showing complete and concise market data, franchisors can demonstrate to their franchisees that they have considered the benefits and downsides of the proposed technology in light of their franchisees' best interests.

Studies have found that an individual's perceptions about the characteristics of the proposed technology play a significant role in their willingness to adopt it.¹²³ These studies have also identified several characteristics which impact whether new technology is

¹²⁰ Brian B. Schnell & Ronald K. Gardner, Jr., *Battle over the Franchisor Business Judgment Rule and the Path to Peace*, 35 FRANCHISE L.J. 167 (Fall 2015).

¹²¹ Jeffrey C. Selman, *Applying the Business Judgment Rule to the Franchise Relationship*, 19 FRANCHISE L.J. 111, 112 (Winter 2000).

¹²² Erica L. Calderas and Jason M. Murray, "Good Faith and Fair Dealing – Alive and Well or is it a Matter of Business Judgment?" presented to the ABA Forum on Franchising 39th Annual Forum on Franchising Meeting in Miami, Florida (Nov. 2-4, 2016) at p. 9.

¹²³ R. Agarwal & J. Prasad, *The Role of Innovation Characteristics and Perceived Voluntariness in the Acceptance of Information Technologies*, 28 DECISION SCI. 557 (1997).

adopted by users, including its relative advantage and usefulness,¹²⁴ complexity and ease of use,¹²⁵ and compatibility.¹²⁶ An individual franchisee is more likely to accept and use new technology where they perceive it as offering an advantage over previous ways of performing the same task, easier to use and less complex, and consistent with the existing values, needs, and past experiences of the franchise.¹²⁷ The tangibility of the results of using a new technology is also an important consideration – franchisees want to see or experience the benefits of using the new technology.¹²⁸

Early research on the implementation of technology in the franchise context focused mainly on the introduction of intranets. This research suggested that the ability to monitor and participate in franchisee-to-franchisee communications has the potential to improve franchisee-franchisor relationships, increase virtuality, and facilitate technology adoption.¹²⁹ While the use of technology in franchising has grown well beyond intranets and simple intra-franchise portals, communication and transparency remain essential to navigating and fostering the relationships with franchisees.

A significant factor identified by researchers as influential on an individual's willingness to adopt new technology is perceived voluntariness.¹³⁰ This means that franchisees should feel included in the decision-making process through consultation and open communication. Importantly, however, this factor has been described as non-binary by researchers, meaning that different franchisees may perceive varying levels of voluntariness. This increases the necessity for consultation with franchisees.

The Canadian *Fairview* case discussed above demonstrates an excellent example of effective franchisee consultation. Tim Hortons had previous mechanisms in place for non-binding consultation with its franchisees, affording them with an efficient means of discussing the proposed changes with its franchisees, and for accepting franchisee feedback. Utilizing those mechanisms to engage franchisees in good faith on the nature and implementation of changes will be seen as an important step taken by franchisors.

Moreover, the franchisee consultation process, which actually garnered support from a majority of franchisees, provided Tim Hortons with a trail of evidence indicating that widespread franchisee support. If the consultation process had displayed a majority of

¹²⁴ F. D. Davis, *Perceived Usefulness, Perceived Ease of Use, and User Acceptance of Information Technology*, 13 MIS Q. 318 (1989); D. A. Adams, R. R. Nelson & P. A. Todd, *Perceived Usefulness, Ease of Use, and Usage of Information Technology: A Replication*, 16 MIS Q. 227.

¹²⁵ G.C. Moore & I. Benbasat, I., *Development of an instrument to measure the perceptions of adopting an information technology innovation*, 2 INFO. SYS. RES. 192 (1991).

¹²⁶ R. Agarwal & J. Prasad, *The Role of Innovation Characteristics and Perceived Voluntariness in the Acceptance of Information Technologies*, 28 DECISION SCI. 557, 562 (1997).

¹²⁷ G.C. Moore & I. Benbasat, I., *Development of an instrument to measure the perceptions of adopting an information technology innovation*, 2 INFO. SYS. RES. 192, 195 (1991).

¹²⁸ *id.* at 203.

¹²⁹ Michael Dickey & Lisa Murphy, *Intranets as a Source of Increased Virtuality in Franchise Organizations: Observations and Research Directions*, 239 AMCIS 2000 PROCEEDINGS, 1719 (2000) <http://aisel.aisnet.org/amcis2000/239>.

¹³⁰ R. Agarwal & J. Prasad, *The Role of Innovation Characteristics and Perceived Voluntariness in the Acceptance of Information Technologies*, 28 DECISION SCI. 557, 564 (1997).

dissent, Tim Hortons would have had the opportunity to address those franchisee concerns by modifying the system change to better accommodate the franchisees' concerns. Since the consultation process did not indicate major dissent, they were armed with a strong evidentiary record for court.

Beyond the minimum consultation required by the franchise agreement, whether or not a proposed system change can be supported by contractual rights, changes should be made with a degree of transparency and fluid communication, supported with data and rational business objectives, and rolled out at various franchisee consultations, gatherings or other appropriate means of dissemination. Input from franchisees, and particularly those who may be hardest hit by a proposed change, should be obtained, documented and implemented into the process, if possible.

It is important to note that franchisee consultations in the face of a proposed system change may not equate to franchisee approval. While widespread franchisee support is desired, it is not imperative for effecting a system change. It is possible for franchisors to implement a system change despite franchisee resistance, so long as the franchise agreements permit the proposed change, and the change is in fact effected in good faith.

The discussion above demonstrates that the key to franchisee buy-in is collaboration and transparency. As noted by Trevor Ackerman, Chief Marketing Officer of WellBiz Brands, Inc., in an Op-Ed written for Forbes Magazine, collaboration is achieved by getting owners involved in the innovation process and not isolating company changes to boardroom meetings.¹³¹ Mr. Ackerman also notes that franchisors should encourage a high degree of transparency and allow for franchisees to submit innovation proposals.¹³² Franchisors can help encourage engagement by giving pilot program funding and implementation support for new ideas.¹³³ Franchisors may also offer financing, discounts or other incentives to ensure franchisee buy-in.¹³⁴ The rights and obligations of each party in any such pilot or test scenario should be properly documented and clearly aligned with the existing terms and conditions of the franchise agreement. Franchisors may also facilitate franchisee buy-in by implementing trial programs at the franchisor's corporate locations.¹³⁵ This shows the franchisee that the franchisor has faith in the system change and is willing to risk its own bottom line to prove it.

IV. CONTRACTUAL CONSIDERATIONS

As a threshold matter, whether a franchisor can mandate technological upgrades within an existing franchisor/franchisee relationship will be determined by the language of the

¹³¹ Trevor Ackerman, *Top Five Strategies For Embracing Innovation In The Franchise System*, FORBES (May 4, 2018) <https://www.forbes.com/sites/forbescommunicationscouncil/2018/05/04/top-five-strategies-for-embracing-innovation-in-the-franchise-system/?sh=1ab8dbd4600c>.

¹³² *id.*

¹³³ *id.*

¹³⁴ Lorinda Church, *Franchising and Technology: Staying Current and Managing Change* (Paper Delivered at the IFA Symposium, Washington, D.C., May 15-17, 2011).

¹³⁵ *id.*

franchise agreement and/or operations manual¹³⁶. The interpretation of the franchise agreement and/or operations manual will be guided by the general principles of good faith and fair dealing¹³⁷. While not in and of itself a contractual provision, most courts will apply good faith and fair dealing when interpreting the franchise agreement¹³⁸. Historically, challenges related to good faith and fair dealing have caused more problems for franchisors than breach of contract claims because franchise agreements generally have pro-franchisor language that can be used to support a system change.

With regard to the franchise agreement, technology upgrades may be addressed by general or specific terms. With the rapid changes in technology, it is important that the franchise agreement include general terms to build in flexibility for the changing market. Where change is foreseeable, the franchisor should include specific terms: i.e. software updates and point of sale changes.¹³⁹ However, if there is a conflict between a general and specific term, the specific term will control.¹⁴⁰ Thus, franchisors should supplement general terms reserving the right to change various aspects of the franchise system with specific terms. Although it is difficult to anticipate how a franchise system may grow and evolve, available case law demonstrates that the more specific language is, the more clearly a court may interpret it.¹⁴¹

Unlike the franchise agreement, the franchisor may modify its operation manual without the consent of the franchisee. As such, franchisors will often incorporate the operation manual and include language within the operating agreement that the franchisor may update the operation manual from time to time.

A. Key Consideration: Does the Contract Permit the Change?

1. System Modification Provisions

Whether system modifications may be required under an existing franchise agreement will be determined by the language of the agreement. Where there exists an ambiguity, the court's interpretation of the franchise agreement will be guided by the principles of the

¹³⁶ Tanya Morrison, Charlene Wilson & Ashley Williams, *Digital Transformation in a Franchise System: Keeping up with the Technology Race within the Bounds of Existing Franchise Agreements* (Paper Delivered at the IFA Symposium, Washington D.C., May 5-7, 2019) at 12.

¹³⁷ *id.*; In re Van Ness Auto Plaza, Inc., 120 B.R. 545 (Bankr. N.D. Cal. 1990) (citing 15 U.S.C. § 1221); Atlantic Ritchfield Co. v. Razumic, 390 A. 2d 736, 740-41 (Pa. 1978).

¹³⁸ Robert W. Emerson, *The Faithless Franchisor: Rethinking Good Faith in Franchising*, 24 J. Bus. L. 411 (2022).

¹³⁹ Nathaniel Meyersohn, *Nobody Likes Self-checkout: Here's Why It's Popular*, CNN (Jul. 10, 2022)

Error! Hyperlink reference not valid. <https://www.cnn.com/2022/07/09/business/self-checkout-retail/index.html> (noting the rapid changes to self-checkout stations); see also Tatiana Walk-Morris, *Nearly Half of Retailers Are Converting Cash Registers to Self-Checkouts: Report*, RETAIL DIVE (Oct. 28, 2022) <https://www.retaildive.com/news/retail-self-checkout-technology-replacing-cash-registers/635214/>.

¹⁴⁰ Tanya Morrison, Charlene Wilson & Ashley Williams, *Digital Transformation in a Franchise System: Keeping up with the Technology Race within the Bounds of Existing Franchise Agreements* (Paper Delivered at the IFA Symposium, Washington D.C., May 5-7, 2019) at 14.

¹⁴¹ Chris Dull, Clint Ehlers, Andraya Frith, & Max Staplin, *Ch-ch-ch-changes: Implementing System Changes, Upgrades and New Directions Under Existing Franchise Agreements* (Paper delivered at the IFA Legal Symposium, Washington, D.C., May 7-9, 2017) at note 72 at 5.

business judgment rule, the covenant of good faith and fair dealing, applicable statutes, and the previous course of dealing between the parties. In some jurisdictions, such as Canada,¹⁴² the interpretive exercise encompasses the surrounding circumstances at the time of contracting.

i. The business judgment rule & the covenant of good faith and fair dealing

When franchisees seek to oppose a franchisor's business decisions, the franchisor may seek to invoke the business judgment rule as a means to justify its actions. The business judgment rule is a legal principle which holds that decision-makers of a business are not liable for the decisions made within their authority, so long as the decision is reasonable. Thus, under the business judgment rule, the franchisor may justify any action that is ultimately detrimental to individual franchisees so long as the action is conceivably good for the franchise system as a whole. Accordingly, the franchisor could take any number of actions – including the introduction of new technology, changing vendors or suppliers, or requiring automation in place of a franchisee's existing workforce – to the detriment of its franchisees so long as the action is not expressly in breach of the applicable franchise agreement or the duty of good faith and fair dealing.¹⁴³

Notably, franchise agreements need to have inherent flexibility so that the franchisor-franchisee relationship can develop and adapt over time. This leaves room for franchisors to alter franchise systems at their discretion in ways that may be detrimental to individual franchisees, but that would potentially benefit the franchise system as a whole. Further, as a guiding principle often recognized by the courts in corporate law, the franchise agreement may not need to expressly adopt the business judgment rule for the franchisor to seek its protection. Conversely, franchisees may push for a court to consider the covenant of good faith and fair dealing because of its equalizing tendencies in what may otherwise be a weighted business relationship. Franchisees may point to the franchisor's decisions that could reasonably harm the franchisee's business and make the argument that the franchisor is not operating in good faith, in breach of the covenant.

When considering a system change, including those related to technological innovation, the question of whether a franchisor's justification under the business judgment rule outweighs a franchisee's protection under the covenant of good faith and fair dealing depends on the specific facts and the relevant jurisdiction. As discussed above, neither principle overrides the express terms of the franchise agreement. However, it remains that the best way for a franchisor to demonstrate its good faith decision to implement system changes is to show a strong business case for exercising the franchisor's discretion to do so. As long as the decision withstands reasonable scrutiny, courts are less likely to intervene.¹⁴⁴

¹⁴² *Sattva Capital Corp v Creston Moly Corp*, [2014] 2 SCR 633.

¹⁴³ Notably, large-scale automation could play out similarly to the years where e-commerce exploded in popularity, leaving franchisors and franchisees alike unclear about how their territories would be affected by this change under antiquated franchise agreements that "neither contemplated nor set forth protocols for franchise network internet activity." [Implementing System Upgrades: E-Commerce](#)

¹⁴⁴ See, for example, *Fairview Donut Inc. v The TDL Group Corp.*, 2012 ONSC 1252.

ii. *The status of the franchisor-franchisee relationship*

Twenty-one states have franchise laws on their books specifically aimed at the relationship between the franchisor and the franchisee.¹⁴⁵ Under such statutes, franchisees may argue that a franchisor constructively terminated the franchise agreement without cause by implementing or proposing to implement a system change that materially alters the relationship of the parties. However, the prevailing view is that a system wide change does not give rise to a cause of action for constructive termination¹⁴⁶.

In *Petereit et al. v. S.B. Thomas, Inc. et al.*¹⁴⁷ the trial court found merit in a constructive termination argument based on the franchisor's drastic territory realignment of the franchisees¹⁴⁸. However, on appeal, the franchisor was ruled to have terminated the agreement with good cause because it operated under the legitimate business need to increase sales and took steps to increase sales. As such, the appeals court implemented a form of the business judgment rule (within the lens of the *Connecticut Franchise Act*) to determine that a franchisor was acting within its discretion.¹⁴⁹

iii. *Prior course of dealing*

Courts may also look to the parties' prior course of dealing when settling disputes between a franchisor and franchisee, under limited circumstances where the franchise agreement is silent or ambiguous. Regardless of the limited scope within which a court may look at the parties' prior dealings, franchisees have challenged franchisors' system changes under such a theory.

In *Burger King Corporation v. Austin et al.*,¹⁵⁰ one of the franchisee's allegations was that Burger King failed to expend monies on local advertising. The court held that "[t]he Agreement states that BKC retains discretion over advertising spending; accordingly, BKC could not have breached the *express* terms of the contract by failing to spend monies on local advertising".

However, in response to the franchisee's allegation that Burger King breached the implied covenant of good faith "to provide down store support" to franchisees and noting that Burger King had historically furnished such support, the court held:

"In order to define the term 'advise and consult', the Court may eventually have to apply a standard of reasonableness that encompasses all relevant circumstances

¹⁴⁵ Kaufmann, David, *Implementing System Upgrades and Enhancements: Business and Legal Considerations*, (Delivered at the International Franchise Association 44th Annual Legal Symposium May 15-17, 2011), 25.

¹⁴⁶ *Id.*

¹⁴⁷ 63 F.3d 1169, CCH Bus. Fran. Guide ¶10,741 (2d Cir. 1995) *cert. denied* 116 S.Ct. 1351 (1996).

¹⁴⁸ *Id.* at 1173.

¹⁴⁹ *Id.* at 1185.

¹⁵⁰ 805 F.Supp. 1007 (S.D. Fla. 1992).

surrounding the transaction, together with any prior negotiations between them *and any applicable course of dealing, course of performance or usage* (citing 2E. Allan Farnsworth, *Farnsworth on Contracts* §7.10) (emphasis added)”.

Thus, while the court may place a heavier weight on the business judgment rule and the covenant of good faith and fair dealing, courts are clearly cognizant of the length of a franchisor-franchisee relationship and the potential implications of the principles of course of dealing, course of performance and usage.

2. Data Security and Privacy Provisions

In this age of digitization and data collection, franchisors are naturally keen to measure the productivity of their franchisees and, in turn, franchisees are keen to measure the productivity of their employees. The data collected would then naturally be evaluated by those in managerial positions to determine strategies toward higher profitability or greater efficiency. The automated collection and use of data by franchisors can “rob the franchisee of any independence provided under the franchise agreement but, conversely, can create opportunities to ensure quality control”¹⁵¹ and, ultimately, protect or boost the franchise as a whole.

However, the amount and relevancy of the data collected may raise legal issues of privacy.¹⁵² For example, litigation has arisen where third parties using bots extract personal information from an employees' data and then sell it to the employer for use in employee evaluations.¹⁵³ As such, franchisors should be careful of how data is collected, how data is stored and who has access to that data.

The best way to deal with a data breach is to prevent it from occurring in the first place. As such, it is imperative that franchisors compel franchisees to maintain robust security protections. These protections include security software, improved architecture, firewalls, virtual private networks (VPNs), traffic monitoring and restriction, and routine system updates.¹⁵⁴ In addition to the foregoing, employees need to be trained on data security--especially those employees that are front facing and have engagement with customers. Thus, the franchise agreement should have robust requirements for security software and employee training. Indeed, the franchise system should utilize a uniform requirement for security training to ensure predictable and reliable security across the entire system.

¹⁵¹ *The Role of Robotics and Automation in Industry 4.0*, ROBOTICS & AUTOMATION NEWS, <https://roboticsandautomationnews.com/2021/04/22/the-role-of-robotics-and-automation-in-industry-4-0/42638/> (Apr. 21, 2021).

¹⁵² See Maggie Astor, *Microchip Implants for Employees? One Company Says Yes*, NEW YORK TIMES (Jul. 25, 2017), <https://www.nytimes.com/2017/07/25/technology/microchipswisconsin-company-employees.html>; V. John Ella, *Employee Monitoring and Workplace Privacy Law*, AMERICAN BAR ASS'N, at 4-5 (2016) (noting a comprehensive description of the many techniques an employer can use to monitor employees and some of the legal limitations).

¹⁵³ See *hiQ Labs, Inc. v. LinkedIn Corp.*, 273 F. Supp. 3d 1099, 1113 (N.D. Cal. 2017), *appeal docketed*, No. 17-16783 (9th Cir. Sept. 6, 2017).

¹⁵⁴ Nate Nead, *How to Prevent a Data Breach in Your Company*, FORBES (Jul. 30, 2021) <https://www.forbes.com/sites/forbesbusinesscouncil/2021/07/30/how-to-prevent-a-data-breach-in-your-company/?sh=164a94ba18da>.

Franchises may be particularly susceptible to such concerns due to their multi-nodal nature. In systems where franchisees have relative autonomy over their IT systems, the franchisee, seeking to save on cost, may implement weak or easily hacked systems that hackers could target to then use as a launching pad into the franchise as a whole. Conversely, where franchisors require a system-wide vendor or IT package, franchisors may be better able to encroach on the franchisee's independence by data measurement and evaluation. As mentioned above, a franchise-wide system does have the clear benefit of opportunities for quality control.

In the point-of-sale context, many franchise systems are moving to a single point-of-sale (POS) system as it becomes clear what dangers exist for franchisors that allow franchisees to choose their own POS vendor.¹⁵⁵ In June 2016, Wendy's announced that it and its customers were the victims of credit card fraud, alleging that the hackers stole information through several franchisees' POS systems by using the POS vendors' employees' credentials to gain access.¹⁵⁶ Since then, Wendy's has moved to a single POS system to better implement the franchise's underlying technology. Many systems are similarly finding that it creates efficiency in back-of-house systems, such as network-wide customer loyalty programs and mobile ordering and payment systems.

However, implementing system-wide changes like a unified POS can be particularly challenging in international systems, particularly as increasing numbers of individual countries introduce their own privacy or data security laws. Additionally, franchisors attempting to implement system-wide changes, particularly with expensive technology updates, have found franchisees averse to shouldering the cost. At the same time that Wendy's POS systems suffered its 2016 security breach, the franchise was in court attempting to force one of its largest franchisees to upgrade its POS systems.¹⁵⁷ The franchisee refused to refurbish its Wendy's restaurants and update their POS systems, alleging the franchisor's requirements were a "violation of the franchise agreements, commercially unreasonable and breaches of the implied duty of good faith."¹⁵⁸

The prominent use of ransomware and data breaches makes it imperative that franchise agreements include provisions directed to data security and privacy for the security of not only the business but also the protection of the franchise's customers. On January 29, 2020, arstechnica reported that the Maze ransomware ring gained access to customer information from dozens of companies, including a grocery market, accounting firm, a community college, a pest control company, and an international foreign exchange

¹⁵⁵ Jonathan Maze, *Wendy's Security Breach Exposes Weaknesses in POS Systems*, NATION'S RESTAURANT NEWS (Jun. 14. 2016) <https://www.nrn.com/quick-service/wendy-s-security-breach-exposes-weaknesses-pos-systems>. <https://www.nrn.com/quick-service/wendy-s-security-breach-exposes-weaknesses-pos-systems>

¹⁵⁶ *id.*

¹⁵⁷ Beth Ewen, *NPC In, DavCo Out as Wendy's Puts to Rest 3-Year Dispute*, Franchise Times (Oct. 12, 2020) https://www.franchisetimes.com/franchise_news/npc-in-davco-out-as-wendys-puts-to-rest-3-year-dispute/article_65923ea4-37f3-5a64-8269-4e2150e68099.html; *Wendy's Int'l, LLC v. DavCo Rests. LLC*, No. 14CV013382 (Ohio Ct. Comm. Pl.).

¹⁵⁸ *id.*

company.¹⁵⁹ In 2020, the FBI received nearly 2,500 ransomware complaints with losses exceeding \$29 million.¹⁶⁰ On October 5, 2021, the Congressional Research Service released a report indicating that companies that make a ransom payment to an entity known to be a terrorist organization or subject to sanctions by the department of Treasury may be subject to civil and criminal liabilities.¹⁶¹ The Federal Trade Commission has also brought several actions under the Federal Unfair Trade Commission Act¹⁶² alleging that the failure to maintain proper cybersecurity is an unfair or deceptive trade practice.¹⁶³ Additionally, several states, most notably California, have created comprehensive data privacy laws to protect consumer information.¹⁶⁴ These laws include California Consumer Privacy Act of 2018 and the California Privacy Rights Act.¹⁶⁵

i. Ownership and Use of Data

There is an obvious push and pull between franchisors and franchisees regarding the ownership of customer data mined at the franchisee level. On one hand, the franchisor wants to maintain a hold on the customer list and contact information developed by the franchisee as this information is “a crucial factor for [the] franchisor, both to gain a return on investment” and create a franchise system that survives the test of time.¹⁶⁶ On the other hand, franchisees want to control the customer information so that it cannot be used by the franchisor to compete with the franchisee.¹⁶⁷ Indeed, it is not unheard of for certain franchisors to allow for the clustering of franchisees within the same market area.¹⁶⁸

As a practical matter, it is unlikely that the franchisee will have any ownership of customer data during or after the franchise relationship. This is because a franchise agreement is likely to have a non-compete and trade secret provision which defines customer data

¹⁵⁹ Sean Gallagher, *Dozens of Companies Have Data Dumped Online by Ransomware Ring Seeking Leverage*, ARSTECHNICA (Jan. 29, 2020) <https://arstechnica.com/information-technology/2020/01/dozens-of-companies-have-data-dumped-online-by-ransomware-ring-seeking-leverage/>.

¹⁶⁰ Peter G. Berris & Jonathan M. Gaffney, *Ransomware and Federal Law: Cybercrime and Cybersecurity*, U.S. CONGRESSIONAL RESEARCH SERVICES (Oct. 5, 2021) <https://crsreports.congress.gov/product/pdf/R/R46932>.

¹⁶¹ *id.*

¹⁶² (15 U.S.C. § 45(a)),

¹⁶³ *F.T.C. v. Wyndham Worldwide Corp.*, 799 F. 3d 236, 240 (3d Cir. 2015) (noting that “In 2005 the Federal Trade Commission began bringing administrative actions under [15 U.S.C. § 45(a)] provision against companies with allegedly deficient cybersecurity that failed to protect consumer data against hackers.”)

¹⁶⁴ *A Comprehensive Guide to the US State Privacy Laws*, DATAGRAIL (Oct. 11, 2022) <https://www.datagrail.io/blog/data-privacy/us-states-with-data-privacy-laws/>.

¹⁶⁵ *id.*

¹⁶⁶ David L. Cahn & Jordan M. Halle, *At Your Service? Customer Account Ownership and its Impact on Non-Competes, Control Determinations for Vicarious Liability, and Franchise Goodwill*, 39 *Franchise L. J.* 39 (2019).

¹⁶⁷ *id.*

¹⁶⁸ Staff, *John Oliver on Subway Franchisees: ‘Dream Turned Into a Nightmare’*, GUARDIAN (May 23, 2022) <https://www.theguardian.com/tv-and-radio/2022/may/23/john-oliver-subway-franchisees> (noting how Subway franchise “allows locations to open near each other ... with contracts allowing unlimited rights to directly compete.”).

gained during the term of the franchise as a trade secret owned by the franchisor.¹⁶⁹ This definition would also be supported by statute in some jurisdictions. For example, the United States' Uniform Trade Secrets Act,¹⁷⁰ defines a trade secret as any information that:

Derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use; and
Is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.¹⁷¹

A franchisee, especially one using a franchisor provided software or franchisor developed loyalty program, would be hard pressed to argue that customer data does not fall within the above definition. Additionally, privacy laws would also make it difficult for the franchisee to claim ownership of the customer data as such laws may prohibit the use of customer data for any use not compatible with the original purpose.¹⁷²

ii. *Obtaining proper consent at all levels*

Both franchisors and franchisees must be intentional about compliance with privacy laws and any requirements to obtain consent from any subject whose personal data is processed by the franchisor or franchisee. Depending on the jurisdiction of operation, different laws will apply.

The General Data Protection Regulation 2016/679 ("GDPR") defines consent in Article 4 as "any freely given, specific, informed and unambiguous indication of the data subject's wishes by which he or she, by a statement or by a clear affirmative action, signifies agreement to the processing of personal data relating to him or her".¹⁷³ The GDPR and the ePrivacy Directive require all franchises operating in the EU to gain the proper consent from its customers for the use of customer data¹⁷⁴. This consent includes requirements for notice and consent to use cookies¹⁷⁵ and similar technologies and rules relating to unsolicited marketing by email, fax and text, which can require opt-in consent in some

¹⁶⁹ Chris Dull, Clint Ehlers, Andraya Frith, & Max Staplin, *Ch-ch-ch-ch-changes: Implementing System Changes, Upgrades and New Directions Under Existing Franchise Agreements* (Paper delivered at the IFA Legal Symposium, Washington, D.C., May 7-9, 2017) at note 72 at 41.

¹⁷⁰ *Id.*

¹⁷¹ Uniform Trade Secrets Act Sec. 35-51(d).

¹⁷² Chris Dull, Clint Ehlers, Andraya Frith, & Max Staplin, *Ch-ch-ch-ch-changes: Implementing System Changes, Upgrades and New Directions Under Existing Franchise Agreements* (Paper delivered at the IFA Legal Symposium, Washington, D.C., May 7-9, 2017) at note 72 at 41.

¹⁷³ General Data Protection Regulation, 2016/679, art. 4, 2016 O.J. (L. 119) 1–88.

¹⁷⁴ Ruth Boardman & Elizabeth Upton, *Franchise Law Review: Data Protection*, LEXOLOGY (Feb. 1, 2022) <https://www.lexology.com/library/detail.aspx?g=de26609d-e848-4a31-8ad4-cef3acce573c>.

¹⁷⁵ Cookies "help web developers give you more personal, convenient website visits. Cookies let websites remember you, your website logins, shopping carts and more. But they can also be a treasure trove of private info for criminals to spy on.": *What are Cookies?*, KASPERSKY, <https://www.kaspersky.com/resource-center/definitions/cookies> (last visited Apr. 14, 2023).

situations.¹⁷⁶ Failure to obtain proper consent can result in high penalties of up to “€20 million or 4 per cent of their total worldwide annual turnover for infringements.”¹⁷⁷ The responsibility to obtain proper consent will fall on both the franchisor and franchisee as both would be considered a “data controller” and “data processor” under the GDPR.

As such, the franchisor should provide a comprehensive privacy policy that clearly discloses what data the franchise collects and how that data may be used.¹⁷⁸ Additionally, the franchise website must give the consumer an active opportunity to opt-in and out of cookies.

While the GDPR is specific to the EU, companies within Canada and the United States with a global reach will have to take the GDPR in account when designing their websites. Indeed, one need only visit any website in the United States to see the effect of the GDPR’s cookies regulation on US businesses.

iii. Indemnification

Due to the ever growing and consistent threat of a data breach, franchise agreements will often include an indemnification provision for the cost of any investigation or lawsuit in connection with “any cyber- event, identity theft, or theft of personal information of a customer due solely to any security breach by [the franchisee], [the franchisee’s] agents, or [the franchisee’s] employees.”¹⁷⁹ The franchise agreement may also include a provision that the franchisee will reimburse the franchisor for any of the franchisor’s out of pocket expenses in responding and remedying a cyber-event caused by the franchisee, its agents, or employees. Indeed, all franchisors should include such a provision in their franchise agreements. The franchisee should in turn protect itself by carrying cyber security and data breach insurance. Some franchisors may wish to go a step further and have the franchise agreement *require* the franchisee to carry such insurance with the franchisor as a named beneficiary.

The franchisor should also require an indemnification provision and insurance for such events from all third-party vendors that deal with the collection or maintaining of their customer information.¹⁸⁰

¹⁷⁶ Ruth Boardman & Elizabeth Upton, *Franchise Law Review: Data Protection*, LEXOLOGY (Feb. 1, 2022) <https://www.lexology.com/library/detail.aspx?g=de26609d-e848-4a31-8ad4-cef3acce573c>.

¹⁷⁷ *id.*

¹⁷⁸ See Franchise Group Inc. (which brands include the Vitamin Shoppe and Pet Supplies Plus) privacy policy as an example: <https://franchisegrp.com/privacy-policy/>

¹⁷⁹ Justin M. Klein, *Why Franchisees Should Consider Data Breach and Cyber Liability Insurance?*, LINKEDIN (May 31, 2018) <https://www.linkedin.com/pulse/why-franchisees-should-consider-data-breach-cyber-liability-klein/>.

¹⁸⁰ *Franchise System Cyber Liability Considerations*, MARSHMCLENNAN AGENCY (Feb. 10, 2022) <https://www.marshmma.com/us/insights/details/franchise-system-cyber-liability-considerations.html>.

3. Capturing Fees

Of course, system and technology upgrades will not pay for themselves, and it is important that franchisees share in the cost. Indeed, it is both the franchisor and franchisee that benefit from such upgrades. Thus, fee structures should be implemented in the franchise system to capture the costs for system and technology upgrades.

In order to maintain a positive relationship between the franchisor and the franchisee,¹⁸¹ it is important for the franchisee to understand that system upgrades benefit both parties, and, thus, the cost should be shared. Franchisors can make this clear by creating incentives in exchange for amending current agreements that do not allow for the franchisor to charge fees for system upgrades.¹⁸² Incentives may include royalty reductions, discounts on renewal fees, and increasing the term of the franchise agreement without additional consideration.¹⁸³

A technology fund provision may look something like the following:

Franchisee must pay Franchisor or its designated supplier the then-current fees for use of any designated software or technology, including any license, maintenance, support or other fees. Franchisor reserves the right to change, update, replace or eliminate the required software or require new software from time to time at Franchisee's expense. Franchisee must use, and at Franchisor's discretion, pay for all future updates, supplements and modifications to the required software programs.

B. Other Tips and Best Practices

Given the multitude of factors that franchisors must weigh from multiple perspectives, including cybersecurity, logistics, and geopolitics, the best practice would be to retain counsel well-suited to advise the franchisor on how to best proceed with system-wide technology changes from both a legal and business outlook. When drafting or revising the franchise document, counsel should use specific terms that are high-priority and do not require adaptation as the franchisor-franchisee relationship evolves. Conversely, the franchise document's language should be broadened where the parties will need flexibility to adapt to changing circumstances over time. For example, consider a franchise document that states "Franchisor has the right to require Franchisee to update point of sale software" versus "Franchisor has the right to require Franchisee to update the [Brand Name] software." In this example, the franchisor likely does not care what the brand of the POS software is. However, if the franchisor wanted to update point of sale software after switching vendors in the future, they would only be able to do so under the former

¹⁸¹ Tanya Morrison, Charlene Wilson & Ashley Williams, *Digital Transformation in a Franchise System: Keeping up with the Technology Race within the Bounds of Existing Franchise Agreements* (Paper Delivered at the IFA Symposium, Washington D.C., May 5-7, 2019) at 15.

¹⁸² *id.* at 14

¹⁸³ *id.*

language because the latter creates no obligation on the franchisee to update any software other than the particular brand name's software.

Franchisors may also consider periodically updating governing documents. Current governing documents facilitate better communication and understanding between the franchisor and franchisee as to the status of their relationship. If the franchisor wants to make a system change that is not contemplated by an outdated franchise document or operations manual, then the franchisor may have to rely on their implied authority to make a change rather than any express authority. This also prevents the franchisee from having notice that this change may occur under the franchisor-franchisee relationship and lead to friction as the franchisor attempts to implement such changes.

V. CONCLUSION

It is clear that automation, robotics and new digital technologies can enable franchisors to streamline operations, enhance customer experiences, expand their reach and more. When considering the introduction of such technologies into their system, franchisors should be mindful of internal and external factors that impact the successful implementation of such system changes. These internal factors include the franchisor-franchisee relationship as evidenced by the contracts and the duties of fair dealing and good faith. External factors include geo-political issues, economic concerns, supply chain disruptions, data security, and privacy.

When making system changes, franchisors should prioritize early, frequent, and honest communication with franchisees. In the event of franchisee opposition, franchisors should be prepared to engage in meaningful consultation and remain flexible and open to suggestions from franchisees. In any case, a franchisor should at all times be prepared to show good faith in decision-making, supported by a sound and strong business rationale for the proposed change.