Avoiding Common Franchising Pitfalls for Franchisees

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A Practice Note discussing select causes of disputes and other liabilities that franchisees commonly overlook when entering into franchise agreements or other transactions that implicate state or federal franchise laws. This Note describes certain steps prospective franchisees can take to identify potential liability in franchise arrangements, including understanding franchising disclosure documents, fees and contract provisions. This Note primarily addresses franchisee concerns and does not present a comprehensive list of all possible franchising pitfalls. It is merely a guide to assist franchisees to avoid important, but commonly overlooked, areas of liability in franchising transactions.

Parties can risk significant legal liability if they fail to enter into a contract without understanding whether their transaction is regulated as a franchise agreement under federal or state law and how those laws may apply to the transaction. For example, a failure to comply with the Federal Trade Commission's (FTC) Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities (the Franchise Rule), including its 2007 amendment (*16 C.F.R. §§ 436.1- 436.11*), can constitute an unfair or deceptive act or practice in violation of Section 5 of the Federal Trade Commission Act (FTC Act). For information regarding the implications of FTC Act violations, see *Practice Note, FTC Consumer Protection Investigations and Enforcement (http://us.practicallaw.com/4-549-3090)*.

This Note discusses select causes of disputes and other liabilities that franchisees commonly overlook when entering into franchise agreements or other transactions that implicate state or federal franchise laws. It describes certain steps prospective franchisees can take to identify potential liability in franchise arrangements, including understanding franchising disclosure documents, fees and contract provisions. While this Note primarily addresses franchisee concerns, it does not present a comprehensive list of all possible franchising pitfalls, but does provide a guide to assist franchisees to avoid essential, but commonly overlooked, areas of liability in franchising transactions.

IS THE OFFERED BUSINESS A FRANCHISE?

Franchises are regulated by the FTC under the Franchise Rule and by the laws of some states. Under the Franchise Rule, the term "franchise" refers to a continuing commercial relationship that has each of the following three elements:

- **Trademark license**. The business involves the distribution of goods or services associated with the licensor's trademark or trade name.
- **Payment of a fee**. The licensor requires payment by the licensee for the right to operate the licensee's business.
- **Control or assistance**. The licensor exercises significant control over or provides significant assistance in the licensee's method of operation.

Determining whether a specific business arrangement is a franchise is not always easy. There has been a great deal of litigation regarding the application of each of the above elements. However, where all three elements are present in a business relationship, the relationship is considered a franchise regardless of the name assigned to it by the parties.

Some state laws, however, use a different definition for determining whether a franchise relationship exists. Therefore, applicable state law must be identified and understood before determining whether a business relationship is or is not a franchise.

UNDERSTAND APPLICABLE FRANCHISE LAWS

While both federal and state laws apply to franchises, they are not exclusive of one another. For example, if state law applies to the transaction, federal law also applies.

The laws of more than one state can also apply to a transaction. For example, where a franchisor offers to a Maryland resident a franchise to be located in Virginia, both Maryland's Franchise Registration and Disclosure Law and Virginia's Retail Franchising Act apply to that transaction (see *Md. Code. Ann., Bus. Reg. § 14-203*; *Va. Code § 13.1-559*). In this example, the franchisor must be registered to sell franchises in both states. Therefore, because all state laws do not have the same breadth or applicability, a practitioner must evaluate and understand what laws apply to a given transaction.

There are three different types of laws that specifically pertain to franchising:

- Disclosure laws (see *Disclosure Laws (http://us.practicallaw.com/3-573-6126#a555785)*).
- Registration laws (see *Registration Laws (http://us.practicallaw.com/3-573-6126#a535243)*).
- Relationship laws (see *Relationship Laws (http://us.practicallaw.com/3-573-6126#a314980)*).

For information on the implications of breaching franchising laws, see *Practice Note, The Franchise Rule and its Disclosure Requirements (http://us.practicallaw.com/3-524-1564)*.

DISCLOSURE LAWS

Disclosure laws are pre-sale laws that govern the franchisor's conduct in making franchise sales. Disclosure laws:

- Require a franchisor to provide the prospective franchisee, within a specified time before requiring the franchisee to pay money or sign a binding franchise contract, a Franchise Disclosure Document (FDD) (see *Understand the Disclosure Document (http://us.practicallaw.com/3-573-6126#a68194)*).
- Specify the nature of the information that must be disclosed in the FDD.

All franchise transactions in the US are governed by the Franchise Rule. Some are also governed by state disclosure laws as found in these 15 states:

- California.
- Hawaii.
- Illinois.
- Indiana.
- Maryland.
- Michigan.
- Minnesota.
- New York.
- North Dakota.
- Oregon.
- Rhode Island.
- South Dakota.
- Virginia.
- Washington.
- Wisconsin.

Of these states, all but Oregon also have registration laws (see *Registration Laws (http://us.practicallaw.com/3-573-6126#a535243)*).

Under federal and state law, a franchisor must update its FDD annually (typically within 90 to 120 days of the end of its fiscal year) with new information. If the information disclosed in the FDD changes materially before the end of the fiscal year, the franchisor must update the FDD when the material change occurs.

To comply with disclosure requirements applicable to the transaction, parties must identify and evaluate any applicable state disclosure laws, which differ by state. For example, some states have broadly written disclosure laws, so that a franchisor must register if any of these circumstances exist:

- The prospective franchisee lives in the state.
- The prospective franchisee plans to open the franchised business in the state.
- The franchisor has a place of business in the state.

Some states instead have disclosure laws that apply to a more limited set of circumstances. Others do not have disclosure laws, but instead have business opportunity laws written broadly enough to apply to franchisors.

Most of these business opportunity laws specifically exempt franchise offerings, but only if the franchisor complies with the disclosure requirements under the Franchise Rule. As a result, these business opportunity laws, while not franchise disclosure laws, contain enforcement mechanisms to ensure that franchisors that sell franchises in the state comply with the Franchise Rule.

REGISTRATION LAWS

Like disclosure laws, registration laws are pre-sale laws. Fourteen states have registration laws and all states that have disclosure laws, with the exception of Oregon, also have registration laws (see *Disclosure Laws (http://us.practicallaw.com/3-573-6126#a555785)*). There is no federal registration law. As a result, franchisors that comply with the Franchise Rule's disclosure requirements can sell in states that do not require registration without having to file their document with any governmental authority.

Under most state registration laws:

- A franchisor must:
  - register in the jurisdiction before offering to sell or selling franchises in the jurisdiction by filing its FDD, plus various application forms with the jurisdiction's applicable regulatory agency; and
  - update or renew its registration annually.
- If a franchisor is not registered in the relevant jurisdiction, a franchisor typically cannot either:
  - offer to sell a franchise in the registration jurisdiction; or
  - sell a franchise in the registration jurisdiction.

To ensure that they comply with registration requirements applicable to the transaction, parties must identify and evaluate any applicable state registration laws. Registration laws differ by state and it is possible that more than one state's registration laws apply to a given transaction. For example, some states have registration laws that:

- Are written broadly, so that a franchisor must register if:
  - the prospective franchisee lives in the state;
  - the prospective franchisee plans to open the franchised business in the state; or
  - the franchisor has a place of business in the state.
- Apply to a more limited set of circumstances.

RELATIONSHIP LAWS

Unlike disclosure and registration laws, relationship laws are post-sale laws because they apply only after the franchisee has purchased the franchise and the parties have begun their contractual relationship.

While there is no federal franchise relationship law, 22 states and two territories have franchise relationship laws:

- Arkansas.
- California.
- Connecticut.
- Delaware.
- Hawaii.
- Idaho.
- Illinois.
- Indiana.
- Iowa.
- Kansas.
- Michigan.
- Minnesota.
- Mississippi.
- Missouri.
- Nebraska.
- New Jersey.
- North Dakota.
- Rhode Island.
- South Dakota.
- Virginia.
- Washington.
- Wisconsin.
- US Virgin Islands.
- Puerto Rico.

Relationship laws can govern a variety of post-sale conduct by the franchisor. Many relationship laws prohibit a franchisor from terminating or refusing to renew a franchisee unless the franchisor either:

- Fulfills specific conditions.
- Offers to compensate the franchisee for the termination or non-renewal.

Some relationship laws prohibit discrimination (preferential treatment) between similarly situated franchisees. Others prevent a franchisor from restricting the venue for legal disputes between the parties to locations outside the state. Still others prohibit a franchisor from terminating a franchisee's contract unless the franchisor has given the franchisee notice and a statutorily-mandated period to cure a default.

To ensure that they comply with relationship requirements applicable to the parties' relationship with one another, the parties must identify and evaluate any applicable and likely varying state relationship laws.

UNDERSTAND THE DISCLOSURE DOCUMENT

Apart from the franchise contract itself, the Franchise Disclosure Document is the most important document in an actual or potential franchise purchase transaction. The FDD contains several disclosures that explain the franchisor, its history and the franchise contract itself. They should not be ignored by any potential franchise purchaser. The FTC enacted the Franchise Rule to protect franchisees from apparent and widespread unfair and deceptive practices by franchisors, such as:

- Material misrepresentations.
- Failure to disclose material facts.
- Unsubstantiated earnings claims.
- Failures to honor promised refund requests.

The Franchise Rule and some state laws require any franchisor that wants to offer a franchise in the US to:

- Provide a FDD to a prospective franchisee at least 14 calendar days before asking the prospective franchisee to pay any money or sign a binding agreement with the franchisor.
- Make in its FDD certain disclosures pertaining to the company, its officers, the expected initial investment, fees and other aspects of the franchise relationship (see *Areas of Disclosure (http://us.practicallaw.com/3-573-6126#a406765)*).

AREAS OF DISCLOSURE

Each area of disclosure is referred to in the FDD as an "Item" and there are 23 different items in the FDD. Significant areas of disclosure in the FDD include:

- Fee disclosures, including:
  - initial fees, such as any fees that are paid to the franchisor or its affiliates before the franchisee opens the franchised business (see *Initial Franchise Fees (http://us.practicallaw.com/3-573-6126#a384134)*);
  - other fees, such as fees that are paid to or imposed by the franchisor or its affiliates during the life of the franchise (see *Profit and Administrative Fees (http://us.practicallaw.com/3-573-6126#a76781)* and *Other Service Fees (http://us.practicallaw.com/3-573-6126#a765162)*); and

  - an estimate of the initial investment that is required for the franchisee to build, open and begin operating the franchise.
- The prior business experience of the franchisor, its affiliates and the officers, managers, directors and other key employees who have management responsibility relating to the franchise.
- The litigation and bankruptcy history of the franchisor and its officers, managers, directors and other key employees who have management responsibility relating to the franchise.
- Whether the franchisee is offered an exclusive territory and a description of any limitations on the scope of the franchisee's territorial rights, including any rights the franchisor retains in the franchisee's territory.
- A description of the types of initial and ongoing assistance, including a summary of training, that the franchisor agrees to provide to the franchisee.
- A list of any restrictions on the types of products, services, inventory items, equipment, real estate or other items that the franchisee must purchase from the franchisor, its affiliates or approved suppliers.
- The financial statements of the franchisor, which must be audited by an independent certified public accountant.
- A list of the existing franchised and company-owned units in the franchisor's national system and information regarding the history of those locations over the franchisor's previous three fiscal years.
- If the franchisor makes any projections or claims regarding the franchisee's potential earnings (financial performance representations), the franchisor must include in the FDD:
  - the financial performance representations; and
  - the material assumptions or bases for the projection or claim.

(See *Financial Performance Representations (http://us.practicallaw.com/3-573-6126#a502341).*)

For more detailed information about the areas of disclosure, see *Practice Note, The Franchise Rule and its Disclosure Requirements: Franchise Disclosure Document (http://us.practicallaw.com/3-524-1564#a700509)*.

Financial Performance Representations

Financial performance representations take a variety of forms and include any statement (express or implied) that promises that the prospective franchisee can achieve a specific financial goal under the franchise regarding:

- Potential sales.
- Income.
- Gross profits.
- Net profits.

The financial performance representations disclosure is the only disclosure that is optional for franchisors. A franchisor can choose not to make any financial performance representations, but if it does not, it:

- Must include a clear and conspicuous statement in the FDD that it has elected not to make that disclosure. The FTC included this requirement to help mitigate the common misstatement by franchisor salespeople that federal law prohibits franchisors from making financial performance representations.
- Is prohibited from making any statement, whether in the FDD or otherwise, about the sales, income or profits that the franchisee can expect to achieve, including implied earnings claims, such as:
  - "you will be able to replace your current income by working at your franchise";
  - "you will earn enough money to buy a new sports car"; or
  - "100% return on investment within the first year of operation."

Mere puffery, however, like "earn big money" or "this is the opportunity of a lifetime" generally does not constitute a financial performance representation.

If a franchisor does not make a financial performance representation in its FDD, prospective franchisees can ask existing and former franchisees in the system (listed under Item 20 of the FDD) for information regarding their own historical performance. Franchisees are generally not subject to the same restrictions against sharing their own financial information as the franchisor.

For more information about franchisor financial performance representations, see *Practice Note, The Franchise Rule and its Disclosure Requirements: Item 19: Financial Performance Representations (http://us.practicallaw.com/3-524-1564#a473927)*.

OBTAIN EXPERIENCED LEGAL COUNSEL

A franchise purchaser should retain attorneys experienced in franchise law to interpret applicable laws and how those laws may provide the franchisee with additional protections, because:

- Many different federal and state laws and regulations pertain to franchising.
- Multiple, varying state laws can apply to the same transaction.

Attorneys experienced in franchise law also:

- Are accustomed to interpreting and advising on franchise disclosure documents and franchise agreements.
- Typically understand how franchising differs from other types of business relationships.

As a result, experienced franchise attorneys can advise clients whether a particular franchise offering and the terms of the offering:

- Is typical for the industry or outside the norm.
- Contains negotiable terms.
- Is more or less one-sided than is typical for those agreements.

Attorneys inexperienced in franchising can seriously harm the client by frustrating or needlessly complicating the process, which can result in:

- The franchisor's unwillingness to negotiate.
- The franchisee failing to negotiate a more protective agreement.
- The franchisee failing to properly understand the franchise agreement and the risks in franchising.

UNDERSTAND THE TYPES OF FEES CHARGED

Failure to understand transaction-specific fees or the typical fees that apply to franchise agreements can lead to:

- The franchisee paying more than it thought it had bargained for. For example, the franchisor may require the franchisee to periodically invest in expensive systems or services upgrades.
- Disagreement or litigation between the parties.

Although there is no one-size-fits-all in franchising, most franchise agreements contain one or more of these three basic types of fee arrangements:

- Franchisor's profit and administrative fees (see *Profit and Administrative Fees (http://us.practicallaw.com/3-573-6126#a76781)*).
- Service fees (see *Service Fees (http://us.practicallaw.com/3-573-6126#a265131)*).
- Expense reimbursement and cost recovery fees (see *Expense Reimbursement and Cost Recovery Fees (http://us.practicallaw.com/3-573-6126#a87593)*).

PROFIT AND ADMINISTRATIVE FEES

Profit and administrative fees:

- Give companies the incentive to start and continue franchising.
- Set the franchisee's expectation that the franchisor will likely share in the income of the individual franchised business.
- Help pay for the franchisor's administrative infrastructure used to support its franchisees and franchise system.

There are three types of profit and administrative fees:

- Initial franchise fees (see *Initial Franchise Fees (http://us.practicallaw.com/3-573-6126#a384134)*).
- Royalty fees (see *Royalty Fees (http://us.practicallaw.com/3-573-6126#a117866)*).
- Successor or transfer fees (see *Successor Franchise or Transfer Fees (http://us.practicallaw.com/3-573-6126#a919599)*).

Initial Franchise Fees

Prospective franchisees pay initial franchise fees to the franchisor for the privilege of entering into the franchise relationship. Typically made in a lump sum and disclosed in Item 5 of the FDD, the amount:

- Is usually large enough to signify the franchisee's commitment to build the business and learn the franchise system.
- May have some component of profit built in, but in most circumstances the franchisor uses the initial franchise fee to cover its costs to locate and train new franchisees.
- Usually helps new franchisors cover their significant start-up costs.

The amount of initial fees is disclosed in Item 5 of the FDD (see *Practice Note, The Franchise Rule and its Disclosure Requirements: Item 5: Initial Fees (http://us.practicallaw.com/3-524-1564#a907499)*).

Royalty Fees

Royalty fees are typically ongoing fees that a franchisee must pay the franchisor during the life of the franchise relationship. Royalty fees are usually expressed as either or a combination of:

- A percentage of the franchisee's gross revenue.
- A flat fee.

Royalty fees are usually paid weekly or monthly, but in rare instances are paid quarterly or annually. The amount of the royalty fee is disclosed in Item 6 of the FDD (see *Practice Note, The Franchise Rule and its Disclosure Requirements: Item 6: Other Fees (http://us.practicallaw.com/3-524-1564#a550970)*).

Successor Franchise or Transfer Fees

Under the franchise agreement, the franchisor typically reserves the right to assess either or both:

- **Successor fees**. These fees compensate the franchisor if and when the franchisee decides, at the end of its term, to continue in the franchise relationship, typically by entering into a successor franchise agreement (also referred to as renewing and renewal fees).
- **Transfer fees**. These fees compensate the franchisor if and when the franchisee transfers, sells or assigns its rights under the franchise agreement to a third party.

Successor and transfer fees are ordinarily charged as either:

- A fixed fee.
- As a percentage of the initial franchise fee that the franchisor is charging new franchisees at the time that the franchisee obtains the successor franchise or transfers the franchise to a third party.

Successor franchise and transfer fee amounts are disclosed in Item 6 of the franchisor's FDD (see *Practice Note, The Franchise Rule and its Disclosure Requirements: Item 6: Other Fees (http://us.practicallaw.com/3-524-1564#a550970)*).

SERVICE FEES

Depending on the franchise system used, franchisors charge franchisees service fees, including brand building fees, among others, for services provided.

Brand Building Fees

Brand building fees are the most common of service fees. Brand building fees are charged by a franchisor for the purpose of creating or increasing brand awareness. These fees have different names, including:

- National advertising fund.
- Marketing fund.
- Brand awareness fund.
- Brand fund.

Regardless of the name, the fee usually works the same way:

- The franchisee pays the franchisor either or a combination of both:
  - a percentage of its gross revenues; or
  - a flat fee on a weekly or monthly basis.

- The franchisor:
  - aggregates all of these payments across the franchise system into a common fund; and
  - spends the money in the fund to advertise the franchise system locally, regionally or nationally.

In most cases, the franchisor:

- Does not make any guarantees or promises to its franchisees that it will conduct advertising or brand awareness activities in a way that ensures that each individual franchisee will benefit directly or indirectly from the fund.
- Usually retains complete discretion over how the funds are spent, although some franchise systems use a council of franchisees to help direct advertising.
- Reserves the right to use a specified portion of the money paid into the advertising fund to pay its own internal administrative expenses that relate specifically to its advertising or brand-building activities.

The amount of the required brand building fund payment is disclosed in Item 6 of the franchisor's FDD. The specific ways that the franchisor uses or intends to use the brand building fund are disclosed in Item 11 of the franchisor's FDD (see *Practice Note, The Franchise Rule and its Disclosure Requirements: Item 11: Franchisor's Assistance, Advertising, Computer Systems and Training (http://us.practicallaw.com/3-524-1564#a963496)*).

Other Service Fees

Franchisors also charge a fairly wide variety of other service fees, including those that are related to a specific service that the franchisor requires its franchisees to pay for and use. These fees include:

- Technology fees (typically, fees paid to license proprietary software or technology or to maintain and update a system-wide website).
- Customer relationship management fees (paid for the franchisor to manage or administer a system-wide program for customer service).
- Fees paid for the franchisee to attend national meetings or conventions.

These fees are disclosed in Item 6 of the franchisor's FDD (see *Practice Note, The Franchise Rule and its Disclosure Requirements: Item 6: Other Fees (http://us.practicallaw.com/3-524-1564#a550970)*).

EXPENSE REIMBURSEMENT AND COST RECOVERY FEES

Expense reimbursement and cost recovery fees are designed to reimburse the franchisor for expenses and costs that it might incur over the life of the franchise relationship in supporting or focusing on the franchisee. These typically include:

- **Indemnification fees**. The franchisee pays indemnification fees when the franchisor requires the franchisee to hold harmless or indemnify the franchisor for claims relating to franchisee's operation of the franchised business. For a sample indemnification clause, see *Standard Clauses, General Contract Clauses: Indemnification (http://us.practicallaw.com/5-507-8048)*.
- **Attorneys' fees and costs after dispute is resolved**. Most franchise agreements have a "loser pays" attorneys' fees provision. A minority of agreements have a non-reciprocal fee provision requiring the franchisee to pay the franchisor's attorneys' fees if the franchisee loses in a dispute. For a sample attorneys' fees provision, see *Standard Clauses, General Contract Clauses: Litigation Costs and Expenses (http://us.practicallaw.com/3-540-2608)*.
- **Audit fees**. The franchisor typically reserves the right to audit the franchisee to ensure the franchisee is accurately reporting gross revenue. If the franchisee underreports gross revenue, the franchisor often charges the franchisee the audit costs. For a sample audit provision, see *Standard Clauses, General Contract Clauses: Audit Rights (http://us.practicallaw.com/4-567-1110)*.
- **Legal fees and administrative costs**. These are assessed if the franchisee does not timely pay the franchisor amounts owed or breaches another provision of the franchise agreement that requires the franchisor to take administrative action or use legal counsel to provide notice of the breach.
- **Interest and late fees**. These fees are assessed if the franchisee's payments owed to the franchisor are not paid in a timely manner. For a sample late payment provision, see *Standard Clauses, General Contract Clauses: Late Payment (http://us.practicallaw.com/8-530-5351)*.
- **Management or step-in fees**. In most systems, the franchisor retains the right to step into the franchisee's shoes and temporarily manage, operate or terminate the franchised business if the franchisee:
  - dies;
  - becomes temporarily or permanently incapacitated; or
  - commits a material default that has remained uncured.

  Step-in or management rights typically last for a fixed duration and are charged in a specified dollar amount per day that the franchisor operates the franchised business.
- **Insurance**. The franchisor typically has the right (but is not obligated) to obtain insurance on behalf of its franchisee if the franchisee fails to purchase insurance for itself. The franchisor typically charges a fee to cover its expenses of making these arrangements for the franchisee.
- **Income tax reimbursement**. An increasing number of states are now taking the position that if a franchisor has a franchisee located in the state, the franchisee's presence in the state gives a sufficient economic nexus to charge income taxes to the franchisor based on the income earned from the franchisees in that state. Some franchisors in their franchise agreement retain the right to pass these income taxes to the franchisee, effectively requiring the franchisee to gross-up the amount paid to the franchisor, plus the amount of the income tax, so that the franchisee reimburses the franchisor for payments to the franchisee's home state.

This list of expense reimbursement and cost recovery fees is illustrative and non-exhaustive. These fees are disclosed in Item 6 of the franchisor's FDD (see *Practice Note, The Franchise Rule and its Disclosure Requirements: Item 6: Other Fees (http://us.practicallaw.com/3-524-1564#a550970)*).

KNOW YOUR FRANCHISE AGREEMENT

To avoid shouldering disproportionate liability, before signing a franchising agreement, prospective franchisees should carefully scrutinize the franchise agreement's terms and conditions.

For more information on franchise agreements, see *Article, Franchising country questions: US: The Franchise agreement (http://us.practicallaw.com/2-102-2118#a155040)*.

TERRITORIAL PROVISIONS

Most franchise agreements grant to the franchisee a protected territory (sometimes known as a protected area, exclusive territory, territory or area of operations). The franchisor often reserves to itself the right to conduct certain types of activities within the territory, such as:

- The right to sell products or services under the franchisor's trademarks within the territory through alternative channels of distribution (which are methods of sale that are dissimilar to the business being franchised), such as:
  - internet sales;
  - mail order sales; or
  - branded product sales through unaffiliated retailers or wholesalers.
- The right to operate, directly or through franchisees, franchised units at non-traditional locations, such as:
  - airports;
  - sport stadiums;
  - military bases;
  - hospitals; or
  - schools.
- The right to operate, directly or through franchisees, businesses under trademarks other than the marks being franchised that may sell products or services that are similar or dissimilar to the products or services that will be sold by the franchisee.

NON-COMPETE PROVISIONS

Typically limited by geography and time, non-compete provisions prevent the franchisee from continuing to operate a similar business both before and after the franchise relationship ends. Some states have laws that prohibit or restrict the application of non-compete provisions after the termination, transfer or expiration of the franchise agreement.

SUCCESSOR FRANCHISE OR RENEWAL PROVISIONS

If a franchisee wishes to continue in the franchise relationship after the end of the first term, the franchisor often requires the franchisee to:

- Sign the franchisor's form of franchise agreement that it is then offering to new franchisees, which may include higher fees and a smaller territory, as well as other provisions that are materially different from those that are in the original franchise agreement.
- Remodel, update or renovate the franchised business.
- Sign a general release of claims that the franchisee may have against the franchisor and its affiliates.
- Demonstrate that it has been in substantial compliance with the franchise agreement during the original term and that it has not been in default of the agreement more than a set number of times during the original term.
- Demonstrate that the franchisee has the right to continue at the same location under its lease or propose an alternative location.
- Demonstrate that the franchisee continues to meet the franchisor's criteria for franchise operators.
- Pay a successor franchise fee that is charged as either:
  - a fixed fee; or
  - a percentage of the initial franchise fee that the franchisor is charging new franchisees at the time that the franchisee obtains the successor franchise or transfers the franchise to a third party.

See *Successor Franchise or Transfer Fees (http://us.practicallaw.com/3-573-6126#a919599)*.

Some state franchise relationship laws restrict a franchisor's right to refuse to renew the franchise agreement, except under certain enumerated circumstances.

TRANSFER PROVISIONS

When a franchisee wishes to sell the franchised business to a third party, the franchisor often requires:

- The transferee (incoming franchisee) to sign the franchisor's form of franchise agreement that it is then offering to new franchisees, which may include higher fees and a smaller territory, as well as other provisions that are materially different from those that are in the original franchise agreement.
- The transferee to remodel, update or renovate the franchised business.
- The franchisee to sign a general release of claims that the franchisee may have against the franchisor and its affiliates.
- The franchisee to demonstrate that it has been in substantial compliance with the franchise agreement during the original term and that it has not been in default of the agreement more than a set number of times during the original term.
- The transferee to demonstrate that the transferee meets the franchisor's criteria for new franchise operators.
- Pay a transfer fee that is charged as either:
  - a fixed fee; or
  - a percentage of the initial franchise fee that the franchisor is charging new franchisees at the time that the franchisee obtains the successor franchise or transfers the franchise to a third party.

See *Successor Franchise or Transfer Fees (http://us.practicallaw.com/3-573-6126#a919599)*.

Some state franchise relationship laws restrict a franchisor's right to refuse a franchisee's request to transfer the franchise agreement except under certain enumerated circumstances.

COOPERATIVE ADVERTISING PROVISIONS

These provisions require the franchisee, if it is within a geographic area where an advertising cooperative has been established, to contribute a fixed amount or percentage of the franchisee's gross sales to the cooperative for the purpose of buying advertising that benefits all of the members of the cooperative.

AUTOMATIC OR IMMEDIATE TERMINATION PROVISIONS

Franchisors often retain the right to terminate the franchise agreement immediately, with or without notice to the franchisee, for certain types of franchise agreement violations. Automatic or immediate termination rights often include the right to terminate the franchise agreement for the franchisee's:

- Insolvency or bankruptcy.
- Abandoning the franchised business.
- Underreporting or otherwise falsely reporting income to the franchisor.
- Misusing the franchisor's confidential information, trade secrets or intellectual property.
- Misrepresenting facts to the franchisor.
- Making an unauthorized transfer of the franchised business or its assets.
- Committing a felony or misdemeanor that is likely to reflect materially unfavorably on the franchisor or the franchised business.
- Failing to comply with applicable laws.
- Repeatedly defaulting under the franchise agreement, even if the defaults can be cured
- Violating restrictive covenants.
- Selling products or services that have not been approved for sale by the franchisor.

Some state franchise relationship laws restrict a franchisor's right to terminate the franchise agreement under certain enumerated circumstances.

For franchise-related termination drafting and negotiating tips, see *Drafting and Negotiating a Franchise Agreement Checklist: Termination (http://us.practicallaw.com/9-524-1429)*.

TERMINATION WITH OPPORTUNITY TO CURE

Franchisors usually have the right to terminate the franchise agreement if the franchisee commits a material default that remains uncured after a specified time, for example where the franchisee fails to:

- Make timely payments to the franchisor, its affiliates or approved suppliers.
- Comply with the franchisor's operations manual or other system standards.

DISPUTE RESOLUTION

Many franchise agreements require the franchisee and franchisor to first attempt to mediate any dispute between them before proceeding to litigation or arbitration. The franchisee should expect the franchise agreement to:

- Require arbitration for any disputes, as is common in most franchise agreements.
- Except franchisor actions for emergency, injunctive or other provisional relief from any mandatory arbitration or mediation proceedings.
- Have a forum selection clause requiring any litigation to occur in its home city and state.
- Apply the franchisor's home state laws as the agreement's governing laws.
- Include jury trial, punitive damages and class actions waivers.

The franchisee should note that any state franchise relationship laws limit the application of choice-of-law or forum-selection provisions, permitting the franchisee to litigate or arbitrate in the franchisee's home state, under that state's laws.

ATTORNEYS' FEES PROVISIONS

Most franchise agreements contain provisions for the unsuccessful party to pay the successful party's attorneys' fees after the arbitration or litigation proceedings conclude. A small minority of franchise agreements are non-reciprocal and do not require the franchisor to pay the franchisee's attorneys' fees if the franchisee is the successful party in dispute resolution proceedings.

REQUIRED PURCHASES

Franchisors typically require franchisees to purchase from the franchisor or its approved suppliers all, substantially all or part of the products, inventory, equipment, items or supplies used in or sold by the franchisee in the franchised business. For franchise-related purchase requirement drafting and negotiating tips, see *Drafting and Negotiating a Franchise Agreement Checklist: Assignment: Equipment and Supplies; Products (http://us.practicallaw.com/9-524-1429)*.

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