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# Franchise Contract Clauses and the Franchisor's Duty of Care toward Its Franchisees

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# FRANCHISE CONTRACT CLAUSES AND THE FRANCHISOR'S DUTY OF CARE TOWARD ITS FRANCHISEES

ROBERT W. EMERSON\*

*Franchising is an attractive business opportunity for both the franchisor and franchisee. The "franchise relationship," however, is not easy to define. It has various aspects with each party having different expectations about the other's performance responsibilities. In the typical franchise relationship, the franchisor and franchisee will sign a "franchise agreement" that codifies the rights and responsibilities of each party. Although the agreements are detailed and comprehensive, it is impossible to predict what situations will develop after the parties sign the contract.*

*In this Article, Professor Emerson examines the criteria that he believes courts should use to analyze the various aspects of the franchise relationship. He argues that the complex relationship calls for the application of three distinct standards of care: fiduciary relationship, good cause, and the implied covenants of good faith and fair dealing. Professor Emerson details the appropriate standard of care to use for many different types of franchise clauses. Utilizing these standards and applying them consistently will, he maintains, clearly define the scope of the franchise relationship, enabling the parties to settle disputes fairly without the need for costly litigation.*

I. INTRODUCTION .....	906
A. <i>The Problem</i> .....	906
B. <i>Franchise Regulation and the Establishment of Franchise Relationship Standards</i> .....	908
II. DEFINING FRANCHISE RELATIONSHIPS .....	915
A. <i>Business Opportunities</i> .....	915
B. <i>The Nature of the Franchise Relationship</i> .....	920
C. <i>The Fiduciary Obligation</i> .....	922
D. <i>Strict Interpretation of Express Contracts</i> .....	926
E. <i>Implied Covenants of Good Faith and Fair Dealing</i> .....	929

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<i>F. Affirmative Showing of Good Cause</i> .....	930
III. APPLYING THE CORRECT STANDARD .....	933
<i>A. Introduction</i> .....	933
<i>B. Clauses Requiring a Fiduciary Relationship</i> .....	934
1. Site Selection .....	934
2. Physical Layout and Signs .....	938
3. Training of Franchisees .....	939
4. Operational Standards .....	939
5. Variance in Contractual Terms for Other Franchisees .....	940
6. Opening and Financing .....	941
7. Advertising .....	942
<i>C. Clauses Requiring "Good Cause"</i> .....	943
1. Territorial Development and Protection .....	944
2. Covenants Against Competition .....	946
3. Franchise Transfers and Franchisor Assignments .....	948
4. Franchise Terminations and Nonrenewals .....	949
5. Miscellaneous Provisions .....	953
<i>D. "Arm's Length" Clauses: Applying No More Than the         General, Implied Covenant of Good Faith and Fair         Dealing</i> .....	954
1. Royalties and Other Franchise Fees .....	955
2. Franchise Time Periods, Arbitration and Venue Stipulations, and Insurance Requirements .....	956
3. Declarations About the Ownership of Intellectual Property .....	957
4. Declarations About the Franchisee's Review of the Franchise Contract Before Signing It .....	958
IV. IMPLEMENTATION .....	959
V. CONCLUSION .....	963
APPENDIX .....	966

## I. INTRODUCTION

### A. *The Problem*

Assume that two parties, Fred Franchisee (Fred) and Fast-Food Franchisor (FFF), sign a franchising agreement. They begin a long-term relationship that encompasses numerous subjects, including Fred's business site, his training and financing, and the royalties and other fees Fred must pay to FFF. The agreement between the parties covers details such as the system's advertising program and Fred's corresponding expenses; FFF's operational standards, which Fred must meet; FFF's auditing of Fred's books and inspection of his business premises; Fred's covenant not to com-

pete against FFF; the right of FFF to assign its interest; Fred's rights and duties concerning FFF's trademarks; the insurance Fred must obtain; FFF's right to terminate Fred's franchise; and the supplies offered to Fred by FFF or FFF-approved suppliers.

If a dispute were to arise over fees, intellectual property, or other set terms such as insurance requirements or arbitration and venue stipulations, the franchise agreement typically would reflect a full accord reached before the contract started; therefore, the written terms could stand alone. Franchisors and franchisees, however, tend to have legitimate expectations about their franchise relationship that often go far beyond the terms specified in their written agreement. If the parties later disagree about other terms—especially those dependent upon an ongoing series of judgments by the franchisor—then concepts of fairness and rationality would require the parties to reconsider any naive notions they may have had about a completed franchise contract necessitating no judicial or statutory refinements. FFF may point to contractual clauses giving it almost unfettered power to restrict Fred's competition, to assign FFF's rights and duties while barring any franchise transfers by Fred, and even to terminate or decline to renew Fred's franchise. Nevertheless, Fred, like most franchisees, expects far more than what the written document promises. A court that reads the franchise contract literally can adequately interpret and apply some provisions, but may have to adopt a wholly different approach to other clauses to effectuate the "spirit" of the franchise agreement.

When the franchise contract clauses involve areas in which the franchisee depends upon the franchisor's judgment and fiduciary-like status, the need to impose extra-contractual standards is even clearer. Yet when courts review disputes over such clauses, they generally hesitate to do anything more than quickly examine whether the parties acted in good faith and exercised fair dealing. That remains so even when the courts examine crucial franchisor decisions that affect the franchised business's continuing viability. Although different clauses require different standards of review, the courts generally have difficulty dividing a written contract and applying several different interpretative standards to it. Courts judge fiduciary matters such as site selection, financing, opening, advertising, and training by the same common law of contracts methods that they use for set terms such as royalties. The former terms are subject to the franchisor's discretionary power over the course of a long franchise relationship, but they are judged no differently from other contractual provisions that were established at the outset of the franchise relationship and have not thereafter been subject to the franchisor's discretionary interpretation or enforcement.

In short, the law of franchising must recognize the various implications of the franchise relationship, especially the divergent standards by which

different franchise contract clauses should be interpreted and applied. This Article discusses the development and use of such standards.

*B. Franchise Regulation and the Establishment of Franchise Relationship Standards*

The popularity of franchising as a marketing technique is not surprising. Franchising presents a relatively inexpensive method for rapid expansion into new markets and diverse geographic areas. A business may, by franchising, sell its goods, services, or overall business format through independently owned and financed outlets that pay the originating business royalties and other fees.<sup>1</sup> Franchisees probably are drawn to franchising by the prospect of running their own businesses while at the same time benefitting from the expertise, credibility, and purchasing power of a much larger business.

Franchising continues to boom. In the past decade, the growth of franchising has easily outpaced overall economic growth.<sup>2</sup> Over half a million franchises operate in the United States, and they account for more than

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1. A franchise involves a continuing contractual relationship in which the franchisor grants the franchisee a right to conduct business or sell products according to the franchisor's marketing plan and in conjunction with the franchisor's trademark. *See* N.J. STAT. ANN. § 56:10-3 (West 1989) (enacted in 1971); WASH. REV. CODE § 19.100.010 (1989 & Supp. 1993) (enacted in 1972); *see also* U.S. DEP'T OF COMMERCE, BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES: 1992, at 770-71 (112th ed. 1992) (charting growth of the number and sales of franchised businesses); Donald P. Horwitz & Walter M. Volpi, *Regulating the Franchise Relationship*, 54 ST. JOHN'S L. REV. 217, 228 (1980) (observing that franchising encourages the creation of small, independently-owned businesses). Franchising can be more extensively defined as: [A] system for the selective distribution of goods and/or services under a brand name through outlets owned by independent businessmen, called "franchisees." Although the franchisor supplies the franchisee with know-how and brand identification on a continuing basis, the franchisee enjoys the right to profit and runs the risk of loss. The franchisor controls the distribution of his goods and/or services through a contract which regulates the activities of the franchisee, in order to achieve standardization.

ROBERT ROSENBERG & MADELO BEDELL, PROFITS FROM FRANCHISING 41 (1969). For a comprehensive treatment of the franchising concept as defined by the commentators, *see* Robert W. Emerson, *Franchising and the Collective Rights of Franchisees*, 43 VAND. L. REV. 1503, 1506 n.1, 1508-09 (1990).

2. From 1980 to 1991, the United States' gross domestic product (GDP) increased by 109.7%, its total retail sales (TRS) increased by 94.9%, and its retail sales by franchised businesses (RS-FB) rose 125.4%. *See* U.S. DEP'T OF COMMERCE, BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES: 1993, at 445, 776, 780 (113th ed. 1993) (showing for those years a GDP increase from \$2,708 billion to \$5,677.5 billion, a TRS increase from \$957.4 billion to \$1,865.5 billion, and a RS-FB increase from \$336.2 billion to \$757.8 billion).

a third of the nation's total retail sales.<sup>3</sup> By the end of 1993, they will probably account for a trillion dollars in annual retail sales.<sup>4</sup>

Many franchisees, however, suffer business problems directly related to "insufficient capital, inadequate experience, or incomplete understanding of the . . . risks and responsibilities" of owning a franchise.<sup>5</sup> In response to these problems, state and federal legislators enacted disclosure requirements that utilize perhaps the most effective form of consumer protection: self-help.<sup>6</sup> The prospective franchisee can use information contained in the

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3. See Robert W. Emerson, *Franchisors' Liability When Franchisees Are Apparent Agents: An Empirical and Policy Analysis of "Common Knowledge" about Franchising*, 20 HOFSTRA L. REV. 609, 614-15 & n.13 (1992); see also FTC Official Debunks Franchise "Myths," *Reports on Franchise Rule Enforcement*, Bus. Franchise Guide (CCH) ¶ 9785, at 22,051 (prepared statement of Barry J. Cutler, Director of the FTC Bureau of Consumer Protection, before the Committee on Small Business of the U.S. House of Representatives, March 20, 1991) ("Most projections expect that [franchised outlets' percentage of total retail sales] will jump to one-half of all retail sales by the year 2000.") [hereinafter *Franchise "Myths"*].

4. *Franchise "Myths," supra* note 3, ¶ 9785, at 22,051.

5. John M. Tifford & Craig Tregillus, *The Federal Trade Commission Franchise Rule, in FRANCHISING 1990: BUSINESS STRATEGIES AND COMPLIANCE ISSUES* 189, 193 (P.L.I. Commercial Law & Practice No. 525, 1990); see also Harold Brown, *Franchising: The 20-Year Agreement*, N.Y. L.J., Oct. 22, 1992, at 3, 28 (denying the usual premise that franchisors and franchisees "are jointly intent on achieving successful operations" inasmuch as a "gross imbalance in the relationship has precluded genuine restraint by franchisors both in the drafting of agreements and in their administration and termination conduct"); Andrew A. Caffey & Jeffrey E. Kolton, *Solving the Continuing Problems with Earnings Claims*, 3 FRANCHISE LEGAL DIG. 9 (Spec. Symposium Issue, May 5-6, 1986) (stating that in many circumstances current franchise law makes it impossible for franchisors to deliver information that is vital to the franchisees).

6. The first state disclosure legislation, enacted by California in 1970, regulated the offer and sale of business ventures that fit within the definition of "franchise," but did not reach business opportunities (defined *infra* notes 24-33 and accompanying text). CAL. CORP. CODE §§ 31,000-31,516 (West 1977 & Supp. 1993). In 1979, North Carolina became the first state to enact legislation that required written disclosure of non-franchise business ventures. N.C. GEN. STAT. §§ 66-94 to -100 (1992). In October 1979, the Federal Trade Commission adopted Disclosure Requirements and Prohibitions Concerning Franchises and Business Opportunity Ventures, requiring written disclosure by the sellers of both franchises and business opportunities. 16 C.F.R. § 436.1 (1993) [hereinafter *FTC Rule*] (promulgated October 21, 1979 pursuant to the Federal Trade Commission Act § 5, 15 U.S.C. § 41 (1976)).

The FTC Rule, like other federal legislation, preempts state and local laws to the extent that those laws conflict with the federal statute. *Illinois Corporate Travel, Inc. v. American Airlines, Inc.*, 889 F.2d 751, 754-55 (7th Cir. 1989) (finding that the Federal Aviation Act preempted the Illinois Consumer Fraud and Deceptive Business Practice Act, ILL. REV. STAT. ch. 121 1/2, paras. 261-262 (1990); thus, the state could not force an air carrier to deal with a would-be agent who refused to respect a contract restricting advertising of discount prices). However, the FTC Rule does not preempt consistent state laws, and it permits *inconsistent* state laws insofar as they provide prospective purchasers equal or greater protection than that imposed by the FTC Rule. 16 C.F.R. § 436 n.2 (1993); *Tousley v. North Am. Van Lines, Inc.*, 752 F.2d 96, 100-03 (4th Cir. 1985); *Morgan v. Air Brook Limousine, Inc.*, 510 A.2d 1197, 1205-07 (N.J. Super. Ct. Law Div. 1986); Final Guides to the Franchising and Business Opportunity Ventures Trade Regulations Rule, 44 Fed. Reg. 49,966 (1979).

disclosure documents to make as intelligent an investment decision as possible.<sup>7</sup>

Twenty-two states regulate the offer and sale of franchises,<sup>8</sup> while twenty-four states regulate the offer and sale of business opportunities.<sup>9</sup>

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7. The goal of the FTC Rule, *supra* note 6, is to enable prospective franchisees to assess the potential benefits and risks of their investment by ensuring that they receive full pre-sale disclosure of relevant information about the franchise investment, as well as sufficient time to review the information before purchase.

The FTC Rule reduces the opportunity for fraudulent conduct by forcing franchisors to choose from three unattractive disclosure alternatives. First, the seller can make a complete and accurate disclosure to all potential buyers. Obviously, full disclosure should reduce the potential for sales abuse by fraudulent franchisors. Second, the franchisor can ignore the FTC Rule and not make any disclosure. In this case, however, the seller would be strictly liable for any violation of the FTC Rule and subject to civil penalties of up to \$10,000 per violation, as well as a permanent injunction against future violations. 15 U.S.C. § 45(l) (1988). More importantly, the FTC would not have to prove that actual misrepresentations, reliance, or damages took place to prevail in an enforcement action—mere noncompliance would be sufficient. *Id.* Finally, the franchisor can comply with the FTC Rule but omit certain required information. In this case, however, the omitted information would significantly ease the burden of proof in both private actions for misrepresentations as well as FTC enforcement actions. *Brill v. Catfish Shaks of Am., Inc.*, 727 F. Supp. 1035, 1042 & n.13 (E.D. La. 1989) (holding plaintiff's allegations that defendant failed to make certain disclosures relevant as a minimum standard of reasonableness and fairness in a jurisdiction that applies an objective standard of good faith).

8. See ARK. CODE ANN. §§ 4-72-201 to -210 (Michie 1987) (enacted in 1977); CAL. CORP. CODE §§ 31,000-31,516 (West 1977 & Supp. 1993) (enacted in 1970); HAW. REV. STAT. § 482E (1992) (enacted in 1974); ILL. REV. STAT., ch. 121 1/2, paras. 1701-1744 (Smith-Hurd Supp. 1992) (revised law enacted in 1987); IND. CODE ANN. §§ 23-2-2.5-1 to -51 (Burns 1989 & Supp. 1992) (enacted in 1975); IOWA CODE ANN. §§ 523H.1-.17 (West Supp. 1993) (enacted in 1992); MD. BUS. REG. CODE ANN. §§ 14-201 to -233 (1988 & Supp. 1992) (enacted in 1977); MICH. COMP. LAWS ANN. §§ 445.1501-.1546 (West 1989 & Supp. 1992) (enacted in 1974); MINN. STAT. ANN. §§ 80C.01-.30 (West 1986 & Supp. 1993) (enacted in 1973); MISS. CODE ANN. §§ 75-24-51 to -61, 75-77-1 to -19 (Supp. 1992) (enacted in 1975 and 1977, respectively); MO. REV. STAT. § 407.400-.420 (1978 & Supp. 1992) (enacted in 1974); NEB. REV. STAT. §§ 87-401 to -410 (1987 & Supp. 1992) (enacted in 1978) (no registration required); N.J. STAT. ANN. §§ 56:10-1 to -15 (West 1989 & Supp. 1991) (enacted in 1971); N.Y. GEN. BUS. LAW §§ 680-695 (McKinney 1984 & Supp. 1993) (enacted in 1981); N.D. CENT. CODE §§ 51-19-01 to -17 (1989 & Supp. 1991) (enacted in 1975); OR. REV. STAT. §§ 650.005-.250 (1991) (enacted in 1973); R.I. GEN. LAWS §§ 19-28-1 to -15 (1989) (enacted in 1973); S.D. CODIFIED LAWS ANN. §§ 37-5A-1 to -87 (1986 & Supp. 1992) (enacted in 1974); TENN. CODE ANN. §§ 47-25-1501 to -1511 (Supp. 1992) (enacted in 1989); VA. CODE ANN. §§ 13.1-557 to -574 (Michie 1989 & Supp. 1992) (enacted in 1972); WASH. REV. CODE ANN. §§ 19.100.010-.940 (West 1989) (enacted in 1972); WIS. STAT. ANN. §§ 135.01-.07 (West 1989 & Supp. 1992) ("Fair Dealership Law" enacted in 1973); *id.* §§ 553.01-.78 (West 1989 & Supp. 1992) ("Franchise Investment Law" enacted in 1972). The District of Columbia, Puerto Rico, and the Virgin Islands also have franchise legislation. See D.C. CODE ANN. §§ 29-1201 to -1208 (Supp. 1991) (enacted in 1989); P.R. LAWS ANN. tit. 10, §§ 278-278d (1978 & Supp. 1989) (enacted in 1964); V.I. CODE ANN. tit. 12A, § 132 (1982) (enacted in 1973).

9. ALA. CODE § 8-19-5(20) (1984) (enacted in 1981) (providing solely substantive regulation, with no disclosure or registration requirements); CAL. CIV. CODE §§ 1812.200-.221 (West 1985 & Supp. 1993) (enacted in 1978); CONN. GEN. STAT. ANN. §§ 36-503 to -521 (West 1987 & Supp. 1993) (enacted in 1979); FLA. STAT. ANN. §§ 559.80-.815 (West 1988 & Supp. 1993) (enacted in 1979); GA. CODE ANN. §§ 10-1-410 to -417 (1990 & Supp. 1992) (enacted in 1980); IND.

Although federal disclosure regulations do *not* require registration,<sup>10</sup> state laws governing franchise sales generally require franchisors to register a detailed offering circular before soliciting prospective franchisees.<sup>11</sup> Registrations ordinarily must contain copies of all advertising and promotional literature that the franchisor proposes to use and must identify all persons who will sell the franchises.<sup>12</sup>

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CODE ANN. §§ 24-5-8-1 to -21 (Burns Supp. 1992) (enacted in 1984); IOWA CODE ANN. §§ 523B.1-.11 (West 1988 & Supp. 1993) (enacted in 1981); KY. REV. STAT. ANN. §§ 367.801-990 (Michie/Bobbs-Merrill 1987 & Supp. 1988) (first part enacted in 1984); LA. REV. STAT. ANN. §§ 51:1821-1824 (West 1987 & Supp. 1993) (enacted in 1981, and providing solely substantive regulation, including surety bond filing, with no disclosure or registration requirements); ME. REV. STAT. ANN. tit. 32, §§ 4691-4700B (West 1988 & Supp. 1992) (enacted in 1979); MD. BUS. REG. CODE ANN. §§ 14-101 to -129 (1992) (enacted in 1980); MICH. COMP. LAWS ANN. §§ 445.902-903b (West 1989) (enacted in 1977); MINN. STAT. ANN. §§ 80C.01-30 (West 1986 & Supp. 1993) (enacted in 1973); NEB. REV. STAT. §§ 59-1701 to -1761 (1988) (enacted in 1979); N.H. REV. STAT. ANN. §§ 358-E:1-6 (1984 & Supp. 1991) (first enacted in 1977); N.C. GEN. STAT. §§ 66-94 to -100 (1992) (enacted in 1977); OHIO REV. CODE ANN. §§ 1334.01-99 (Anderson Supp. 1989) (enacted in 1979); OKLA. STAT. ANN. tit. 71, §§ 801-827 (West 1987 & Supp. 1993) (enacted in 1985); S.C. CODE ANN. §§ 39-57-10 to -80 (Law. Co-op. 1985 & Supp. 1992) (enacted in 1980); S.D. CODIFIED LAWS ANN. §§ 37-25A-1 to -54 (1986 & Supp. 1992) (enacted in 1985); TEX. REV. CIV. STAT. ANN. arts. 5069-16.01 to .17 (West 1987 & Supp. 1992) (enacted in 1981); UTAH CODE ANN. §§ 13-15-1 to -7 (1992) (enacted in 1981); VA. CODE ANN. §§ 59.1-262 to -269 (Michie 1992) (enacted in 1979); WASH. REV. CODE ANN. §§ 19.110.010-930 (West 1989) (enacted in 1971).

For the distinction between franchisees and business opportunities, see *infra* notes 26-32 and accompanying text.

10. The federal disclosure requirements are met by following a format prescribed by the FTC or by using the Uniform Franchise Offering Circular (described *infra* notes 11-12 and accompanying text). Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,966, 49,970 (1979); see also *supra* notes 6-7. For more detailed information on disclosure under the FTC Rule, see W. MICHAEL GARNER, *FRANCHISE AND DISTRIBUTION LAW AND PRACTICE* §§ 5:05-5:25 (1993).

11. Registration is accomplished by the franchisor's submission of an application and filing fee to the appropriate state authorities. The franchisor generally must register in each state that mandates registration and in which there is at least one franchise. The heart of every such application is the offering circular.

A comprehensive, 23-item Uniform Franchise Offering Circular ("UFOC") was adopted on September 2, 1975 by the Midwest Securities Administrators Association, now the North American Securities Administrators Association. UFOC is a prevalent format for state disclosure regulations. Of the states requiring registration, 15 have adopted the UFOC as their format for disclosure. These states are: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. Bus. Franchise Guide (CCH) ¶¶ 2000-2001 & 6026-6027 (1993).

12. State authorities must approve all of the information and material before the offer of any franchise. A sample UFOC application and the information required therein can be found in Bus. Franchise Guide (CCH) ¶ 5828 (1980); see also Bus. Franchise Guide (CCH) ¶ 8862 (adopting amendments to Items 19 & 20 by the FCC on June 15, 1987); Bus. Franchise Guide (CCH) ¶ 7541 (1980) (giving supplemental advertising and registration guidelines).



Substantive statutory law regulates the post-purchase relationship between franchisor and franchisee in over one-third of the states.<sup>13</sup> These laws are most notable for (1) requiring the franchisor to provide franchisees notice and a period to cure before terminating or declining to renew franchises, and (2) restricting the franchisors' rights of termination or non-renewal to decisions made in "good faith."<sup>14</sup> Substantive statutes also regulate many other aspects of the franchise relationship, affording greater protection to franchisees on the theory that an imbalance exists in the franchisor-franchisee relationship.<sup>15</sup>

Despite this extensive regulation, the nature of the relationship between franchisors and franchisees remains ambiguous.<sup>16</sup> Courts have tried to define the nature of the relationship by applying common-law contract

13. See ARK. CODE ANN. § 4-72-201 to -210 (Michie 1987); CAL. CORP. CODE §§ 31,000-31,516 (West 1977 & Supp. 1993); CAL. BUS. & PROF. CODE § 20,000 (West 1987 & Supp. 1993); CONN. GEN. STAT. § 42-133E (1992); DEL. CODE ANN. tit. 6, § 2551 (1975 & Supp. 1992); FLA. STAT. ANN. § 817.416 (West 1976 & Supp. 1993) (limited to prohibitions on the making of intentional misrepresentations in connection with the sale of a franchise); HAW. REV. STAT. § 482E (1992); ILL. ANN. STAT., ch. 121 1/2, paras. 1701-1744 (Smith-Hurd Supp. 1992); IND. CODE ANN. §§ 23-2-2.5-1 to -51 (Burns 1989 & Supp. 1992); IOWA CODE ANN. §§ 523H.1-.17 (West Supp. 1993); MICH. COMP. LAWS ANN. §§ 445.1501-.1546 (West 1989 & Supp. 1992); MINN. STAT. ANN. §§ 80C.01-.30 (West 1986 & Supp. 1993); NEB. REV. STAT. §§ 87-401 to -410 (1987 & Supp. 1992); N.J. STAT. ANN. §§ 56:10-1 to -15 (West 1989 & Supp. 1991); S.D. CODIFIED LAWS ANN. §§ 37-5A-1 to -87 (1986 & Supp. 1992); TENN. CODE ANN. §§ 47-25-1501 to -1511 (Supp. 1992); VA. CODE ANN. §§ 13.1-557 to -574 (Michie 1989 & Supp. 1992); WASH. REV. CODE §§ 19.100.010-.940 (1989); WIS. STAT. ANN. §§ 135.01-.07 (West 1989 & Supp. 1992). The District of Columbia, Puerto Rico, and the Virgin Islands also have substantive franchise legislation. See D.C. CODE ANN. §§ 29-1201 to -1208 (Supp. 1991); P.R. LAWS ANN. tit. 10, §§ 278-278d (1978 & Supp. 1989); V.I. CODE ANN. tit. 12A, § 132 (1982).

14. The Restatement of Contracts, see RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979), the Uniform Commercial Code, see U.C.C. § 1-203 (1989), and a majority of jurisdictions all recognize that every contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement. See Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369 app. (1980) (providing an appendix of cases indicating jurisdictions that explicitly recognize a general obligation of good faith in every contract at common law).

15. For example, substantive laws may prevent a franchisor from unfairly discriminating among franchisees, from unreasonably prohibiting the transfer or assignment of a franchise, from failing to repurchase items upon termination or non-renewal, or from interfering with the free association among franchisees. See GARNER, *supra* note 10, §§ 10:30, 10:34, 10:39, 10:43 (1993) (describing and citing the state statutes in these areas); see also Emerson, *supra* note 1, at 1511 & nn.27-28 (describing and citing the statutes in 16 states that regulate the substance of the franchising relationship and that bar some or all of the above practices as well as other activities).

16. At a very basic level, there is the problem of different state definitions of a "franchise." Thomas M. Pitegoff, *Franchise Relationship Laws: A Minefield for Franchisors*, 45 BUS. LAW. 289, 289-90 (1990). Inasmuch as the franchise itself is a type of business relationship, see *supra* note 1, the states' vague or conflicting definitions of that relationship leave the parties—the franchisor and franchisee—unclear about their rights and responsibilities. In short, the imperfect statutory and regulatory definitions add to the definitional ambiguities and contradictions found in the case law. Together, the statutes, regulations, and case law reinforce the franchise parties' uncertainty about what exactly is the legal relationship between a franchisor and its franchisees.

principles, fiduciary duty rules, or other intermediate concepts.<sup>17</sup> Still, when litigants and courts operate without understanding the precise nature of a franchising relationship, they find it exceedingly difficult to determine what standard of care is required in a particular franchise agreement. The rapidly escalating number and size of franchised businesses<sup>18</sup> render this problem—the need for more specific definition and delineation—increasingly significant to both the legal and business communities. Furthermore, as existing franchises mature and agreements come to an end, disputes over termination, renewal, and other terms of the franchise agreement will arise ever more frequently. Absent a consensus on the appropriate framework for franchise law, courts and legislatures increasingly will confront similar fact patterns and adopt different approaches that will lead to unpredictable results.

A fundamental step toward clarification and uniformity in the law of franchising would be to define the basis and scope of the franchise relationship. After distinguishing franchises from other business ventures,<sup>19</sup> one could then define the nature and scope of the relationship between franchisor and franchisee *for each clause in the agreement*. Most franchise contracts have various provisions that, in application, require different standards of care between the franchisor and franchisee. Thus, the nature of the franchise relationship may depend on the matter in dispute. In some areas, significantly greater franchisor duties may be customary or otherwise expected, while in other areas the franchisor and the franchisee are on a more equal bargaining plane—both in reaching a contract and then in continuing their relationship. Typical franchise agreement clauses can be classified according to the proper application of one of three standards of care: (1) a fiduciary obligation of the franchisor; (2) a contractual relationship with the added franchisee protection that franchisors show “good cause” for their actions; or (3) an ordinary contractual relationship, generally including only the implied covenants of good faith and fair dealing.

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17. See, e.g., *Tidmore Oil Co. v. BP Oil Co.*, 932 F.2d 1384, 1390-91 (11th Cir. 1991) (holding that, under common-law contract principles and the covenant of good faith and fair dealing, disapproval of franchise locations did not violate a franchise agreement); *Arnott v. American Oil Co.*, 609 F.2d 873, 880-84 (8th Cir. 1979) (evaluating the nonrenewal of a lease agreement and finding that a fiduciary relationship existed between the franchisor and the franchisee); *Shell Oil Co. v. Marinello*, 307 A.2d 598, 603 (N.J. 1973) (holding that, in addition to common-law contract principles and the covenant of good faith and fair dealing, good cause also must be shown to justify the non-renewal of a franchise).

18. See *supra* notes 2-4 and accompanying text.

19. Seller-controlled business ventures encompass a wide variety of business relationships, including business opportunities and franchises. Many of these ventures include promises, or at least strongly voiced assertions, about the retailer/franchisee's potential profits and seller assistance in marketing. See *infra* notes 24-60 and accompanying text (defining business opportunities and franchises).

By examining court decisions and the standard clauses used in most franchise agreements,<sup>20</sup> this Article identifies criteria for analyzing various aspects of the franchise relationship. The Article then proceeds to develop standards of care appropriate to the nature of the relationship as it exists under particular contractual provisions. The approach announced in the Article will enable franchisors and franchisees to understand better their respective roles and, thus, eliminate or curtail some disputes.<sup>21</sup> Those disagreements that nonetheless reach the courts will more likely result in relatively uniform applications of legal principles—similar cases leading to similar conclusions. Attorneys will then be able to advise their clients with greater precision and confidence about the likely outcome of franchising disputes. This heightened capacity to predict results will facilitate negotiation and alternative dispute resolution mechanisms, thereby helping to reduce, to a small degree,<sup>22</sup> overcrowded court dockets.

The Introduction in Part I of the Article is followed by a review, analysis, refinement, and application of contractual and other legal concepts to the actual agreements entered into by franchisors and franchisees. Part II of the Article defines the franchise relationship and delineates the criteria for the three distinct standards of care applicable to franchise contract clauses. Part III then applies these three standards to clauses usually found in franchise agreements. It incorporates data from the author's examination of 100 franchise agreements involving fast-food outlets, restaurants, and ice cream parlors, compared for trends with comparable data from a 1971 study of 121 fast-food agreements.<sup>23</sup> Part IV considers the implementation of the author's suggested reforms. Both Parts IV and V reach some general conclusions about the trends in franchising and why a court analysis of standards of care dependent upon individual contract clauses should replace the present unsatisfactory approach of trying to treat all franchise agreements, and all portions of franchise agreements, the same.

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20. University of Wisconsin College of Business Professors Urban B. Ozanne and Shelby D. Hunt conducted an exhaustive study of franchise contracts. SENATE SELECT COMM. ON SMALL BUSINESS, 92D CONG., 1ST SESS., REPORT PREPARED FOR THE SMALL BUSINESS ADMINISTRATION: THE ECONOMIC EFFECTS OF FRANCHISING (Comm. Print 1971) [hereinafter THE ECONOMIC EFFECTS OF FRANCHISING]. To update that study, from October 1992 to February 1993, this Article's author obtained copies of 100 franchise agreements to verify the frequency and general content of various, so-called typical provisions. See *infra* app.

21. The franchising relationship has been analogized to almost every relationship known at common law (e.g., agency, employment, independent contracting, partnership, marriage, securities investment, and fiduciary arrangement). Because franchising is relatively new—a distribution and marketing device of the last few decades, Emerson, *supra* note 1, at 1507 & n.8—the common law provides little guidance in assessing the basis for franchise relationships.

22. Although growing in number, franchising disputes presumably constitute just a small fraction of the filings in state or federal civil courts. Obviously, the more important result of refining the parties' duties of care is to improve the franchise relationship itself.

23. THE ECONOMIC EFFECTS OF FRANCHISING, *supra* note 20.

## II. DEFINING FRANCHISE RELATIONSHIPS

A. *Business Opportunities*<sup>24</sup>

The first step in understanding the nature of the franchise relationship is to distinguish it from other business ventures. A franchise involves a long-term contractual relationship in which the franchisor grants the franchisee a right to conduct business or sell products according to the franchisor's marketing plan, to use the franchisor's trademark, and often to adopt its overall business standards.<sup>25</sup> The format that most closely resembles a franchise, but often is not one, is the "business opportunity,"<sup>26</sup> which typically involves a simpler relationship than does the franchise. The business opportunity entails a sale of goods or services enabling the purchaser to start a business. Such a sale expressly or implicitly includes specific representations from the seller to the purchaser.<sup>27</sup> Representations may

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24. "Business opportunities" are also known as "seller-assisted marketing plans." See, e.g., CAL. CIV. CODE § 1812.200-1812.221 (West 1985 & Supp. 1993).

25. See *supra* note 1.

26. The definitions of franchise and business opportunity are not mutually exclusive; in some circumstances, a business venture could fall within *both* definitions. Kim A. Lambert & Charles G. Miller, *The Definition of a Franchise: A Survey of Existing State Legislative and Judicial Guidance*, FRANCHISE L.J., Fall 1989, at 3, 4; see also *infra* notes 35-37 and accompanying text. See generally Robin D. Glenn, *The Applicability of Business Opportunity Laws to Franchisors*, FRANCHISE L.J., Summer 1989, at 3 *passim* (discussing state business opportunity laws). The title of the FTC Rule refers to both franchising and business opportunity ventures, and the definition section of the Rule neither specifically defines a business opportunity venture nor distinguishes it from a franchise. 16 C.F.R. § 436.1-436.2 (1993).

Both of these business relationships involve common characteristics. Each requires the buyer to pay a fee to the seller. The requirement that the franchisee receive the right to sell goods or services under a marketing plan is similar to the requirement that the business opportunity buyer receive the right to begin or maintain a business of the business opportunity seller. Finally, both franchises and business opportunities involve a seller rendering services to a buyer.

In light of these similarities, it is not surprising that the business opportunity laws of many states provide an express exemption for some or all franchises. See, e.g., CAL. CORP. CODE § 31,000 (West 1977 & Supp. 1993); IND. CODE ANN. § 23-2-2.5-1 (Burns 1989 & Supp. 1992); MICH. COMP. LAWS ANN. § 445.1501 (West 1989 & Supp. 1992); S.D. CODIFIED LAWS ANN. § 37-5A-1 (1986 & Supp. 1992); VA. CODE ANN. § 13.1-557 (Michie 1989 & Supp. 1992); WASH. REV. CODE ANN. § 19.100.010 (West 1989). However, the legislation enacted by each state varies so much that a business venture may be subject to the franchise or business opportunity laws of one state but not those of another. H. Bret Lowell & John F. Dienelt, *Drafting Distribution Agreements: The Unwitting Sale of Franchises and Business Opportunities*, 11 DEL. J. CORP. L. 725, 736 (1986). Similarly, a business venture may be subject to the FTC Rule but not to state franchise or business opportunity statutes. *Id.*

27. See N.C. GEN. STAT. § 66-94(1)-(4) (1992). An agreement to distribute goods or services may take any number of forms and still constitute a franchise and/or business opportunity. It does not matter what the agreement is called or how the agreement identifies the parties. See Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,966 (1979); Statement of Basis and Purpose Relating to Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 43 Fed. Reg. 59,621 (1978). For example, a franchise or business opportunity may exist even though the relationship

consist of the seller's assertions,<sup>28</sup> promises,<sup>29</sup> or monetary guarantees.<sup>30</sup> Typical business opportunities are vending machine routes and businesses involving the assembly of parts in the home.<sup>31</sup>

Some states' business opportunity statutes are broad enough to cover franchise relationships. If the state also specifically regulates franchise arrangements, there may be a problem insofar as these often-detailed statutes conflict or are at cross-purposes.<sup>32</sup> Even when there is no state statute regulating franchises per se, a broad definition of business opportunities might encompass relationships that traditionally have been considered franchise arrangements.<sup>33</sup>

Definitional problems may also arise at the federal level. A business opportunity may be covered by the same Federal Trade Commission rule that covers franchises.<sup>34</sup> Such coverage occurs if the business opportunity

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is stated to be with a distributor, sales agent, manager, wholesaler, jobber, or licensee. 16 C.F.R. § 436.1(a) (1993).

28. For example, the seller may assert that the purchaser will be provided locations for the use of vending machines, display cases, or other devices. *See, e.g.*, N.C. GEN. STAT. § 66-94(1) (1992).

29. The seller may promise to buy products produced by the purchaser that were made with the seller's goods or services. *See, e.g., id.* § 66-94(2).

30. Typical monetary guarantees include buy-back options or investment guarantees. *See, e.g., id.* § 66-94(3).

31. *See, e.g.*, GARNER, *supra* note 10, § 6:01, at 1-2 (describing several types of business opportunities). For two cases involving FTC and state regulation of business opportunities, see *In re Hardy Hardware Centers, Inc.*, Bus. Franchise Guide (CCH) ¶ 6426 (FTC staff advisory opinion, Oct. 9, 1980) (concluding that the FTC disclosure rule subjects a business opportunity's earnings claims to the same requirements as it does a franchise's earnings claims); *In re Florida Div. of Consumer Servs.*, Bus. Franchise Guide (CCH) ¶ 6410 (FTC staff advisory opinion, April 15, 1980) (discussing the overlapping coverage of the FTC disclosure rule and various state statutes regulating the sales of business opportunity ventures); *see also* FTC v. H.N. Singer, Inc., 668 F.2d 1107, 1109-14 (9th Cir. 1982) (upholding the trial court's grant of pre-trial orders requested by the FTC, which alleged that the franchisor had violated the FTC disclosure rule and had engaged in false and misleading representations to prospective franchisees; thus, to permit a complete accounting for fees paid by the allegedly defrauded franchisees, the franchisor's assets remained subject to a pre-judgment attachment and the franchisor was compelled to produce all documents concerning any of its property interests).

32. Most states resolve any potential conflict by deciding, in the statutes themselves, which statute governs in the event of a conflict. *See, e.g.*, MICH. COMP. LAWS ANN. §§ 445.902(a)(iv) (West 1989); UTAH CODE ANN. §§ 13-15-2(1)(b) (1992); Emerson, *supra* note 1, at 1509 n.22.

33. "As a result of ambiguous drafting, under either state or federal law, many franchises may fall within the definition of a business opportunity." Lambert & Miller, *supra* note 26, at 4. For example, Ohio does not regulate the sale of franchises, but its business opportunity statute specifically addresses issues arising when the seller assists the purchaser in establishing retail outlets, developing accounts for the sale of goods, or otherwise providing and placing equipment used in the distribution of goods. OHIO REV. CODE ANN. § 1334.01(D)(3)(a)-(b) (Anderson 1992). Thus, a good argument can be made that the Ohio business opportunity law is broad enough to encompass franchise agreements.

34. *See supra* note 26. A common misconception among franchisors is that companies with registered trademarks are exempt from business opportunity laws. A number of business opportunity statutes do exempt marketing programs offered in conjunction with a registered trademark.

meets three requirements. First, the buyer of the opportunity must offer, sell, or distribute goods or services either supplied by the seller or its affiliate or supplied by a party with whom the seller requires the buyer to do business.<sup>35</sup> Second, the buyer of the business opportunity must pay some-

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See CONN. GEN. STAT. ANN. § 36-504(6) (West 1987 & Supp. 1993); FLA. STAT. ANN. ch. 559.801(1)(d) (West 1988 & Supp. 1993); LA. REV. STAT. ANN. § 51:1821(1)(d) (West 1987 & Supp. 1993); ME. REV. STAT. ANN. tit. 32, § 4691.3A(5) (1988 & Supp. 1992); MICH. COMP. LAWS ANN. § 445.902(2)(a)(iv) (West 1989); N.C. GEN. STAT. § 66-94(4) (1992); OKLA. STAT. ANN. tit. 71, § 802(3)(b)(3) (West 1987 & Supp. 1993); S.C. CODE ANN. § 39-57-20(4) (Law. Co-op. 1985 & Supp. 1992); S.D. CODIFIED LAWS § 37-25A-2(5) (1986 & Supp. 1992); UTAH CODE ANN. § 13-15-2(1)(a)(iv) (1992); WASH. REV. CODE ANN. § 19.110.040(7) (West 1989). However, these exemptions only apply when the "business opportunity" representations—i.e., representations that bring the offering within the definition of "business opportunity"—are based on the seller's provision of a sales or marketing plan. See, e.g., N.C. GEN. STAT. §§ 66-94(4) (1992). In all other cases, a registered trademark will not exempt a business venture from business opportunity laws if the venture includes investment guarantees, buy-back options, or promises to obtain retail locations.

Whether a seller made other representations to a purchaser, and thus precluded an exemption from business opportunity laws, can be the crucial issue in contract litigation. In *Martin v. Pilot Indus.*, 632 F.2d 271 (4th Cir. 1980), the franchise purchaser successfully argued that the franchisor had made income guarantees that constituted representations requiring compliance with the North Carolina Business Opportunity Sales Act's disclosure, bonding, and earnings projection provisions. *Id.* at 275-76. Advertisements and promotional literature had stated specific profit percentages and gross sales assurances, while both the purchase agreement and a pre-purchase disclosure document disclaimed any guarantees of profit. *Id.* at 273. *Martin* illustrates that even an express disclaimer may not serve to negate an implied representation that could be interpreted as an earnings claim or projection. Moreover, if the disclaimer does not remove the effects of the implied representation, then the transaction may fall under a business opportunity statute. *Id.* at 275; see also *Adams v. State*, 443 So. 2d 1003, 1007 (Fla. Dist. Ct. App. 1983) (stating that the seller of a business venture, when enjoined from terminating a distributor, discovered that it had accidentally created a franchise).

35. 16 C.F.R. § 436.2(a)(1)(ii)(A) (1992). The majority of states that regulate the offer and sale of business opportunities likewise define these opportunities as involving the sale or lease of goods or services from the business opportunity creator to the party seeking such an opportunity. See, e.g., FLA. STAT. ANN. § 559.801(1) (West 1988 & Supp. 1993); LA. REV. STAT. ANN. § 51:1821(1) (West 1987 & Supp. 1993); MD. BUS. REG. CODE ANN. §§ 14-101(b)(1) (1992); MICH. COMP. LAWS § 445.902(2)(a) (West 1989); N.C. GEN. STAT. § 66-94 (1992); S.C. CODE ANN. § 39-57-20 (Law. Co-op. 1985 & Supp. 1992); UTAH CODE ANN. § 13-15-(1)(a) (1992); WASH. REV. CODE ANN. § 19.110.020(1) (West 1989); accord CAL. CIV. CODE § 1812.201(a) (West 1985 & Supp. 1993) ("any sale or lease or offer to sell or lease"); CONN. GEN. STAT. ANN. § 36-504(6) (West 1987 & Supp. 1993) ("sale or lease or offer for sell or lease"); KY. REV. STAT. ANN. § 367.801(5) (Michie/Bobbs-Merrill 1987) ("opportunity to offer, sell or distribute"); ME. REV. STAT. ANN. tit. 32, § 4691.3A (West 1988 & Supp. 1992) ("sale, lease or distribution"). In most states, the goods or services must be purchased to begin a business. See, e.g., CAL. CIV. CODE § 1812.201(b)(6) (West 1985 & Supp. 1993); CONN. GEN. STAT. ANN. § 36-504(6) (West 1987 & Supp. 1993); FLA. STAT. ANN. § 559.801(1)(d) (West 1988 & Supp. 1993); LA. REV. STAT. ANN. § 51:1821(1)(d) (West 1987 & Supp. 1993); MICH. COMP. LAWS ANN. § 445.902(2)(a)(iv) (West 1989); N.C. GEN. STAT. § 66-94(4) (1992); OKLA. STAT. ANN. tit. 71, § 802(3)(b)(2) (West 1987 & Supp. 1993); S.C. CODE ANN. § 39-57-20(4) (Law. Co-op. 1985 & Supp. 1992); S.D. CODIFIED LAWS ANN. § 37-25A-2(1 & 2) (1986 & Supp. 1992); UTAH CODE ANN. § 13-15-2(1)(b)(i) (1992). In others, they can be used in an existing business. See, e.g., NEB. REV. STAT. § 59-1703 (1988).

thing to the seller.<sup>36</sup> Third, the seller must assist the buyer in acquiring a location for the business venture.<sup>37</sup>

Business opportunity statutes, like franchise laws, require that pertinent information be furnished to the purchaser at designated times prior to the sale.<sup>38</sup> The majority of the state statutes also permit business opportunity sellers to use the same format of disclosure required by franchise legislation.<sup>39</sup> In addition, the seller of a business opportunity usually must register the offering circular with the appropriate state agency before attempting to sell the business venture.<sup>40</sup>

Business opportunity laws often contain provisions comparable to franchise laws that make certain representations and practices unlawful.<sup>41</sup> The business opportunity laws, though, often go further than franchise laws by requiring the seller to obtain a surety bond or establish a trust account in favor of potential purchasers<sup>42</sup> and by prohibiting the seller from engaging

36. 16 C.F.R. § 436.2(a)(2) (1993).

37. 16 C.F.R. § 436.2(a)(1)(ii)(B) (1993). Assistance can come in several forms: the seller secures retail outlets or accounts for the goods or services to be sold by the buyer; the seller obtains sites for dispensing of the buyer's goods, such as vending machine locations or rack displays; or the seller provides the services of a third person to secure outlets, accounts, or locations for the buyer.

38. In effect, the seller of a business opportunity must make certain representations to the purchaser. These mandatory representations generally concern information about guarantees of income, refund of initial investments, repurchase of goods supplied by the seller, and provisions for vending machines or display racks. *See, e.g.*, N.C. GEN. STAT. §§ 66-94(1)-(4) (1992).

39. *See* GARNER, *supra* note 10, § 6:03, at 4-5 (referring to business opportunity disclosure documents "similar to that required for sale of a franchise").

40. Generally, the process for registering a business opportunity offering is less difficult than registering a franchise offering. *See* Philip F. Zeidman et al., *Franchising: Regulation of Buying and Selling a Franchise*, 34 C.P.S. (BNA), at A-81 to A-84 (1983) (describing procedures for complying with the business opportunity laws).

41. For example, it would be unlawful for a seller to misrepresent certain information or to engage in any false, fraudulent, misleading, or deceptive acts. *Id.* at A-78, A-83 to A-84.

Sanctions available under business opportunity laws are similar to those available under franchise laws. Business opportunity laws, however, often require that the seller provide the purchaser with a specific period of time within which to cancel the agreement. *See, e.g.*, CAL. CIV. CODE § 1812.209(b) (West 1985 & Supp. 1993) (three business days); IOWA CODE ANN. § 523B.6 (West 1988 & Supp. 1993) (three business days); KY. REV. STAT. ANN. § 367.819(1) (Michie/Bobbs-Merrill 1987 & Supp. 1992) (thirty calendar days); OHIO REV. CODE ANN. § 1334.05 (Anderson 1979 & Supp. 1992) (five business days); WASH. REV. CODE ANN. § 19.110.110(4)(d) (West 1989 & Supp. 1993) (seven business days).

42. This requirement of a bond or trust, before business opportunities may be offered for sale, typically is the most costly feature of business opportunity laws. In some states, the amount of the bond or trust account can be so excessive as to preclude the sale of business opportunities. *See, e.g.*, CAL. CIV. CODE § 1812.214(b)(4) (West 1985 & Supp. 1993) (the lesser of \$300,000 or the total amount of the initial payments from all of the previous years' business opportunity sales); GA. CODE ANN. § 10-1-412(a) (1990 & Supp. 1992) (at least \$75,000); ME. REV. STAT. ANN. tit. 32, § 4695 (West 1988 & Supp. 1992) (at least \$30,000). Other statutory provisions, however, may limit the bond or trust account requirement to situations when the seller represents that the initial payment by the purchaser of the business opportunity is secured. *See, e.g.*, CAL. CIV. CODE

in numerous practices specifically related to the sale of goods to business opportunity purchasers.<sup>43</sup> Some statutes, for example, make it illegal to accept money for goods that will not be delivered within a short, state-specified time period<sup>44</sup> or, more generally, will not be delivered in a "timely manner."<sup>45</sup> Under certain circumstances, these statutes may also permit the purchaser to void the contract and receive a refund up to one year after the contract's execution.<sup>46</sup>

Even if all of the statutory elements necessary to create either a franchise or a business opportunity are present, the parties making such an arrangement may not know about legislative characterizations of their relationship or the legal consequences thereof. The parties' failure to classify properly a business venture may prove insignificant.<sup>47</sup> On the other hand, it could lead to grave consequences for the seller of a business venture.<sup>48</sup> To

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§ 1812.204(C) (West 1985); KY. REV. STAT. ANN. § 367.815(2) (Michie/Bobbs-Merrill 1992); ME. REV. STAT. ANN. tit. 32, § 4695 (West 1988 & Supp. 1992); NEB. REV. STAT. § 59-1728 (1988). Alternatively, the agreement does not contain a seller's buy-back option. *See, e.g.*, CONN. GEN. STAT. ANN. § 36-505 (West 1987 & Supp. 1993); GA. CODE ANN. § 10-1-412(b) (1990 & Supp. 1992); NEB. REV. STAT. § 59-1728 (1988).

43. Zeidman et al., *supra* note 40, at A-83 to A-84. In contrast, the prohibitions imposed by the franchise statutes are more general in nature.

44. *See, e.g.*, OHIO REV. CODE ANN. § 1334.03(f) (Anderson 1979 & Supp. 1992) (two-week period).

45. *See* ALA. CODE § 8-19-5(20) (1984) ("within the time presented").

46. *See, e.g.*, CAL. CIV. CODE § 1812.215(A) (West 1985); N.C. GEN. STAT. § 66-100(A) (1992); VA. CODE ANN. § 59.1-261 (Michie 1992).

47. Many state and federal laws apply equally to both relationships. Lambert & Miller, *supra* note 26, at 4. State legislatures also have identified certain business relationships that are exempt from statutory coverage. Such exemptions usually apply to business relationships subject to other kinds of state regulation (e.g., securities laws) or considered inherently less subject to abuse (e.g., sale of an ongoing business). Most franchise or business opportunity statutes provide some exemptions. *See, e.g.*, CAL. CORP. CODE § 31101 (West 1977 & Supp. 1993) (stating that the exemption applies to franchisors having conducted the franchise business for at least five years, or having at least 25 franchises; additionally, the franchisor must have a net worth of at least \$5 million); HAW. REV. STAT. § 482E-4(a)(5) (1992) (providing that renewals and extensions of existing franchise agreements are exempt).

48. *See, e.g.*, Adams v. State, 443 So. 2d 1003 (Fla. Dist. Ct. App. 1983) (enjoining the seller of a business venture from terminating a distributor; the seller thereby discovered that it had accidentally created a franchise).

A recent case illustrates how an entity, one *not* in the business of selling business ventures, may still fall within the requirements of business opportunity statutes. In Eye Assocs., P.C. v. Incomrx Sys., Ltd., 912 F.2d 23 (2d Cir. 1990), the parties had agreed that Incomrx would provide a debt recovery service system intended to analyze Eye Associates' medical business records. *Id.* at 25. Incomrx would ascertain what bills were outstanding and who was the appropriate payor. *Id.* In return, Eye Associates agreed to pay Incomrx one-half of all sums collected through the recovery program. *Id.* Eye Associates later refused to make payments. *Id.* It contended that the agreement constituted a business opportunity within the meaning of the Connecticut Business Opportunity Investment Act, CONN. GEN. STAT. ANN. § 36-503 (West 1987 & Supp. 1990), and that Incomrx had failed to meet many of the Act's requirements, i.e., registration, disclosure, bond security, appointment of attorney and fee requirements. 912 F.2d at 25. Thus, the agreement was invalid. *Id.*



be safe, the seller must navigate the intricate maze that business venture statutes create. This maze becomes even more confusing—indeed, potentially treacherous to a seller's legal and business interests—for the seller who lacks knowledge of the administrative policies and practices of state and federal franchise regulators.<sup>49</sup>

The conservative course of action is to treat a franchise offering and a business opportunity in the same manner. Unless the state statute specifically excludes a franchise arrangement from the business opportunity venture statute, or a business opportunity from the franchise statute, the cautious owner, manager, or legal advisor will strictly comply with *both* statutes.<sup>50</sup>

### B. *The Nature of the Franchise Relationship*

The term "franchise" is typically used to denote a significantly more sophisticated business relationship than a "mere" business opportunity.<sup>51</sup> Franchises can be divided into two categories. In "business format" or "package" franchising, the franchisor provides the franchisee with a busi-

The Second Circuit Court of Appeals noted that the seller of a business opportunity is not required to have solicited business from the purchaser for a business opportunity to exist. *Id.* at 26. Therefore, under the court's reasoning, a mutually beneficial business relationship initiated by a purchaser will not exempt a seller from the Act's coverage. *Id.* Indeed, the court's holding suggests that even a single sale of a business venture may be enough to bring a seller within the Act's reach. *Id.*

49. It is often only through experience, or—more commonly—hiring experts in law and accounting, that a seller obtains the necessary familiarity with the many interpretative opinions and releases in this area. See Zeidman et al., *supra* note 40, at A-85; see also *Instructional Sys., Inc. v. Computer Curriculum Corp.*, Bus. Franchise Guide (CCH) ¶ 10,119 (N.J. Oct. 19, 1992) (providing extensive analysis to find that an arrangement was a franchise); STAFF OF HOUSE COMMITTEE ON SMALL BUSINESS, 101ST CONG., 2D SESS., *FRANCHISING IN THE U.S. ECONOMY: PROSPECTS AND PROBLEMS* 28-29 (Comm. Print 1990) (finding that "[c]onsiderable inconsistency also exists in state agency interpretation, evaluation and implementation of [franchising's] common statutory requirements and procedures," and that even different regulators within the same agency often treat quite differently the same or similar contractual provisions and corresponding UFOC materials); Lambert & Miller, *supra* note 26, at 5-6 (discussing Washington state, Hawaii, and FTC administrative proceedings on businesses that met the definition of a franchise relationship, yet failed to register as such).

50. See generally Thomas M. Pitegoff, *Ways to Avoid Being a Franchise*, 12 *FRANCHISE L.J.* 67 *passim* (1992) (discussing methods of avoiding the FTC Rule and state franchising laws, but concluding that full compliance with disclosure and registration requirements often is the most sensible policy even when a business could opt for avoidance).

51. For a definition of franchising, see *supra* note 1. For an extensive analysis of the basic question whether a business offering constitutes a franchise for purposes of state law, see Lambert & Miller, *supra* note 26, *passim*. See generally Martin D. Fern, *The Overbroad Scope of Franchise Regulation: A Definitional Dilemma*, 34 *BUS. LAW.* 1387, 1389-97 (1979) (describing the "uniform business plan" and "community of interest" approaches); Stanley K. Okawachi, *Federal Franchise Regulation: A Definitional Dilemma*, 13 *U.C. DAVIS L. REV.* 813 *passim* (1980) (analyzing the scope of the definition of franchise in the Federal Trade Commission's first franchise regulation).

ness format, or total package, for operating a business.<sup>52</sup> This type of arrangement ordinarily involves a franchisee who is responsible for operating the business, but is required to sell goods or services supplied by the franchisor or otherwise produced in accord with the franchisor's specifications.<sup>53</sup> Examples of business format franchises include convenience stores, fast-food restaurants, hotels, hair styling salons, and employment agencies.<sup>54</sup> Franchises can also exist in the form of a product or service distribution arrangement in which the franchisee/dealer is identified with the franchisor/supplier of the goods or services.<sup>55</sup> Examples of this type of franchise include gasoline stations, motor vehicle dealerships, farm equipment distributors, and soft drink bottlers.<sup>56</sup>

In their attempts to define the parameters of the franchising relationship, courts and commentators have used legal analogy and economic analysis.<sup>57</sup> Approaches range from pure "freedom of contract" theories, generously laced with old-fashioned *caveat emptor* rhetoric, to one-sided fiduciary obligations based on evolving notions of equity and good faith.<sup>58</sup>

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52. See U.S. DEP'T OF COMMERCE, *FRANCHISING IN THE ECONOMY 1986-1988* 3 (1988); Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,966 (1979).

53. Zeidman et al., *supra* note 40, at A-5.

54. See U.S. DEP'T OF COMMERCE, *supra* note 52, at 3-4; Lambert & Miller, *supra* note 26, at 3.

55. U.S. DEP'T OF COMMERCE, *supra* note 52, at 1.

56. *Id.*; accord Lambert & Miller, *supra* note 26, at 3; see also Krehl v. Baskin-Robbins Ice Cream Co., 664 F.2d 1348, 1353 (9th Cir. 1982) (reiterating and expanding on the distinction between two kinds of franchising systems—the business format system and the distribution system); Robert W. Emerson, *Franchising and Consumers' Beliefs about "Tied" Products: The Death Knell for Krehl?* 45 U. FLA. L. REV. 1163 *passim* (1993) (criticizing a court-created distinction, for antitrust tying purposes, between distribution and business format franchises on the basis of consumers' supposed beliefs about the products sold at those franchises). Soft drink bottlers may be placed in a third category: *production* franchises. See BRUCE WEBSTER, *THE INSIDER'S GUIDE TO FRANCHISING* 6-7 (1986) ("The industry most often associated with franchising as a method of *manufacturing* is the soft drink industry. Each local or regional bottling plant is a franchisee licensed [to produce drinks from] the concentrates and associated products [sold to it by the franchisor, e.g., Coca-Cola. The franchisee bottlers] mix the concentrates with other ingredients, largely soda water, and bottle or 'can' the beverage for distribution to retail dealers.") (emphasis added).

57. See, e.g., *Arnott v. American Oil Co.*, 609 F.2d 873, 880-84 (8th Cir. 1979) (finding fiduciary duties owed by the franchisor to the franchisee); *In re Sbarro Holding, Inc.*, 445 N.Y.S.2d 911, 913-914 (Sup. Ct. 1981), *aff'd*, 456 N.Y.S.2d 416 (App. Div. 1982) (holding that the franchisor was a fiduciary—a relationship "which many authorities have accepted as typical of the franchisor/franchisee association"); Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 STAN. L. REV. 927, 932 (1990) (applying economic analysis to contend that franchising relationships typically lie between employer-employee relationships and independent contracting).

58. See, e.g., *O'Neal v. Burger Chef Sys., Inc.*, 860 F.2d 1341, 1349 n.4, 1352 (6th Cir. 1988) (deciding that there was no fiduciary or confidential relation between the parties to a franchise agreement—citing 19 cases—asserting that "[t]his observation is in accordance with the vast majority of the courts"); *Bain v. Champlin Petroleum Co.*, 692 F.2d 43, 47 (8th Cir. 1982)

Although the basis and scope of the relationship is situational, properly defining its nature would generally clarify and otherwise improve franchise law.<sup>59</sup> Understanding the nature of the relationship would assist courts that face the difficult task of resolving disputes about franchise contracts that are usually incomplete when limited to their written form.<sup>60</sup> Perhaps even more important, delineating the nature of each franchise contract term could heighten each party's awareness of its legal rights and duties as a franchisor or franchisee.

### C. *The Fiduciary Obligation*

Some courts and commentators have argued that the franchise contract involves a fiduciary relationship<sup>61</sup> between the franchisor and the franchisee.<sup>62</sup> The fiduciary's duties consist of more than fairness and honesty; they include an obligation to act in furtherance of the beneficiary's best

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(finding no evidence of a fiduciary relationship between a gas dealer and the manufacturer); *Arnott v. American Oil Co.*, 609 F.2d 873, 880-84 (8th Cir. 1979) (finding a fiduciary relationship), *cert. denied*, 446 U.S. 918 (1980); *Scheck v. Burger King Corp.*, 756 F. Supp. 543, 548-49 (S.D. Fla. 1991) (holding that there is an implied covenant of good faith and fair dealing that extends beyond the written franchise agreement); *C. Pappas Co. v. E. & J. Gallo Winery*, Bus. Franchise Guide (CCH) ¶ 8378, at 15,341 (E.D. Cal. May 23, 1985) (finding no fiduciary relationship between a wine manufacturer and its distributor, but distinguishing a case finding a fiduciary status between franchisor and franchisee); *In re Sbarro Holding, Inc.*, 445 N.Y.S.2d 911, 913 (Sup. Ct. 1981) (concluding that a "linkage between the parties was one of trust on one side [franchisee] and superiority on the other [franchisor]," resulting in a relationship "awesome" in terms of the parties' disparity in both knowledge and power), *aff'd*, 456 N.Y.S.2d 416 (App. Div. 1982); see also Ernest A. Braun, *Policy Issues of Franchising*, 14 Sw. U. L. Rev. 156, 229-31, 230 n.293 (1984) (noting that courts have almost uniformly rejected the notion of a fiduciary franchising relationship).

59. Because legislatures often differ about which relationships to regulate, which key elements will define the relationship, and which relationships should be exempt, a lack of uniformity has arisen among the various state statutes. See *supra* notes 8-15 and accompanying text.

The task of determining coverage under the various state laws is formidable, owing not only to the statutory maze, but also to the large body of regulations, advisory opinions, and informal administrative practices used to interpret these statutory provisions. *Zeidman et al.*, *supra* note 40, at A-85.

60. See Hadfield, *supra* note 57.

61. See BLACK'S LAW DICTIONARY 625-26 (6th ed. 1990) (stating that a fiduciary duty "is the highest standard of duty implied by law" that "arises whenever confidence [or trust] is reposed on one side, and domination and influence result on the other"; the duty prohibits fiduciaries from engaging in "business shrewdness, hard bargaining, and astuteness to take advantage of the [dependent party]").

62. See, e.g., *Arnott v. American Oil Co.*, 609 F.2d 873, 881 (8th Cir. 1979), *cert. denied*, 446 U.S. 918 (1980) (holding that the franchisor owed fiduciary duties to the franchisee); Harold Brown, *Franchising—A Fiduciary Relationship*, 49 TEX. L. REV. 650, 663-75 (1971) (contending that the treatment of franchisors as fiduciaries would prevent many of the abuses found in, and potential abuses inherent to, most franchising arrangements).

interests.<sup>63</sup> At its most basic level, this means that the fiduciary must avoid placing its own interests in conflict with the beneficiary's interests.<sup>64</sup> Of special significance to franchisor and franchisee is that, while analysis of an allegedly fiduciary status between two contracting businesses includes reviewing the contract's express terms, the parties' manifest intent does not control their mutual obligations, as it generally would under common-law contract analysis.<sup>65</sup>

For courts to find a fiduciary obligation with regard to a franchise agreement, each of the following characteristics should be present: (1) The franchisee reasonably believes that it is purchasing, as part of the franchise, franchisor expertise;<sup>66</sup> (2) the franchisor clearly dominates and has superior knowledge and bargaining power over the franchisee;<sup>67</sup> (3) the agreement (or at least the clause in question) is incomplete or otherwise necessitates great flexibility in its enforcement;<sup>68</sup> and (4) absent some external motive, the interests of franchisor and franchisee are the same.<sup>69</sup>

When typical franchise clauses reflect these characteristics, then the relationship, with respect to those clauses, should be considered fiduciary. Examples of such clauses include site selection, physical layout, training, operational standards, manuals, financing, and advertising requirements. For each such clause, the franchisee is relying on the franchisor for exper-

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63. Fiduciary obligations originated in the courts of equity. See Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 880-85; L.S. Sealy, *Some Principles of Fiduciary Obligation*, 1963 CAMBRIDGE L.J. 119, 123-26.

64. See DeMott, *supra* note 63, at 128-31.

65. *Id.* at 882 (explaining the development and current meaning of the fiduciary relationship).

66. Brown, *supra* note 5, at 28 (stating that franchisees purchase the franchisor's "know-how" and are otherwise induced by the franchisor to trust in the franchisor's skills). Franchise attorneys have described the situation as follows:

While the classic dependence on a superior party may not exist in every franchise relationship, its absence is more the exception than the norm. The start of most franchise relationships is marked by a dependency on the franchisor to participate integrally in the start-up of the franchise business. In many cases this can involve complete dependency, as in the case of the turnkey franchise. Even after the relationship's initial stages, ongoing supervision, advertising and other franchisor services, as well as responsibilities for policing licensed trademarks, serve to maintain the franchisor's involvement in the franchise business and perpetuate the franchisee's dependency on such continued involvement.

Rochelle Buchsbaum Spandorf et al., *Implications of the Covenant of Good Faith: Its Extension to Franchising*, FRANCHISE L.J., Fall 1985, at 3, 5 (1985).

67. One commentator suggests that the franchisor's superiority as "the institutional ruler of the franchise system" is indisputable. Braun, *supra* note 58, at 226.

68. Hadfield, *supra* note 57, at 991-92.

69. An example of equivalent interests is the business premises' appearance and function. Interests of the parties would not be the same, however, if the franchisor was motivated by opportunism, see *infra* note 119, and was trying to require additional investments just for the sake of achieving a stronger, leveraged position over the franchisee.

tise.<sup>70</sup> As a result, the franchisor is in a position to take advantage of the franchisee because these clauses are usually incomplete or open-ended.<sup>71</sup>

70. See *supra* note 66 and accompanying text.

71. The following are somewhat typical clauses in current franchise agreements for restaurants or ice cream stores. Each affords wide latitude to the franchisor in establishing or modifying the duties and rights of the franchisee.

*Training*

Franchisee agrees that it is necessary to the continued operation of the System and the Restaurant that Franchisee, Franchisee's General Manager and Secondary Managers, and Restaurant personnel of Franchisee receive such training as specified in the [Franchisor's Operating] Manuals or *as Franchisor may require*.

Southwest Cafes, Inc. Franchise Agreement (El Chico), Aug. 6, 1992, at 25, § X (emphasis added) (on file with the *North Carolina Law Review*).

*Site Selection*

Licensor [franchisor] shall furnish to Developer [franchisee] . . . such site selection counseling and assistance *as Licensor may deem advisable*.

Cucos Inc. Development Agreement, Sept. 27, 1991, at 3, § V, para. A, part 1 (emphasis added) (on file with the *North Carolina Law Review*).

[Franchisor] makes no guarantees concerning the success of the Store located on any site consented to by [Franchisor].

Dairy Queen Operating Agreement, February 1992, at 5, § 5, para. A (on file with the *North Carolina Law Review*).

*Standards of Quality and Operating Manuals*

In order to protect the Franchise System and to maintain uniform standards of operation under the Licensed Rights, Franchisee shall operate the Store in accordance with the Manual, a numbered copy of which the Franchisee acknowledges having received on loan from Franchisor . . . Franchisee understands and acknowledges that Franchisor may, from time to time, revise the contents of the Manual to implement, among other things, new or different operating requirements applicable to all Freshens Premium Yogurt stores . . . and Franchisee expressly agrees to comply with each changed requirement within such reasonable time as Franchisor may require.

Yogurt Ventures U.S.A., Inc. Standard Franchise Agreement, Fall 1992, at 10 (on file with the *North Carolina Law Review*).

Franchisee shall use only such food products and ingredients . . . and methods of operation and service as conform to the standards and specifications of Franchisor in effect from time to time. Franchisee shall discontinue selling or offering for sale from the Store any products Franchisor may, *in its discretion*, disapprove in writing at any time.

*Id.* at 11 (emphasis added) (on file with the *North Carolina Law Review*).

Licensor [franchisor] shall, *as it deems advisable*, continue its efforts to maintain high standards of quality, cleanliness, appearance and service of the System, and to that end shall . . . [on request] disseminate Licensor's standards and specifications for non-secret items to Licensee [franchisee].

Cucos Inc. License Agreement, at 2-3 (emphasis added) (on file with the *North Carolina Law Review*).

*Physical Layout*

[T]he store . . . will be erected in accordance with Carvel designs or will be altered in accordance with the now current Carvel plans and specifications. . . . All equipment installed in this Carvel Store shall be in accordance with Carvel specifications . . . [and] the Licensee [franchisee] shall have no right to make any changes or alterations in said Carvel Store, not first authorized in writing by Carvel.

Carvel Retail Manufacturer's License Agreement, June 30, 1992, at 2) (on file with the *North Carolina Law Review*).

In addition, both the franchisee and the franchisor have common interests; for instance, both want appropriate training for franchisees, suitable business sites, high standards of quality, helpful operating manuals, and an intelligent design or layout for the business premises.

In *Arnott v. American Oil Co.*,<sup>72</sup> the Eighth Circuit Court of Appeals stated that "inherent in a franchise relationship is a fiduciary duty" running from the franchisor to the franchisee.<sup>73</sup> While the dissent argued that the same pro-franchisee, anti-termination result could be reached by finding a cause of action for fraud,<sup>74</sup> the court cited the surge in general franchise legislation during the 1970s, which, among other things, barred termination or nonrenewals without good cause. The Eighth Circuit held that this legislative trend supported the notion that franchisors are fiduciaries.<sup>75</sup>

Many courts have disagreed with the *Arnott* ruling.<sup>76</sup> Indeed, three years after its decision in *Arnott*, the Eighth Circuit found that it was "un-

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Franchisee must independently obtain any architectural, engineering, and design services it deems necessary for the construction [remodelling, or leasing] of the Restaurant at its own expense. Franchisee shall utilize or adapt, for Restaurant premises requiring remodelling or renovation, the prototype architectural and design plans and specifications for construction of the Restaurant provided to Franchisee by Franchisor . . . and shall submit any such adapted plans to Franchisor for review. If Franchisor determines, *in its sole discretion*, that any such plans are not consistent with the best interests of the System, Franchisor shall have the right to prohibit the implementation of such plans.

Southwest Cafes, Inc. Franchise Agreement (El Chico), Aug. 6, 1992, at 15-16 (emphasis added) (on file with the *North Carolina Law Review*).

72. 609 F.2d 873 (8th Cir. 1979), *cert. denied*, 446 U.S. 918 (1980).

73. *Id.* at 881. In *Arnott*, the franchisee-plaintiff operated a gas station leased by the franchisor-defendant. The franchisee alleged that the franchisor terminated the lease without good cause and in bad faith. *Id.* at 880. The franchisee's failure to remain open 24 hours a day, which was the franchisor's supposed basis for termination, *id.* at 879, was excused by the trial court; it found that the franchisor had failed to provide enough products for the franchisee to maintain a 24-hour schedule. *Id.* at 884.

The *Arnott* court instructed the jury that a fiduciary relationship existed, and the jury found that the franchisor had breached its fiduciary duties. *Id.* at 873, 881. The trial record indicated that the franchisor had violated several provisions in its own statement of policy on franchisees' rights. *Id.* at 878-80.

74. *Id.* at 889 (Bright, J., concurring in part and dissenting in part).

75. *Id.* at 883.

76. *See, e.g.,* Amoco Oil Co. v. Cardinal Oil Co., 535 F. Supp. 661, 666-67 (E.D. Wis. 1982) (arguing that franchising parties are in a business relationship; specifically rejecting *Arnott's* finding of a fiduciary duty); Picture Lake Campground, Inc. v. Holiday Inns, Inc., 497 F. Supp. 858, 869 (E.D. Va. 1980) (stating that franchisors and franchisees have a business relationship and that the purported fiduciary duty in *Arnott* was merely a "duty of good faith and fair dealing"); *accord* Boat & Motor Mart v. Sea Ray Boats, Inc., 825 F.2d 1285, 1291 (9th Cir. 1987); Vaughn v. General Foods Corp., 797 F.2d 1403, 1414 (7th Cir. 1986), *cert. denied*, 499 U.S. 1087 (1989); Domed Stadium Hotel, Inc. v. Holiday Inns, Inc., 732 F.2d 480, 485 (5th Cir. 1984) (applying Louisiana law); Bain v. Champlin Petroleum Co., 692 F.2d 43, 48 (8th Cir. 1982) (applying South Dakota law); Carter Equip. Co. v. John Deere Indus. Equip. Co., 681 F.2d 386, 391 (5th Cir. 1982) (applying Mississippi law); Murphy v. White Hen Pantry Co., 691 F.2d 350, 354-355 (7th

necessary" for the *Arnott* decision to have labeled the duty of "good faith and fair dealing" as "fiduciary."<sup>77</sup> While this Article maintains that some clauses in a franchise contract merit the imposition of fiduciary duties,<sup>78</sup> characterizing the *entire* relationship as fiduciary in nature sometimes would produce harsh results. For instance, the strict imposition of an overall fiduciary obligation would require the franchisor to put the interests of the franchisee ahead of its own, even when a particular aspect of the franchising arrangement is actually adversarial. It may even be against the long-term interests of *franchisees* to impose a fiduciary relationship in certain aspects of the franchisor-franchisee relationship.<sup>79</sup>

#### D. *Strict Interpretation of Express Contracts*

Many states now regulate franchising.<sup>80</sup> This regulation seems to reflect legislative and administrative recognition of an imbalance in the relationship, with franchisors enjoying strong, potentially abusive, bargaining leverage over the franchisees.<sup>81</sup> Still, some courts adopt a somewhat doctri-

Cir. 1982) (applying Wisconsin law); *MAACO Enters., Inc. v. Cross*, No. CIV.A.92-4688, 1992 WL 30677, at \*4 (E.D. Pa. Nov. 20, 1992) (unpublished opinion); *Pizza Management, Inc. v. Pizza Hut, Inc.*, 737 F. Supp. 1154, 1183 (D. Kan. 1990); *Coca-Cola Bottling Co. v. Coca-Cola Co.*, 696 F. Supp. 57, 74-75 (D. Del. 1988), *aff'd*, 988 F.2d 386 (3d Cir.), *cert. denied*, 114 S. Ct. 289 (1993); *Premiere Wine & Spirits of South Dakota v. E. & J. Gallo Winery*, 644 F. Supp. 1431, 1435 (E.D. Cal. 1986), *aff'd*, 846 F.2d 537 (9th Cir. 1988); *General Bus. Mach. v. National Semiconductor Datachecker/DTS*, 664 F. Supp. 1422, 1425-1426 (D. Utah 1987); *Morse v. Gibraltar Transmission Corp.*, No. CIV.A.85-1788-E, 1986 WL 15618, at \*6 (S.D. Cal. Nov. 12, 1986) (unpublished opinion); *Power Motive Corp. v. Mannesmann Demag Co.*, 617 F. Supp. 1048, 1051-1052 (D. Colo. 1985) (applying Ohio law); *Schaeffer v. Collins*, No. CIV.A.80-2797, 1980 WL 1965, at \*7 (E.D. Pa. Dec. 9, 1980); *Newark Motor Inn Corp. v. Holiday Inns, Inc.*, 472 F. Supp. 1143, 1151-53 (D. N.J. 1979); *Weight Watchers of Quebec, Ltd. v. Weight Watchers Int'l, Inc.*, 398 F. Supp. 1047, 1053-54 (E.D.N.Y. 1975); *Crim Truck & Tractor Co. v. Navistar Int'l Transp. Corp.*, 823 S.W.2d 591, 594 (Tex. 1992); *Braun*, *supra* note 58, at 230 & n.293.

77. *Bain v. Champlin Petroleum Co.*, 692 F.2d 43, 48 (8th Cir. 1982).

78. See *infra* notes 121-81 and accompanying text; see also *Crim Truck & Tractor Co.*, 823 S.W.2d at 597-602 (Mauzy, J., dissenting) (arguing that a special, confidential, fiduciary relationship existed between the franchisor and franchisee in that particular case); Anne L. Austin, Comment, *When Does a Franchisor Become a Fiduciary?* *Crim Truck & Tractor Co. v. Navistar International Transportation Corporation*, 43 CASE W. RES. L. REV. 1151, 1170-74 (1993) (arguing that the Texas Supreme Court should have found a confidential relationship justifying the imposition of a fiduciary duty upon the franchisor, "even though under ordinary circumstances the franchise relationship is a business relationship, governed by contract, and nothing more").

79. See, e.g., *Arnott v. American Oil Co.*, 609 F.2d 873, 893 (8th Cir. 1979) (Bright, J., dissenting) (contending that to limit the franchisor's power of termination "invites wholesale suppliers to replace their lessees and distributors with . . . employees whose freedom of action would be considerably more restricted"), *cert. denied*, 446 U.S. 918 (1980). Long-term, the encouragement of vertical integration over contractual arrangements between independent parties is likely to diminish the role of franchising and thus decrease the opportunities for franchisees or would-be franchisees.

80. See Emerson, *supra* note 1, at 1509-12; *supra* notes 6-15 and accompanying text.

81. Emerson, *supra* note 1, at 1511. In an attempt to remedy business venture sales abuse, several states attempted to place the sale of a business venture within the definition of security.

naire approach to franchise contractual clauses. These courts rely on the sanctity of contract and infer no special relationship between the franchisor and the franchisee.<sup>82</sup> For instance, in *O'Neal v. Burger Chef Systems, Inc.*,<sup>83</sup> the Sixth Circuit Court of Appeals noted that the vast majority of courts have found no fiduciary aspect to the franchise relationship.<sup>84</sup> The *O'Neal* court rejected the argument that the franchisor had a duty to disclose to franchisees the sale of the corporate franchisor to another franchisor in the same industry.<sup>85</sup> According to the court, there were no provisions, express or implied, that suggested the franchisor's interest

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Braun, *supra* note 58, at 194-95. Some commentators contended that the federal securities laws could, and should, cover the sale of franchises. See Bernard Goodwin, *Franchising in the Economy: The Franchise Agreement as a Security Under Security Acts, Including 10b-5 Considerations*, 24 BUS. LAW. 1311, 1319-20 (1969). But see Michael M. Coleman, *A Franchise Agreement: Not a "Security" Under the Securities Act of 1933*, 22 BUS. LAW 493, 508 (1967).

Most courts, however, were unwilling to adopt the "franchise as security" arguments. See, e.g., *Fox v. Ehrmantraut*, 615 P.2d 1383, 1385 (Cal. 1980) (holding that sale of stock in a licensee company, as part of the sale of an ongoing business, was exempt from securities laws); *Polikoff v. Levy*, 204 N.E.2d 807, 810 (Ill. App. Ct.) (holding that sale of interest in land upon which a motel was to be built was not the sale of a "security" but was a joint venture), *cert. denied*, 382 U.S. 903 (1965); Braun, *supra* note 58, at 196. This reluctance was effectively bolstered by federal regulation and state legislation during the 1970s that was directed specifically at franchising's supposed problems and thus appeared to make unnecessary the use of securities laws as a means of regulating franchise ventures. *Id.*

Another tactic has been for allegedly defrauded purchasers to invoke antitrust principles in a search for effective relief from business opportunity sales abuses. However, in the past few decades, successful private actions have become uncommon. See generally Symposium, *Franchisor-Franchisee Relationships—Antitrust Considerations*, 47 ANTITRUST L.J. 869, 880-98 (1978) (discussing ways in which antitrust law has been applied in franchise settings); Emerson, *supra* note 1, at 1562 (discussing the reduction in enforcement of antitrust violations).

Eventually, states focused on disclosure concepts borrowed from securities statutes and enacted business opportunity and franchising laws to prevent seller abuses. Disclosure regulations require the seller to reveal material facts about the business venture so the purchaser can evaluate the offering and make a knowledgeable business decision. Prior to the enactment of such statutes, the only remedy usually available to a defrauded purchaser was a common-law action for breach of contract or fraud. Sandra M. Bourbon, Note, *The Georgia Sale of Business Opportunities Act*, 1 GA. ST. U. L. REV. 219, 222 (1985). Often these remedies were not very helpful, particularly if the seller had become insolvent or disappeared with the purchaser's money. *Id.*

82. To paraphrase *Dragner's* Sergeant Joe Friday, this view may simply be, "Just the facts in the contract, Ma'am."

83. 860 F.2d 1341 (6th Cir. 1988).

84. *Id.* at 1349. The *O'Neal* court cited 19 court opinions, which were from three other federal courts of appeals (the Fifth, Seventh, and Eighth Circuits), 12 different federal district courts, and the highest state appellate courts in New York and Oregon. See also Braun, *supra* note 58, at 230 (citing numerous cases for the conclusion that "[t]he greater number of jurisdictions have . . . rejected a proposed characterization of the franchise relationship as a fiduciary relationship"). These and other courts relied on fundamental contract principles and concluded that there is nothing fiduciary in nature about the franchise because, among other things, each party to it has an independent interest in its own profits.

85. *O'Neal*, 860 F.2d at 1350.



would remain static.<sup>86</sup> Therefore, relying specifically on express contractual terms and refusing to recognize any special relationship outside of contract, the court reasoned that the identity of the franchisor's corporate parent was not part of the subject matter of the contract.<sup>87</sup>

The *O'Neal* court proceeded no further with its analysis. Basic contract law sufficed, as the court failed to consider how different clauses in a franchise agreement may deserve varying standards of interpretation. The author recommends that only certain types of franchise agreement clauses be interpreted in accord with a constricted, literalistic approach comparable to that used in *O'Neal*. To classify a clause as one deserving merely a contractual relationship, the following characteristics should exist: (1) any bargaining on that clause ended before or upon the issuance of the franchise;<sup>88</sup> (2) the clause is complete, is definite, and can be enforced without requiring interpretation or "flexibility" depending on the circumstances; (3) the clause creates no reasonable expectation of franchisor assistance to the franchisee; and (4) with respect to the terms of the clause, the rightful interests of franchisor and franchisee are adverse. This four-part standard could be adopted via legislation or judicial holding.

Examples of these strict contractual clauses might include initial franchise fees, royalties, other payments, the duration of the franchise, arbitration and venue stipulations, insurance requirements, and declarations about intellectual property ownership. The parties normally agree to these unambiguous, nondiscretionary terms at the outset of the franchise relationship. For these terms, a reasonable franchisee would not be at a disadvantage or have to look to the franchisor for advice or other guidance; the parties presumably negotiate at arm's length.<sup>89</sup> Note that even "strict" contract law still allows for some implied protection of a presumably weak franchisee.<sup>90</sup>

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86. *Id.* at 1352. In fact, the author's survey of 100 franchise agreements reveals that 66% expressly state that the franchisor has a right to assign the agreement, while 93% expressly deny such an uninhibited right of transfer to the franchisee. *Infra* app. § B-3-a-2, B-3-b.

87. *O'Neal*, 860 F.2d at 1352. Therefore, the sale of the corporate franchise presented the franchisees with no cause of action.

88. In other words, the clause is not in flux as part of the dynamic, ongoing relationship between the franchisor and franchisee.

89. When the agreement is silent about a particular matter, courts still could find covenants of good faith and fair dealing in an effort to preserve the spirit of the contract and the justifiable expectations of the parties. See *infra* notes 91-98 and accompanying text.

90. The resulting implied rights or duties perhaps originate in public policy concerns as much as from any reading between the lines of a particular franchise agreement. Obviously, to find such implied protection requires that there be no contrary express provisions in the franchise contract.

*E. Implied Covenants of Good Faith and Fair Dealing*

Under the common law as presently developed, courts may infer that all contracts contain covenants of good faith and fair dealing.<sup>91</sup> When a franchisee sues a franchisor for breach of contract, the franchisee has the burden of proof to show that the franchisor acted in bad faith. While these covenants cannot override a franchise agreement's express provisions,<sup>92</sup> they can assist courts in interpreting the parties' intentions when the agreement is silent about a particular issue. Therefore, unlike the *O'Neal* court, which ended its analysis after finding nothing in the contract expressly on point,<sup>93</sup> many courts have refused to let the franchisor do as it wished. In the 1991 case of *Scheck v. Burger King Corp.*,<sup>94</sup> for example, the court permitted the franchisee to go to trial on its claim that the franchisor had breached an implied covenant of good faith and fair dealing by opening another franchised restaurant just two miles away from the franchisee's location.<sup>95</sup> The court recognized that a contract includes not only its written provisions, but also terms and matters that are implied at law.<sup>96</sup> According to the court, although the franchise contract explicitly denied the franchisee any territorial rights, the franchisor had no right to open additional franchises without taking into account their effect on the nearby franchisee.<sup>97</sup> According to the court, the implied covenant of good faith and

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91. *Dunkin' Donuts of Am., Inc. v. Minerva, Inc.*, 956 F.2d 1566, 1569-70 (11th Cir. 1992).

92. *See, e.g.*, *Devery Implement Co. v. J.I. Case Co.*, 944 F.2d 724, 728 (10th Cir. 1991) (holding that an implied covenant of good faith and fair dealing cannot be applied "so as to write the termination-at-will provision out of" a franchise contract); UNIF. FRANCHISE AND BUSINESS OPPORTUNITIES ACT § 201 cmt. 1, 7A U.L.A. 118 (Supp. 1993) (stating that a franchise agreement "imposes on the parties a duty of good faith in its performance and enforcement," but limiting the duty to those instances in which it would not "add to or override substantive provisions of a [franchise] contract"); *accord* *Flint Davis v. Sears, Roebuck and Co.*, 873 F.2d 888, 894 (6th Cir. 1989); *Cloverdale Equip. Co. v. Simon Aerials, Inc.*, 869 F.2d 934, 938 (6th Cir. 1989) (restricting the good faith standard to only those cases in which a party acted in bad faith while negotiating the original franchise agreement, not simply cases involving alleged, subsequent bad faith); *Rosenberg v. Pillsbury Co.*, 718 F. Supp. 1146, 1152 (S.D.N.Y. 1989). *But see* *B.P.G. Autoland Jeep-Eagle, Inc. v. Chrysler Credit Corp.*, 799 F. Supp. 1250, 1257 (D. Mass. 1991) (concluding that the franchisor's prior failure to enforce certain credit provisions meant that its sudden withdrawal of the franchisee's inventory financing may have breached an implied covenant of good faith and fair dealing, even though the written agreement between the parties expressly permitted such an abrupt withdrawal).

93. *See supra* notes 83-87 and accompanying text.

94. 756 F. Supp. 543 (S.D. Fla. 1991).

95. *Id.* at 545. The court granted summary judgment to the franchisor on all other theories advanced by the franchisee: breach of (1) an implied contract created by promissory estoppel, (2) an implied non-competition agreement, and (3) the duty established by the Massachusetts Consumer Protection Act. *Id.* at 545, 550.

96. *Id.* at 548-49.

97. *Id.* at 549. This same reasoning was adopted in *Burger King Corp. v. Weaver*, 798 F. Supp. 684, 689 (S.D. Fla. 1992), in which the court noted that just because the franchise agree-

fair dealing entitles a franchisee to expect the franchisor to refrain from destroying the franchisee's ability to "enjoy the fruits of the contract."<sup>98</sup>

#### F. Affirmative Showing of Good Cause

Decisions such as *Scheck* draw from contract law and find no special relationship beyond implied covenants between franchisor and franchisee.<sup>99</sup> In contrast, *Arnott v. American Oil Company* suggests that a fiduciary relationship exists: it requires the franchisor to meet the highest standard of care and act in the franchisee's best interest.<sup>100</sup>

Other courts take the middle ground—franchisors must make an affirmative showing of "good cause" before terminating or otherwise affecting a franchise.<sup>101</sup> Although this standard is more protective of franchisees than the common law of contract, it is far short of a fiduciary relationship. The good cause requirement does not force the franchisor to put its franchisees' interests ahead of its own;<sup>102</sup> however, it does require that even in the presence of an express contractual term to the contrary, "good cause" must be demonstrated to validate a franchisor's actions. The mere absence of bad faith is thus an insufficient basis for "good cause" court decisions that would favor the franchisor.

ment failed to grant the franchisee an exclusive area or other express area rights, it did not somehow authorize the franchisor to place additional, competing franchises on any site it wanted.

98. *Scheck*, 756 F. Supp. at 549; see also *Photovest Corp. v. Fotomat Corp.*, 606 F.2d 704, 728 (7th Cir. 1979) (stating that the implied covenant of good faith "prohibit[s] actions . . . that would preclude profitable operation of the franchise or coerce franchise owners to terminate their agreements on terms favorable to [the franchisor]"), cert. denied, 445 U.S. 917 (1980); Burton, *supra* note 14, at 373 (contending that good faith consists of actions within the reasonable contemplation of the parties when the contract was formed, while it is bad faith when a party exercises its discretion to recapture opportunities foregone upon contracting); Spandorf et al., *supra* note 66, at 6 (stating that "the good faith covenant requires that each party act in a manner consistent with the contract's purpose," and—since economic profit is the main reason for entering a franchise contract—a franchisor should not take any "action that precludes profitable operation of a franchise").

99. *Scheck*, 756 F. Supp. at 548-49; accord *O'Neal v. Burger Chef Sys., Inc.*, 860 F.2d 1341, 1350 (6th Cir. 1988).

100. *Arnott v. American Oil Co.*, 609 F.2d 873, 881 (8th Cir. 1979) (opining that this fiduciary duty remains even if there appear to be contrary, express contract terms), cert. denied, 446 U.S. 918 (1980).

101. Some courts have adopted this intermediate standard for termination cases. Even if there is an express contractual provision about termination, these courts require the franchisor to show good cause before terminating the franchise. See, e.g., *P & W Supply Co. v. E.I. DuPont de Nemours & Co.*, 747 F. Supp. 1262, 1267 (N.D. Ill. 1990) (concluding that an implied covenant effectively overturns the express language of the contract which allows termination without good cause); *Dayan v. McDonald's Corp.*, 466 N.E.2d 958, 994 (Ill. App. Ct. 1984) (finding good cause for termination because franchisee failed to maintain quality, service, and cleanliness standards); *Shell Oil Co. v. Marinello*, 307 A.2d 598, 602 (N.J. 1973), cert. denied, 415 U.S. 920 (1974); see also *infra* notes 103-10 and accompanying text (discussing the *Marinello* court's requiring, but not finding, evidence of good cause for termination).

102. That is, it does not mandate a fiduciary relationship.

In *Shell Oil Co. v. Marinello*,<sup>103</sup> the New Jersey Supreme Court considered whether "good cause" should be required despite an express clause in the franchise agreement giving the franchisor a right to terminate almost at will.<sup>104</sup> The plaintiff-franchisee in *Marinello* leased a gas station from the defendant-franchisor for a three-year term with year-to-year renewals thereafter.<sup>105</sup> Either the franchisee or the franchisor could terminate the lease so long as the prescribed advance notice was given.<sup>106</sup> The franchisor gave notice of termination pursuant to the terms of the lease agreement.<sup>107</sup> The franchisee immediately sued to enjoin the proposed termination and reform the agreement.<sup>108</sup>

Ultimately, New Jersey's Supreme Court agreed with the trial court that good cause is a prerequisite for termination.<sup>109</sup> The *Marinello* court concluded that the franchisor's bargaining power was so disproportionate that to allow termination without good cause would violate state public policy.<sup>110</sup>

Many courts have cited *Marinello* with approval.<sup>111</sup> Also, numerous state statutes now require "good cause" for franchisors to terminate a franchise.<sup>112</sup> The same policy reasons for having a "good cause" termination standard applies to a franchisor's use of certain other franchise agreement provisions. These include provisions about territorial development and protection, covenants against competition, franchise transfers, franchisor assignments, franchise non-renewals, prices, supplies, business hours, franchisee employees, inspections, and auditing.<sup>113</sup> In each of these

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103. 307 A.2d 598 (N.J. 1973).

104. *Id.* at 602.

105. *Id.* at 599.

106. *Id.* at 600 (stating that 90 days' notice was necessary for termination at any time; only 30 days' notice was needed for a decision not to renew).

107. *Id.*

108. *Id.*

109. *Id.*

110. The court had decided that New Jersey's newly enacted franchise practices statute did not retroactively apply to the *Marinello* termination. Nonetheless, the court found that the new statute reflected the legislature's deep concern over abuses by franchisors, particularly in the termination and non-renewal of franchises; as such, the statute supposedly just codified the already existing public policy of New Jersey. *Id.* at 602.

111. *See, e.g.,* *Corenswet, Inc. v. Amana Refrigeration, Inc.* 594 F.2d 129, 139 (5th Cir.), *reh'g denied*, 597 F.2d 772 (5th Cir.), *cert. denied*, 444 U.S. 938 (1979); *Tulowitski v. Atlantic Richfield Co.*, 396 A.2d 956, 961 (Del. 1978); *Atlantic Richfield Co. v. Razumic*, 390 A.2d 736, 742 (Pa. 1978).

112. *See* Emerson, *supra* note 1, at 1511 n.27 (listing 16 states that have good cause requirements for terminating franchises). In 1992, a seventeenth state, Iowa, added such a requirement via its newly enacted franchise act. IOWA CODE §§ 523H.1-523H.17 (Supp. 1993).

113. *See, e.g.,* *AAMCO Transmissions, Inc. v. Harris*, 759 F. Supp. 1141, 1148 (E.D. Pa. 1991) (holding that the implied duty of good faith and fair dealing, recognized by Pennsylvania courts to cover franchise terminations, also may extend to other areas of the franchise relationship).

situations, the franchisee is arguably at the mercy of its franchisor, and the franchisee's bargaining position is weakened severely by its sunk costs at risk. The franchisee rightfully expects the franchisor not to abuse its discretion when dealing with an incomplete or otherwise flexible clause that affords the franchisor much discretionary power.

A "good cause" approach preserves franchisor flexibility—much more so than under a fiduciary approach—while offering to franchisees a degree of comfort that completely untrammelled franchisor discretion fails to allow. In general, contractual clauses with the following elements should lead to the application of a "good cause" requirement in addition to the normal contract relationship: (1) in setting or carrying out the clause's terms, the franchisor held a superior bargaining position to that of the franchisee;<sup>114</sup> (2) the clause is incomplete or otherwise naturally requires some flexibility in interpretation or enforcement, perhaps including judicial recognition of the parties' subjective intent; and (3) the franchisee reasonably expected that—regardless of any contrary express provision in the contract—the franchisor would not abuse its discretion<sup>115</sup> by invoking the

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114. Spandorf et al., *supra* note 66, at 5-6 (noting that prospective franchisees have very little bargaining freedom because "franchising normally involves a franchisor's presentation of a form franchise agreement to a prospective franchisee on a 'take it or leave it' basis"); accord Harold Brown, *A Fair Dealership Law—Proposed Findings and Purpose*, N.Y. L.J., Mar. 28, 1991, at 3, 7 (citing several cases for the proposition that the franchise agreement is an adhesion contract that only offers the franchisee onerous terms on a "take-it-or-leave-it" basis). While potential franchisees generally have the power to decide not to enter into a contract at all, if these possible franchisees have no genuine power over the setting of terms within a franchise contract, then it seems fair to label their bargaining position as inferior to the franchisor with respect to the making of that contract.

115. The *Marinello* court considered the franchisor's abuse of discretion to be a key concern. 307 A.2d at 601-02; see also *Carvel Corp. v. Diversified Management Group, Inc.*, 930 F.2d 228, 232 (2d Cir. 1991) (acknowledging that the franchise agreement gave franchisor Carvel "considerable discretion" in and "near absolute control over" matters such as advertising, store locations, and wholesale sales, but concluding that "even if [Carvel] acted within the bounds of its discretion, Carvel would be in breach if it acted unreasonably"); *Bonfield v. AAMCO Transmissions, Inc.*, 708 F. Supp. 867, 885 (N.D. Ill. 1989) (holding that "even if the express terms of the [franchise] Agreement permitted [franchisor] AAMCO to alter its policies, it could not change them arbitrarily"); *Dayan v. McDonald's Corp.*, 466 N.E.2d 958, 972 (Ill. App. Ct. 1984) (requiring good cause for a franchise termination and stating that a franchisor "vested with contractual discretion must exercise that discretion reasonably and with proper motive, and may not do so arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties").

clause. The resulting moderate approach<sup>116</sup> should promote a sense of fair play.<sup>117</sup>

### III. APPLYING THE CORRECT STANDARD

#### A. Introduction

In the cases discussed above, a franchise relationship was clearly present, but the courts were inconsistent as to what the relationship meant. This inconsistency can be found in case law throughout the United States.<sup>118</sup> Franchisors and franchisees thus are left bereft of guidance about what standards of care, if any, a court may impose.

The nature of the franchise relationship must be defined so that both franchisor and franchisee know their respective roles and can avoid disputes about contractual clauses. When a dispute does arise, the parties' ability to negotiate a quick and fair settlement will be greatly improved when they

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116. The middle approach lies between fiduciary analysis and relatively strict common-law contract analysis. In summation, the three approaches involve these elements:

	Fiduciary	Good Cause	Common Law (Arm's Length)
<i>Franchisee Expectations</i>	Aid; franchisor expertise	No abuse of franchisor power	No aid; only what is expressly in the contract
<i>Bargaining Process</i>	Franchisor domination & superior knowledge	Greater franchisor power	Completed by time franchise was issued; no need for ongoing talks
<i>Clause Completeness &amp; Need for Flexible Enforcement</i>	Incomplete or requires very flexible enforcement	Incomplete or requires some flexible enforcement	Definite; no flexibility in enforcement needed
<i>Interests of the Franchisor &amp; Franchisee</i>	Same, for that clause	Not an issue	Opposite, for that clause

The elements of the fiduciary standard and the common-law approach are discussed *supra* notes 66-71, 88-90, and accompanying text.

117. This sense of fair play may reduce the franchisee's perceived risks and thereby increase the value of the franchise to the franchisee. The franchisor, in turn, can charge more for this apparently more valuable franchise. Thus, both franchisee and franchisor may benefit from this standard.

118. See, e.g., GARNER, *supra* note 10, § 8:06, at 11 ("American courts have demonstrated little consistency in applying rules of interpretation to contracts."); Rupert M. Barkoff, Franchise Sales Regulation: A Revisionist's Approach, Remarks at the ABA's Fifth Annual Forum on Franchising 40 (Nov. 4, 1982) (referring to excessive "inconsistency" resulting from, *inter alia*, "judicial idiosyncracies"); see also J. Michael Dady, *One Franchisee Lawyer's Comments on Congressman LaFalce's Proposed Federal Franchise Legislation*, 12 FRANCHISE L.J. 14, 15 (1992) (noting that different courts hold diametrically opposed views about a franchisor's ability to disclaim, in effect, its duties of good faith and fair dealing); Emerson, *supra* note 1, at 1513-16 (discussing the overall "hodgepodge" of inconsistent statutes, regulations, and case law concerning franchise relationships).

have the means to predict more accurately the likely outcome in court. On the other hand, a failure to clarify the relationship's metes and bounds simply promotes the abuse of discretion. For instance, absent consistent application of the proper standards of care, the superior bargaining position of the franchisor may foster opportunism.<sup>119</sup>

To increase certainty and attain justice, courts should hold the franchisor to a standard of care consistent with the interests and expectations of the parties at the time of the agreement. Each franchise contract clause should be analyzed according to the parties' rightful expectations. Once the parties' interests and expectations for each clause are described, then the nature of the franchise relationship, as it exists *under those circumstances*, can be identified. Such identification leads to the proper application of standards.<sup>120</sup>

### B. *Clauses Requiring a Fiduciary Relationship*

Several clauses typically placed in franchise agreements should be interpreted as imposing a fiduciary duty on the franchisor.<sup>121</sup> This section addresses seven clauses that appear to create a fiduciary relationship: site selection, physical layout and signs, training of franchisees, operational standards, variance among franchisees, opening and financing, and advertising.

#### 1. Site Selection

For new or relatively inexperienced franchisees, one major benefit expected from the franchising arrangement is franchisor expertise in areas where the franchisees have limited knowledge. In site selection, for instance, the franchisor is in a position to know from past franchisee performance the demographics best suited for maximum sales and profits. Both

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119. Opportunism can best be described by way of example. Once the franchisee has invested heavily in its franchise, the franchisee becomes vulnerable to the franchisor, which can exploit this advantage (behave opportunistically) in any number of ways: increase rents, raise prices on supplied goods, boost royalties via a required increase in sales volume, charge higher fees for training, marketing, or other "assistance," and other methods. The franchisee, having already invested in the franchise with little hope of selling the invested assets for their cost, has minimal power to object to the franchisor's price increases. Therefore, an opportunistic franchisor can extract a significant portion of the franchisee's sunk costs. See Hadfield, *supra* note 57, at 951-55.

120. As examples, the franchise contract clauses most frequently found in the fast-food industry will be considered. See *supra* note 71; *infra* app.

121. For a discussion of the fiduciary relationship in a franchising context see *supra* notes 61-79 and accompanying text. If found to exist, the fiduciary standard would place the burden of proof on the franchisor to show that it dealt openly and fairly with the franchisee-beneficiary. See *supra* notes 63-65 and accompanying text. Moreover, the subjective intent of the fiduciary would be irrelevant; regardless of whether the franchisor *wanted* what took place, the issue would be whether the franchisor put the franchisee's interests ahead of its own. See *supra* notes 63-65 and accompanying text.

franchisor and franchisee should have similar interests; unless there is fraud or other subterfuge at work, neither franchisor nor franchisee should gain by opting for anything less than the best available site.<sup>122</sup>

Franchisors have an affirmative duty to perform, even if it simply requires approval of suggested sites compiled by the franchisee.<sup>123</sup> Because site selection clauses require franchisor flexibility and discretion,<sup>124</sup> the courts should hold franchisors to a fiduciary standard in disputes over allegedly poor, delayed, or denied sites. Holding franchisors to a fiduciary standard places the burden of proof on franchisors to show that they acted in the franchisee's best interests.<sup>125</sup>

In *Tidmore Oil Co. v. BP Oil Co.*,<sup>126</sup> the Court of Appeals for the Eleventh Circuit recently considered franchise site issues. There, the plaintiff-franchisee, Tidmore, distributed gasoline wholesale to numerous dealers in nine Alabama counties and retailed gasoline directly through a smaller number of stores in the same territory. Defendant-franchisor British Petroleum refined petroleum products and then sold them via its own stations and via franchisees such as Tidmore. When Tidmore requested BP's approval for a new store, BP rejected the request and failed to give any reasons for the denial.<sup>127</sup> Within ten months after the denial, BP approved a marketing plan placing three new stations in the same area as that requested by Tidmore. One of the stations was actually closer to an existing station than the site Tidmore had proposed.<sup>128</sup> BP subsequently informed Tidmore that it simply would not approve any sites within the area Tidmore originally requested.<sup>129</sup>

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122. Of course, parties may differ as to what that site is. Certainly, picking the best site is far from fool-proof. But that does not mean the parties' interests are adverse—only that reaching their joint goals may prove difficult.

123. Given franchisor knowledge of past franchisee performance, the franchisor should not merely accept franchisee choices if others would be better. A fiduciary duty would require franchisor intervention on behalf of the franchisee. At any rate, commentators have concluded that some franchisors, "[w]hether by design or not, [actually] exercise nearly complete control over the process of selecting the site for a franchised business." Gaylen L. Knack & Troy A. Bader, *Franchisor Liability in the Market-Development and Site-Selection Process: Location, Location . . . Liability?*, 13 *FRANCHISE L.J.* 39, 42 (1993).

124. See *supra* note 71.

125. Almost all courts facing the issue have refused to extend fiduciary concepts to franchising agreements; thus, this approach would be new law. Although the court in *Arnott v. American Oil Co.*, 609 F.2d 873, 883 (8th Cir. 1979), *cert. denied*, 446 U.S. 918 (1980), identified the franchising relationship as fiduciary, close analysis reveals nothing more than a contractual analysis with perhaps an affirmative showing of good cause.

126. 932 F.2d 1384 (11th Cir. 1991).

127. Ultimately, a BP representative allegedly told Tidmore that its proposed site was too close to another station, about 2.6 miles away. *Id.* at 1387.

128. *Id.*

129. *Id.*



The court of appeals affirmed the trial court's grant of summary judgment in BP's favor. Analyzing the implied covenants of good faith and fair dealing under Alabama law and determining that these covenants were directive rather than remedial, the court concluded that Tidmore had failed to proffer the necessary evidence that BP's conduct deprived Tidmore of the benefit of its franchising contract bargain.<sup>130</sup> The *Tidmore* decision focused on the express provisions of the contract<sup>131</sup> rather than the expectations, bargaining power, or overall purposes of the site selection clause. Such an approach almost uniformly yields a pro-franchisor outcome. Franchisors, after all, draft the contracts.<sup>132</sup>

The site selection provision implicated in *Tidmore*, which vested ultimate and highly discretionary power in the franchisor, appears to be a typical clause in most franchise agreements.<sup>133</sup> The *Tidmore* court thus essentially granted franchisors the right to disapprove sites for any reason. A better judicial method, one taking into account the strong potential for abuse, would incorporate an understanding of the overall franchising relationship into analysis of site selection provisions.

Other courts, in similar franchise contexts, have looked beyond the strict interpretation of contract terms; in doing so, these courts have better adapted their decision-making process to meet the parties' actual, legitimate expectations when the contract was made. For example, in *Scheck v. Burger King Corp.*,<sup>134</sup> the court held that while a franchise agreement expressly denied to the plaintiff-franchisee an exclusive territorial interest, the franchisor's subsequent opening of other nearby franchises may have violated implied covenants of good faith and fair dealing regardless of their effect on the plaintiff-franchisee's operations.<sup>135</sup> More directly on point is

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130. *Id.* at 1391 (citing two cases holding that the implied covenants do not apply when there are express contract terms on point: *Davis v. Sears, Roebuck & Co.*, 873 F.2d 888, 895 (6th Cir. 1989) (applying Georgia law); *Hubbard Chevrolet Co. v. General Motors Corp.*, 873 F.2d 873, 877-78 (5th Cir. 1989) (applying Michigan law)).

131. The BP-Tidmore clause read: Site selection "[a]pproval will be based on the appearance, location and mode of operation of the outlet. [Franchisor] expressly reserves the right to determine the appropriate geographic density of . . . outlets." *Tidmore*, 932 F.2d at 1386.

132. Emerson, *supra* note 1, at 1509 & n.21 (citing both case law and commentary for the related propositions that the franchisor generally drafts the agreement and that most of the explicit, contractual obligations fall upon the franchisee).

133. *Infra* app. § A-1 (reporting that 71% of the surveyed contracts expressly require franchisor approval of the franchisee's business site, with 18% actually stating that the franchisor picks the site); see also WEBSTER, *supra* note 56, at 99 (concluding that a typical contractual phrase requiring a franchisor's approval of the proposed site will not be unreasonably withheld "offers no protection to the franchisee whatever" and actually constitutes "a universal escape hatch for the franchisor").

134. 756 F. Supp. 543 (S.D. Fla. 1991).

135. *Id.* at 549 (contending that the contract's express denial to the franchisee of any exclusive territorial rights did not mean that the franchisor was permitted "to destroy the right of the franchisee to enjoy the fruits of the contract"); see also *Burger King Corp. v. Weaver*, 798 F. Supp.

*Brennan v. Carvel Corp.*<sup>136</sup> The *Brennan* court refused to apply the rather narrow wording of the franchise agreement's site selection clause. Instead, the court referred to the prior "Application and Deposit Agreement" ("ADA") that the prospective franchisee, Brennan, had signed with Carvel.<sup>137</sup> Carvel stated in the ADA, "[A] substantial amount of time and effort shall be exerted [by Carvel] in seeking, surveying and showing locations suitable for a Carvel store."<sup>138</sup> The court also found great significance in Carvel's informational brochures and the Uniform Franchise Offering Circular (UFOC),<sup>139</sup> which, like the ADA, provided that Carvel would "assume responsibility for selecting, obtaining and negotiating a suitable location for the Carvel store."<sup>140</sup> Carvel argued that it had furnished the promised site selection services by ensuring that the site was properly zoned, had enough space, and contained the necessary electrical wiring and mechanical facilities. In response, the court held that, under the circumstances, a "suitable site means one that is in a location which has adequate traffic or population, or other appropriate characteristics, in which a Carvel franchise may succeed."<sup>141</sup> Concluding that the franchisee's failure was not due to mismanagement or a lack of effort, the court laid the blame squarely upon the franchisor for its failure to evaluate and select a suitable site for the franchisee's ice cream store.<sup>142</sup>

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684, 689 (S.D. Fla. 1992) (described *supra* note 97); Knack & Bader, *supra* note 123, at 42 (proposing that franchisors consider granting franchisees limited protected areas and, "most important, [that] franchisors should establish development policies designed to identify when a proposed new unit may have a significant adverse impact on existing units").

136. 929 F.2d 801 (1st Cir. 1991).

137. *Id.* at 807-08. The court did so despite the merger clause found in the subsequently signed franchise agreement. *Id.* Merger clauses are found in most franchise agreements. *Infra* app. § C-7 (reporting that merger clauses are present in 79% of the surveyed contracts).

A merger clause is a contractual provision that the written terms of that contract "may not be varied by prior or oral agreements because all such agreements have been merged into the written document." BLACK'S LAW DICTIONARY 989 (6th ed. 1990). In effect, the clause purports that the contract is "integrated" and thus governed by the parol evidence rule. *See infra* note 274.

138. *Brennan*, 929 F.2d at 804. The ADA, in effect, contained franchisor Carvel's promise to undertake efforts on behalf of the prospective franchisee in return for the prospective franchisee's deposit of \$1000 and promise not to disclose or use any trade secrets or other information given to it by Carvel. *Id.*

139. The UFOC was adopted on September 2, 1975, by the Midwest Securities Commissioners Association, now the North American Securities Administrators Association. Compliance with UFOC satisfies the FTC rule on franchising disclosures, found at 16 C.F.R. §§ 436.1-436.3 (1992). Final Guides to the Franchising and Business Opportunity Ventures Trade Regulation Rule, 44 Fed. Reg. 49,966, 49,970 (1979); Statement of Basis and Purpose Relating to Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 43 Fed. Reg. 59,621, 59,722-23 (1978).

140. *Brennan*, 929 F.2d at 804.

141. *Id.* at 809.

142. *Id.* at 809-10; *see also* Knack & Bader, *supra* note 123, at 44-46 (discussing TCBY v. Paulson, No. LR-C-91-162 (E.D. Ark. Apr. 24, 1993), an unpublished case in which the jury

## 2. Physical Layout and Signs

Business-format franchisees generally buy a "package" that includes a systematized, rather uniform layout, including signs.<sup>143</sup> Persons who become franchisees presumably expect a measure of franchisor expertise concerning physical layout.<sup>144</sup> It also seems reasonable to assume that many franchisors informally oversee matters of design and construction even when the contract does not require them to do so. Their ultimate right to approve or deny the layout certainly provides most franchisors with leverage in this area.

Franchisor supervision of the layout promotes efficiency and consistency throughout the franchise system. The interests of franchisor and franchisee are, as with site selection, quite similar.<sup>145</sup> Franchisors ordinarily receive no benefit from providing inadequate guidance or otherwise imposing requirements not in the best interest of the franchisees. Therefore, this clause also meets the characteristics needed to mandate fiduciary duties on the part of the franchisor: (1) franchisee expectations of franchisor expertise, (2) franchisor superiority in knowledge and bargaining power, (3) a clause calling for substantial flexibility in its application,<sup>146</sup> and (4) close similarity in the interests of franchisor and franchisee.<sup>147</sup> Obviously, when franchisors can mandate modifications of the franchised business' layout,<sup>148</sup>

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awarded \$70,000 to a franchisee to whom franchisor TCBY did not provide "reasonable assistance" in the site-selection process).

143. This design or display "package" may be in conjunction with the trademarks and service marks provided by the franchisor or as part of the advertising controls. See RAYMOND J. MUNNA, *FRANCHISE SELECTION: SEPARATING FACT FROM FICTION* 141 (1987) (describing display requirements and mandatory decor "as part of the [franchisor's] desire to retain or maintain a certain public visibility and uniformity of look").

144. Obviously, this subject is important in many, probably most, franchised businesses. Of the 100 contracts that the author reviewed, 73% provide that the franchised business premises' layout must be approved by the franchisor, and an additional 10% call upon the franchisor itself to implement the appropriate design layout. See *infra* app. § A-2.

145. While either side may have a covert interest in cheap workmanship or other cost-savers, the overt interests—the only ones that a court and the other party generally can be expected to recognize—are for a relatively uniform, standardized layout that takes advantage of system-wide marketing programs, customer goodwill, and the like.

146. See, e.g., *supra* note 71; see also *infra* app. § A-2-d (reporting that 59% of surveyed contracts give the franchisor the right to mandate future modifications of the layout, with 16% specifically providing that any mandated modifications are entirely at the expense of the franchisee). The franchisor must have flexibility, but operate with extreme fairness, when invoking such a provision.

147. See *supra* note 71 and accompanying text.

148. See *supra* note 146.

often entirely at the franchisee's expense,<sup>149</sup> then the franchisor's powers are even stronger.<sup>150</sup>

### 3. Training of Franchisees

All surveyed franchise agreements contain a clause concerning franchisor training of the franchisee,<sup>151</sup> and most include special "consultation" arrangements, as well.<sup>152</sup> Franchisees rightfully expect the franchisor's assistance; indeed, such aid is often a significant reason why the franchisee decided to buy a franchise.<sup>153</sup> Training, uniformity of approach, and learning from experience are all, in effect, purchased by the franchisee. Of course, training or consultation cannot be completely specified via contract, so these clauses necessitate franchisor flexibility, with the franchisor in a position to control this aspect of the relationship.<sup>154</sup> In essence, the franchisor is called upon to perform a fiduciary service that should redound to the benefit of both sides. A fiduciary duty for these provisions ought to be inferred.

### 4. Operational Standards

Courts routinely uphold franchise terminations when a franchisee has breached the franchisor's quality standards<sup>155</sup> or otherwise failed to meet

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149. See *supra* note 146.

150. In the 1970s, for example, many fast-food franchisees had to build drive-through windows in order to comply with the franchisor's evolving concepts about each outlet's layout and its best method for serving customers and boosting sales. Gary Taylor, *Battle Ahead for Congressional Franchise Bills*, NAT'L L.J., June 1, 1992, at 32.

151. *Infra* app. § A-3 (reporting that 100% of surveyed agreements provide for franchisor training of the franchisee; 43% expressly state that training is to be at the franchisee's expense).

152. *Infra* app. § A-3-c (finding that 59% of surveyed contracts provide for franchisor consulting services on behalf of the franchisee). Training typically involves a well-defined program for new franchisees and their key employees, with almost all of the activity in the early stages of a franchise. Consultation, on the other hand, may occur at any point during the franchise, and it is more likely to involve the problems peculiar to a particular franchise than the more generalized training programs.

153. See *supra* note 66; see also Spandorf et al., *supra* note 66, at 5 ("[C]ourts have noted that in the typical franchise relationship the franchisee depends on the franchisor for the basic viability of the venture."). Franchisor information packets to prospective franchisees routinely extol the franchisor's training programs. See, e.g., Letter from Stephen C. Johnson, President, Franchise Dept., Macayo Mexican Restaurants, Inc. (Fall 1992) (form letter to inquiring potential franchisees, with accompanying brochures about the restaurant chain, stating that "Macayo offers our franchisees assistance in all facets of restaurant management, from inventory control, personnel training and accounting procedures to quality control").

154. See *supra* note 71 (describing the wide latitude given by contract to the franchisor's training of its franchisees).

155. See, e.g., *KFC Corp. v. Goldey*, 714 F. Supp. 264, 266 (W.D. Ky. 1989); *In re Gainesville P-H Properties, Inc.*, 77 B.R. 285, 294-95 (Bankr. M.D. Fla. 1987); *Azcuy v. Amoco Oil Co.*, Bus. Franchise Guide (CCH) ¶ 8394, at 15,450 (N.D. Ga. June 11, 1985); *Dayan v. McDonald's Corp.*, 466 N.E.2d 958, 995 (Ill. App. Ct. 1984).

operational goals or needs.<sup>156</sup> Almost all franchise contracts provide for operating manuals,<sup>157</sup> and most give franchisors the unilateral right to revise these manuals.<sup>158</sup> In effect, the contracts give the franchisor great discretion over maintaining and even altering the system-wide standards.<sup>159</sup> Franchisees, again, depend upon the franchisor's expertise and presumably expect that, to ensure uniformity, all of the system's outlets—whether franchised or not—will have to obey the same rules.<sup>160</sup> If a franchisor fails to update its standards, the system may be weakened; it is thus in both the franchisor's and franchisee's interest to impose an affirmative obligation on the franchisor to maintain the necessary standards.<sup>161</sup> The franchisor's necessary flexibility over operational standards and revisions is difficult to control in a realistic fashion via the franchise contract,<sup>162</sup> but the discretion can be tempered by fiduciary standards limiting the franchisor's ability to abuse its naturally dominant position over the franchisees.

### 5. Variance in Contractual Terms for Other Franchisees

Many franchise agreements expressly provide that the terms offered a franchisee may vary from those offered to other franchisees in the same system.<sup>163</sup> Such variance, however, contradicts a franchisor's arguments that it cannot bargain over terms with franchisees. The franchisor argues that uniformity is essential—that what the franchisee seeks is uniformity

156. See, e.g., *Al Bishop Agency, Inc. v. Lithonia-Division of Nat'l Serv. Indus., Inc.*, 474 F. Supp. 828, 833-34 (E.D. Wis. 1979) (concluding that reasonable, nondiscriminatory sales penetration goals were not met); *American Motors Sales Corp. v. Perkins*, 251 N.W.2d 727, 729 (Neb. 1977) (stating that a car dealer failed to maintain an auto showroom and to employ salespeople); *Tappan Motors, Inc. v. Volvo of Am. Corp.*, 479 N.E.2d 804, 805 (N.Y. 1985) (explaining that a dealer did not maintain sufficient inventory to meet customer needs).

157. *Infra* app. § A-4-a (98%).

158. *Infra* app. § A-4-b (59%).

159. *Supra* note 71 (quoting an illustrative clause). As stated by one franchise attorney: Although the basic terms of the franchise agreement (such as royalty and advertising fees and length of term of the franchise) usually are not subject to change, terms such as operating standards, hours of business, approved products can be modified or varied by reasonable changes to the operations manual. In drafting the clauses in the franchise agreement regarding operational assistance and the operations manual, therefore, care must be taken to allow for flexibility.

Ronald P. Roman, *Structuring the Franchise Agreement and Related Documents*, in *FLORIDA BAR, CLE COMM., FRANCHISE LAW AND PRACTICE* § 4.5, at 4-5 (1993).

160. It may seem strange, then, that a number of franchise agreements expressly provide that a supposedly uniform system's franchise agreements may vary from franchise to franchise. *Infra* app. § A-5 (finding such a clause in 26% of surveyed contracts).

161. *Infra* app. § A-4-c (finding that 92% of surveyed contracts impose quality control standards, and 48% control what the franchisee can sell).

162. Roman, *supra* note 159, § 4.5, at 4-5 (concluding that a confidential, easily amended, operations manual "is a very effective method of supplementing many of the franchisee's contractual obligations").

163. See *supra* note 160.

insofar as it improves the marketing of the trademark, the business concepts, and the overall goodwill that the franchisee purchases.<sup>164</sup> Consistent with this argument, some states statutorily bar a franchisor's discriminatory treatment of one franchisee as compared to others.<sup>165</sup> Such disparate treatment could result in the unfavored franchisee making a discrimination claim.<sup>166</sup>

It is in the best interest of franchisor and franchisee that any variances among the franchised system's outlets be minimal. To do otherwise would permit an erosion of standards and a growing cynicism on the part of those franchisees who object to what they perceive as an overly indulgent franchisor.<sup>167</sup> Thus, the fiduciary standard is appropriate: (1) The franchisee relies on the franchisor's expertise in allowing or refusing system-wide variations, (2) the franchisor clearly dominates and has superior knowledge and bargaining power over the franchisee, (3) the clause granting franchisor discretion to treat franchisees differently calls for great flexibility in its application, and (4) the interests of franchisor and franchisee are the same—they seek an optimal method of marketing and sales.<sup>168</sup>

## 6. Opening and Financing

Franchisor assistance in opening a franchised business is essential.<sup>169</sup> The parties naturally expect the franchisor to play a crucial role in the new

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164. See Spandorf et al., *supra* note 66, at 5-6.

165. Arkansas Franchise Practices Act, ARK. CODE ANN. § 4-72-206(2) (Michie 1987) (enacted in 1977); California Fair Dealership Law, CAL. CIV. CODE §§ 80-86 (West 1982) (enacted in 1980); California Franchise Investment Law, CAL. CORP. CODE § 31,220 (West Supp. 1993) (enacted in 1970); Hawaii Franchise Investment Law, HAW. REV. STAT. § 482E-6(2)(C) (1985) (enacted in 1974); Illinois Franchise Disclosure Act, 815 ILL. ANN. STAT. ch. 121 1/2, § 1718 (West's Smith-Hurd 1993) (enacted in 1987); Indiana Deceptive Franchise Practices Act, IND. CODE ANN. § 23-2-2.7-2(5) (Burns 1989) (enacted in 1976); Michigan Franchise Investment Law, MICH. COMP. LAWS § 445.1527(e) (1989) (enacted in 1974, amended in 1984); MINN. STAT. ANN. § 80C.14 (West 1986 & Supp. 1993); Nebraska Franchise Practices Act, NEB. REV. STAT. § 87-406(2) (1987) (enacted in 1978); New Jersey Franchise Practices Act, N.J. STAT. ANN. § 56:10-7(b) (West 1989) (enacted in 1971); Washington Franchise Investment Protection Act, WASH. REV. CODE ANN. § 19.100.180(2)(c) (West 1989 & Supp. 1993) (enacted in 1971); Wisconsin Fair Dealership Law, WIS. STAT. ANN. § 135.04 (West 1991) (enacted in 1974). There also are anti-discrimination provisions found in franchising statutes covering particular industries. See ARK. CODE ANN. § 4-75-411 (Michie 1987) (auto dealerships).

166. See, e.g., *McDonald's Corp. v. Robert A. Makin, Inc.*, 653 F. Supp. 401, 403 (W.D.N.Y. 1986) (referring to discrimination among franchisees as a violation of Illinois law). *But see* *Kilday v. Econo-Travel Motor Hotel Corp.*, 516 F. Supp. 162, 163 (E.D. Tenn. 1981) (holding that a uniform franchise agreement does not entitle franchisees to require that franchise provisions be enforced uniformly).

167. Such a franchisor could face lawsuits by other franchisees for breaching its duty to protect the franchised trademark. *Pepperidge Farm, Inc. v. Mack*, Bus. Franchise Guide (CCH) ¶ 9530 (S.D. Cal. Nov. 29, 1989).

168. See *supra* notes 66-69 and accompanying text.

169. See, e.g., Spandorf et al., *supra* note 66, at 5.

outlet's formative stages, and a failure to meet that expectation may lead to a successful claim against the franchisor.<sup>170</sup> Indeed, one-half of the surveyed agreements contain clauses about franchisor assistance in opening the franchisee's business.<sup>171</sup>

Likewise, franchisees often depend upon the franchisor to help them obtain financing.<sup>172</sup> Most do not directly supply the financing,<sup>173</sup> but franchisors often help franchisees "set up a relationship with a financing entity."<sup>174</sup> While an express, contractual clause concerning financing assistance is infrequent,<sup>175</sup> when such clauses are used the franchisee and franchisor share the same interests. Presumably the franchisor has greater experience and a far superior position with respect to gaining the necessary financing. As with contractual clauses on opening the franchise, fiduciary concepts are suitable under these circumstances.

## 7. Advertising

Most franchise agreements grant the franchisor power over advertising.<sup>176</sup> Almost all agreements mandate continual franchisee advertising expenditures, usually into funds subject to the control or strong influence of the franchisor.<sup>177</sup> The franchisor's dominance may extend into control over the franchisee's own signs or other advertising on the franchisee's own

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170. See, e.g., *Ciampi v. Red Carpet Corp. of Am.*, 85 DAILY J., D.A.R. 1474 (May 10, 1985) (holding a franchisor liable for the false promises of its salesmen, even though the franchisor corrected the misrepresentations before the franchise agreement was executed); see also Spandorf et al., *supra* note 66, at 3-4 (discussing *Ciampi*).

171. *Infra* app. § A-6-a.

172. For instance, of the 148 franchisors listed in WEBSTER, *supra* note 56, at 238-87, 44 provide direct financing assistance to the franchisee. See also FRANCHISE HANDBOOK, Spring 1994, *passim* (providing brief information on more than 1,700 franchisors, most of which will either furnish some direct financing or at least help the franchisee in seeking loans from a bank or some other source).

173. Michael Garlick, *The Franchise Relationship: Counseling Potential Franchisors and Franchisees*, in FLORIDA BAR, CLE COMM., *supra* note 159, § 3.90, at 3-36.

174. *Id.* (contending that when franchisors do provide financing, their rates "are usually lower than rates obtained through institutional sources").

175. *Infra* app. § A-6-b (finding that only ten percent of the surveyed contracts have such a clause).

176. *Infra* app. § A-7-a, b (finding that 77% of the surveyed contracts call for the franchisor to control and manage the system's advertising; 62% have the franchisor itself run the advertisements).

177. *Infra* app. § A-7-c (reporting that 94% of surveyed agreements require that a percentage of the franchisee's gross sales be devoted to advertising, generally via a franchisor-controlled plan; sometimes, the franchisee must also pay for local advertisements). The median percentage of required advertising spending is three percent of gross revenues. *Infra* app. § A-7-c.

business premises.<sup>178</sup> As a result, most franchisees must spend a substantial amount on advertisements before they open their businesses.<sup>179</sup>

As with other clauses indicating a fiduciary standard, the contractual clauses on advertising involve franchisee expectations of franchisor expertise,<sup>180</sup> a presumably superior (in knowledge and bargaining power) franchisor, the need for flexibility in structuring and restructuring how advertising money is spent, and a coalescence of franchisor and franchisee interests. Franchisors require discretion in carrying out the advertising programs provided for in franchise contracts.<sup>181</sup> Both franchisor and franchisee benefit from successful advertising campaigns. Again, a fiduciary approach makes sense.

### C. Clauses Requiring "Good Cause"

Several important clauses usually found in franchise agreements do not require the protections of a fiduciary-type relationship, but call for more than a simple reading of basic contract law. These clauses arguably require "good cause" for the franchisor to enforce them.<sup>182</sup> This section addresses the several subjects that courts should analyze under the "good cause" standard: territorial development and protection, covenants against competition, franchise transfers, franchisor assignments, franchise terminations and nonrenewals, and miscellaneous provisions such as pricing, supplies, business hours, franchisee employees, inspections, and auditing.

This middle approach retains principles of contract law, except that it requires a showing of good cause for various franchisor actions even when the express contractual terms state otherwise. Some affirmative evidentiary burdens, albeit less than are required of a fiduciary, rest upon the franchisor. Indeed, with "good cause" clauses, such as termination, the focus becomes the overall rationality and fairness of the franchisor's decision rather than the literal or implicit meaning of the contractual terms.

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178. *Infra* app. § A-7-d (finding that 29% of surveyed contracts give the franchisor a right to enter franchised business premises and remove or destroy objectionable signs or advertising); see also GARNER, *supra* note 10, § 3:19, at 31 ("The right to approve or disapprove franchisee advertising is typically wholly within the franchisor's discretion.").

179. *Infra* app. § A-7-e (reporting that 64% of the agreements require the franchisee to spend on "Grand Opening" advertising; \$4,000 is the median amount required).

180. As with the failure to provide grand opening assistance, a franchisor's failure to arrange needed advertising can be actionable. See, e.g., *supra* note 170 and accompanying text.

181. Courts have upheld the franchisor's contractual right of unlimited discretion in determining how to spend the franchisees' advertising funds. E.g., *Burger King Corp. v. Kellogg, Bus. Franchise Guide (CCH)* ¶ 9730 (S.D. Fla. Sept. 7, 1990); *Thompson v. Atlantic Richfield Co.*, 673 F. Supp. 1026, 1028 (W.D. Wash. 1987).

182. For a discussion of the "good cause" standard in a franchising context, see *supra* notes 99-117 and accompanying text.



Unlike a fiduciary approach reaching even farther afield from "pure" contract law, the good cause requirement has been adopted by a number of courts and legislatures.<sup>183</sup>

### 1. Territorial Development and Protection

Rapid territorial development is often an important reason businesses choose to franchise.<sup>184</sup> Sometimes franchisors grant franchisees an exclusive, protected area,<sup>185</sup> precluding the franchisor from competing with the franchisee.<sup>186</sup> The idea is that franchisee protection leading to franchisee growth redounds to the benefit of the entire franchised system.

To franchisees, protection of their particular business territories may be crucial. Obviously, if the franchisee wants and is able to expand its business, the franchisee's and franchisor's interests may coincide. When a franchisee simply wishes to protect its own area without necessarily expanding, the interests may differ dramatically.

A franchisee that is content with its present size cannot realistically expect the franchisor to forego expansion; nevertheless, it does seem reasonable to require the franchisor to act in good faith and accord a franchisee a right of first refusal. Thus, before establishing another franchisee nearby and thereby permitting encroachment on areas the franchisee already serves, the franchisor should give the original franchisee the opportunity to acquire that new outlet.<sup>187</sup> In a broader sense, regardless of whether there are

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183. See, e.g., *Dayan v. McDonald's Corp.*, 466 N.E.2d 958, 973 (Ill. App. Ct. 1984) (finding good cause a requirement for termination); *Shell Oil Co. v. Marinello*, 307 A.2d 598, 603 (N.J. 1973), cert. denied, 415 U.S. 920 (1974) (holding that good cause must be shown for termination); accord *Corenswet, Inc. v. Amana Refrigeration, Inc.*, 594 F.2d 129, 139 (5th Cir.) (following the *Marinello* decision), reh'g denied, 597 F.2d 772 (5th Cir.), cert. denied, 444 U.S. 938 (1979); see also H.R. 5233, 102d Cong., 2d Sess. § 3(b)(2) (1992) (containing the section of the proposed Federal Fair Franchise Practices Act that prohibits terminating a franchise without good cause); *supra* note 112 and accompanying text (discussing state-imposed requirements of good cause for termination).

184. Garlick, *supra* note 173, § 3.35, at 3-21. But see Knack & Bader, *supra* note 123, at 41 (contending that a franchisor should refrain from rapid, uncontrolled market development—perhaps nationwide—in favor of efforts limited to "particular markets in which [the franchisor] can focus its resources").

185. Garlick, *supra* note 173, § 3.88, at 3-35.

186. For example, the franchisor may be barred from placing company-owned units in the same area where the franchise already operates.

187. To attract new franchisees, improve relations with existing franchisees, and head off possible lawsuits or the enactment of new federal or state franchising statutes, a few "maverick" franchisors have voluntarily revised their contracts and operating procedures to give franchisees more rights. Perhaps most notable in this regard is the unilateral decision of Great Clips, Inc., a Minneapolis franchisor of family hair salons, to grant first-refusal rights to all its franchisees as a way to fight encroachment. Jeffrey A. Tannenbaum, *Focus on Franchising: LaFalce Gains Allies in House to Halt Franchise Abuses*, WALL ST. J., July 9, 1993, at B2.

Of course, the franchisee with first-refusal rights must meet the qualifications of any applicant for the new franchise. Some franchisees have stronger territorial powers under the franchise

first-refusal rights, a court should impose "good cause" obligations upon the franchisor that, if not met, would bar the arbitrary establishment of competing businesses in the vicinity of an existing franchise.

In *Domed Stadium Hotel, Inc. v. Holiday Inns, Inc.*,<sup>188</sup> the Court of Appeals for the Fifth Circuit upheld a summary judgment in favor of a defendant-franchisor that opened a competing hotel near the plaintiff-franchisee's hotel in downtown New Orleans. The franchise agreement expressly reserved to the franchisor the right to construct and operate other Holiday Inn hotels at any place "other than on the site licensed" to the franchisee.<sup>189</sup> According to the trial and appellate courts in *Domed Stadium*, as well as courts in comparable cases,<sup>190</sup> the implied covenants of good faith and fair dealing could not overcome countervailing, *express* language in the agreement.<sup>191</sup> Yet a higher standard—"good cause"—might have prevailed. The standard would assure that franchisees have some protection from one-sided, pro-franchisor contractual provisions, which are especially troubling in light of the franchisee's weakened bargaining posture due to its sunk costs and its dependence on the franchisor for so many other services such as training, advertising, and the maintenance of overall standards throughout the system.<sup>192</sup>

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contract because they have been expressly granted some, albeit usually small, exclusive territory. *Infra* app. § B-1 (reporting that 46% of surveyed agreements grant exclusive territory to the franchisee, with a median radius of one mile; 25% expressly stated that the franchisee had no exclusive territory).

188. 732 F.2d 480 (5th Cir. 1984).

189. *Id.* at 483.

190. See, e.g., *Fickling v. Burger King Corp.*, 843 F.2d 1386 (4th Cir. 1988) (unpublished opinion discussed in *Burger King Corp. v. Weaver*, 798 F. Supp. 684, 689 (S.D. Fla. 1992)); *Biscuit Inv., Inc. v. Cajun Enters., Inc.*, No. CIV.A.89-2778, 1991 WL 42584, at \*2-5 (E.D. La. Mar. 27, 1991); *Rado-Mat Holdings, U.S., Inc. v. Holiday Inns Franchising, Inc.*, Bus. Franchise Guide (CCH) ¶ 9975 (N.Y. Sup. Ct. Dec. 17, 1991).

191. In *Scheck v. Burger King Corp.*, 756 F. Supp. 543 (S.D. Fla. 1991), the court invoked implied covenants of good faith and fair dealing to bar the franchisor's opening of nearby outlets. *Id.* at 549. While the *Scheck* franchise agreement expressly denied the franchisee any exclusive territory, *id.*, it did not contain *Domed Stadium* language granting the franchisor the right to open additional business outlets anywhere other than on the franchisee's own site. Without any expressly contradictory language in the contract, the *Scheck* court was free, unlike the *Domed Stadium* court, to find implied protections for the franchisee. See *supra* notes 134-35 for further discussion of this case.

192. Franchisees are not necessarily in a weakened bargaining position when they first agree to a contract containing territorial provisions. Potential franchisees may "shop" for the best possible investment, be it a franchise or something else. Emerson, *supra* note 1, at 1509 n.21. That, however, is not *equal bargaining power*, or anything even approximating such power. See *supra* notes 110-14 and accompanying text. Moreover, in "good cause" matters, the issue includes whether the franchisor holds a superior position over the franchisee at a later time—when the franchisor seeks to act under a particular clause in the franchise contract. The then-existing disparity in power may lead to an unjustified diminution of the "vested interest a franchisee [has built] in his business through years of effort and expenditures." *Milsen Co. v. Southland Corp.*, 454 F.2d 363, 366 (7th Cir. 1971).

## 2. Covenants Against Competition<sup>193</sup>

A franchisee's covenant not to compete must be ancillary to an otherwise lawful contract, the franchise agreement, and must be reasonable in scope.<sup>194</sup> States have adopted this common-law approach prohibiting covenants as unreasonable restraints of trade unless they are necessary to protect the covenantee, not injurious to the public, and reasonable in time, subject matter, and territory.<sup>195</sup>

If franchisors were fiduciaries for their franchisees, then any noncompetition clause most likely would be unenforceable,<sup>196</sup> a rather anomalous result given the ubiquitous nature of such provisions.<sup>197</sup> However, an accurate reading of the law on fiduciary relationships should allay the fears of franchisors; an element crucial to the establishment of a fiduciary relationship—that the noncompetition clause be incomplete or require a great deal of franchisor discretion in its enforcement—typically is not true of noncompetition clauses.<sup>198</sup> The clause is generally worded in some detail so as not

It is thus plain that a "good cause" standard would *not* bar the franchisor from exercising its contractual rights if the franchisor established a fair reason for availing itself of those rights. Actions within the contracting parties' reasonable contemplation of future appropriate franchisor behavior would meet the "good cause" test.

193. For extensive analysis of this topic, see Robert W. Emerson, *Franchising Covenants Against Competition*, 1-19 (unpublished manuscript on file with the author).

194. RESTATEMENT OF CONTRACTS § 515 cmts. b, c (1932) (stating that the ancillary covenant must be necessary to further the legitimate goals of the contract and that the concept of "reasonableness" applies to the protected interests as well as the covered activities, time, and geographic scope).

195. See, e.g., MINN. R. 2860.4400 (1992); *O.V. Marketing Assoc., Inc. v. Carter*, 766 F. Supp. 960, 965-67 (D. Kan. 1991); *Economou v. Physicians Weight Loss Ctrs.*, 756 F. Supp. 1024, 1031 (N.D. Ohio 1991); *In re KBAR, Inc.*, 96 B.R. 158, 160 (Bankr. C.D. Ill. 1988); *South Bend Consumers Club, Inc. v. United Consumers Club, Inc.*, 572 F. Supp. 209, 213 (N.D. Ind. 1983), *appeal dismissed*, 742 F.2d 392 (7th Cir. 1984); *Kutka v. Temporaries, Inc.*, 568 F. Supp. 1527, 1536 (S.D. Tex. 1983); *Gafnea v. Pasquale Food Co.*, 454 So. 2d 1366, 1368-69 (Ala. 1984); *U-Haul Co. of Central Ill. v. Hindahl*, 413 N.E.2d 187, 192 (Ill. App. Ct. 1980); *Herrington v. Hall*, 624 S.W.2d 148, 151 (Mo. Ct. App. 1981); see also FLA. STAT. § 542.33 (1993) (regulating covenants concerning the sale of a business's goodwill, licensing of trademarks, or dissolution of a partnership); MICH. COMP. LAWS § 445.774a (1989) (dealing with covenants by employees); N.D. CENT. CODE § 9-08-06 (1987) (concerning the sale of a business's goodwill or the dissolution of a partnership); TEX. BUS. & COM. CODE ANN. § 15.50-.51 (Supp. 1994) (addressing the enforceability of a covenant against competition); WIS. STAT. ANN. § 103.465 (1988) (governing covenants by an employee); RESTATEMENT (SECOND) OF CONTRACTS § 188 & cmt. d (1981) (discussing covenants against competition generally).

196. RESTATEMENT (SECOND) OF CONTRACTS § 193 & cmt. a (1981).

197. *Infra* app. § B-2 (reporting that 98% of surveyed contracts contain noncompetition clauses).

198. For instance, the noncompetition clause in the Carvel Retail Manufacturer's License Agreement is typical of most such franchise agreement provisions, both in its scope and specificity:

To prevent dilution of the exclusivity of the valuable Carvel know-how and Carvel trade secrets to be acquired by Licensee [franchisee] hereunder, it is agreed as part of the consideration to, and inducement for, Carvel entering into this Agreement, that in the

to be vague or otherwise "unreasonable."<sup>199</sup> Moreover, another fiduciary element—similarity of interest—is definitely absent from noncompetition clauses; there is a direct conflict between the franchisor's interests in protecting its "property" after a franchise is terminated<sup>200</sup> and the franchisee's interest in maintaining its ability to earn a livelihood.<sup>201</sup>

A dilemma remains, however. Judging the covenant's "reasonableness" requires examination of two seemingly polar principles: freedom to contract, even to contract away certain rights, and an individual's freedom to work.<sup>202</sup> Public policy demands close scrutiny of these covenants because the franchisees may have severely limited their opportunities to work via a lengthy, complex, and confusing contracting process in which the

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event Licensee sells the Carvel store or abandons the Carvel Store provided for in this Agreement, or in the event

this Agreement expires, or is terminated for any reason except for Carvel's breach, then for a period of three (3) years next following such event Licensee shall not directly or indirectly engage in whole or in part in the production, distribution or sale of ice cream or other frozen desserts whether as a proprietor, employee, officer, director, agent, joint venturer, partner, or other capacity whatsoever, at the location of the within Carvel Store or, within a radius of two (2) miles of the site of the within Carvel Store. The provisions of this Paragraph shall survive expiration, termination, abandonment or other cancellation of this Agreement.

Carvel Retail Manufacturer's License Agreement, June 30, 1992, at 17, para. 31 (on file with the *North Carolina Law Review*).

199. See *supra* note 198. The same Carvel clause, with extremely minor differences in wording, was enforced against a former Carvel franchisee in *Carvel Corp. v. Eisenberg*, 692 F. Supp. 182, 186 (S.D.N.Y. 1988).

200. The protected franchisor property interests may include customer contacts. See, e.g., *Gold v. Holiday Rent-A-Car Int'l, Inc.*, 627 F. Supp. 280, 282 (W.D. Mo. 1985) (holding that a franchisee's competition with its former franchisor included diversion of potential customers and thus affected the franchisor's legitimate, protectable interests); *South Bend Consumers Club, Inc. v. United Consumers Club, Inc.*, 572 F. Supp. 209, 213 (N.D. Ind. 1983) (upholding a two-year post-term restraint as reasonably necessary to protect customer relationships with the franchisor); *McCart v. H & R Block, Inc.*, 470 N.E.2d 756, 763 (Ind. Ct. App. 1984) (finding that a franchisor has a protectible interest in the goodwill relationship developed with the franchisee's customers); *Budget Rent-A-Car of Washington, Inc. v. Raab*, 302 A.2d 11, 13-14 (Md. App. 1973) (refusing to apply a covenant against an ex-franchisee because, in part, there were no private customer lists or personal contact with customers for the former franchisee to exploit); *Herrington v. Hall*, 624 S.W.2d 148, 152 (Mo. Ct. App. 1981) (noting that customers and goodwill are legitimate interests for a franchisor to protect via a noncompetition covenant).

201. Some courts expressly provide that a noncompetition covenant must not impose undue hardship on the covenantor. C.T. Drechsler, Annotation, *Enforceability of Covenant Against Competition, Ancillary to Sale or Other Transfer of Business, Practice, or Property, as Affected by Territorial Extent of Restriction*, 46 A.L.R.2d 119, 204 (1956). Other courts, while mentioning that covenants can be enforced only after balancing the parties' interests, nonetheless appear to ignore the degree of hardship on the covenantor. See, e.g., *Schnucks Twenty-Five, Inc. v. Betten-dorf*, 595 S.W.2d 279 (Mo. Ct. App. 1980).

202. Drechsler, *supra* note 201, at 200.

other side arguably holds grossly superior bargaining power.<sup>203</sup> Requiring "good cause" for enforcement should not obstruct a franchisor's legitimate interest in avoiding unfair competition. It could, however, prevent former franchisees' from being barred from the productive use of their talents without some showing that the franchisor genuinely needs such a restraint.

### 3. Franchise Transfers and Franchisor Assignments

Occasionally franchisees wish to transfer their franchises to other parties. Almost all franchise agreements grant the franchisor a right of first refusal on the franchisee's proposed transfer,<sup>204</sup> as well as the right to deny any transfer.<sup>205</sup> Courts have generally upheld these provisions.<sup>206</sup>

Some transfers are involuntary in that the franchisee dies and passes the franchise on to the heirs. An overwhelming number of franchise agreements allow transfer by inheritance so long as the heirs meet the standard franchise agreement terms, but most clauses bar transfers unless the franchisor approves the heirs.<sup>207</sup> When such approval is required, the parties' interests may be adverse. Although there may be many acceptable reasons for a franchisor to decide not to permit a transfer, the need for the franchisor to show "good cause" would probably eliminate the most opportunistic reasons and provide some sense of security for the franchisee.

Other franchise transfers are voluntary. For instance, the franchisee may wish to retire or to pursue another career. The inability to effectuate a transfer leaves the franchisee with sunk costs and an inability to recover its investment. While franchisors certainly have a right to expect that the franchisee, or the franchisee's assigns, will comply with the franchise agreement, absolute franchisor discretion to deny a transfer subjects the franchisee to potential abuse. Requiring the franchisor to demonstrate "good cause" in denying a transfer would offset the imbalance in power between the franchisor and franchisee.

The same reasoning supports a "good cause" approach to the franchisor's ability to assign the contract to a new party. Many franchise agreements include clauses stating that the agreement is freely transferable

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203. Hadfield, *supra* note 57, at 963 (describing the franchising relationship as a "highly intimate and interdependent" relationship "between unequals"); *see also supra* notes 114, 192 (discussing the relative bargaining positions of franchisees and franchisors).

204. *Infra* app. § B-3-a-1 (95% of surveyed contracts).

205. *Infra* app. § B-3-a-2 (93% of surveyed contracts).

206. *See, e.g.,* C.L. Thompson Co., Inc. v. Festo Corp., 708 F. Supp. 221, 227 (E.D. Wis. 1989) (upholding a franchise termination because the franchisee tried to transfer the franchise without the franchisor's consent).

207. *Infra* app. § B-3-a-3 (reporting that 89% of surveyed contracts expressly permit some form of transfer by inheritance, with 60% specifically providing that the franchisor must approve the heirs).

by the franchisor,<sup>208</sup> while almost all deny any such right to the franchisee.<sup>209</sup>

#### 4. Franchise Terminations and Nonrenewals

Most franchise agreements contain a statement that any violation of the agreement is considered a material breach.<sup>210</sup> With the considerable discretion afforded franchisors under most franchise agreements, franchises are subject to termination by franchisors for all sorts of violations, even ones that would—absent the contractual clause about materiality—constitute de minimis breach.<sup>211</sup> The same problem exists for franchisor decisions about franchise renewals and leases.<sup>212</sup> While franchise agreements frequently contain clauses about renewal or lease approval, they rarely outline the grounds for granting or denying renewal or for lease approval;<sup>213</sup> thus, the franchisor may have unbridled discretion in this area.

To counter this problem, the parties should specify in the franchise agreement which breaches are truly material. Almost every agreement will list some particular grounds for termination.<sup>214</sup> The author's survey of one hundred fast-food, ice cream, and restaurant franchise systems reveals that the following grounds are often specified: franchisee's insolvency and/or bankruptcy,<sup>215</sup> loss of lease,<sup>216</sup> failure to operate the business,<sup>217</sup> conducting

208. *Infra* app. § B-3-b-1 (66%).

209. *See supra* note 205.

210. *Infra* app. § B-4-a (87%); *see also* Hadfield, *supra* note 57, at 940 (discussing typical franchise clauses).

211. Conversely, relatively few franchise agreements expressly permit franchisees to terminate the franchise relationship, and these few limit termination rights to a few extreme cases of significant contractual breaches by the franchisor. *Infra* app. § B-4-b (14%). Even then, franchisees must give notice, usually some 30 to 90 days ahead of time. *Infra* app. § B-4-b.

212. Franchise renewals and lease approvals are similar in that, by the time these decisions are made by the franchisor, the franchisee may have invested substantial money, effort, and time and, often, have developed considerable goodwill in the business. To deny a franchise renewal or a lease approval without any reasonable justification seems unconscionable; as with terminations during the term of a franchise agreement, the decision to reject a renewal or a lease should require a showing of "good cause."

213. *Infra* app. § B-4-c to B-4-f (including, at § B-4-e, that 38% of the surveyed contracts vest the option to renew entirely with the franchisor, and, at § B-4-f, that 21% specifically require franchisor approval of the franchisee's lease). That the renewal provisions generally are less detailed than the termination clauses may prove especially troubling because a decision against renewal appears more likely than one to terminate during the term of a franchise. *See* HAROLD BROWN, FRANCHISING: REALITIES AND REMEDIES § 2.03[2] (1993) (concluding that "[t]he franchisor's right not to renew is more important, although not so immediate to the franchisee, than the franchisor's right to terminate"); HAROLD BROWN, FRANCHISING: REALITIES AND REMEDIES FORMS VOLUME § 2.02, at 2-23 to 2-24, 2-26 to 2-27 (1991).

214. *Infra* app. § B-4-g (100% of surveyed contracts).

215. *Infra* app. § B-4-g-1 (91%).

216. *Infra* app. § B-4-g-2 (72%).

217. *Infra* app. § B-4-g-3 (65%).

an unlawful enterprise,<sup>218</sup> being found guilty of a crime,<sup>219</sup> abandonment of the business,<sup>220</sup> or denial of franchisor access to inspect the franchised business.<sup>221</sup>

Even without such specificity in the termination clause, grounds clearly exist for termination when a breach not only threatens the viability of the franchisee's business but has, or threatens to have, an impact upon the entire franchised system. For example, in *Dayan v. McDonald's Corp.*,<sup>222</sup> the franchisor had good cause to terminate regardless of contractual specificity because the franchisee had failed to maintain quality, service, and cleanliness standards.<sup>223</sup> Such basic problems do not merely affect the individual franchisee's business in terms of lost customers, problems with governmental regulators, and possible lawsuits; rather, any continuous, serious problem with one franchise may impact the business for other franchises. Lost goodwill can extend beyond the local franchise to the entire system.<sup>224</sup> Furthermore, if nothing happens to the substandard fran-

218. *Infra* app. § B-4-g-4 (32%).

219. *Infra* app. § B-4-g-5 (32%).

220. *Infra* app. § B-4-g-6 (13%).

221. *Infra* app. § B-4-g-7 (9%).

222. 466 N.E.2d 958 (Ill. App. Ct. 1984).

223. *Id.* at 975.

224. Economists have warned that the threat of *free-riding* is greatest with business format franchises. Free-riding has been explained as follows:

Because the quality information [about products distributed via a franchised system] applies to groups of franchisees using a common name, there is a free-riding problem. If each franchisee supplies inputs that significantly influence the quality of the product marketed, and consumers cannot detect the quality of the product before they purchase it, then each franchisee will have the incentive to cut costs and supply less than the desired level of product quality. Because the product is standardized, consumers who receive products of less than anticipated quality will blame the entire group of retailers using the common name. The individual franchisee directly benefits from the sales of the lower-quality product, and the other franchisees share in the losses caused by decreased future demand.

Benjamin Klein & Lester F. Saft, *The Law and Economics of Franchise Tying Contracts*, 28 J.L. & ECON. 345, 349-50 (1985) (citation omitted); see also Richard E. Caves & William F. Murphy, *Franchising: Firms, Markets, and Intangible Assets*, 42 S. ECON. J. 572, 577 (1976) (arguing for the tying of franchisor products to the grant of a franchise as an effective method for deterring franchisee opportunistic behavior); J. Thomas McCarthy, *Trademark Franchising and Antitrust: The Trouble With Tie-Ins*, 58 CAL. L. REV. 1085, 1118 (1970) (discussing tying arrangements); Kurt Strasser, *Big Macs and Radio Shacks: Antitrust Policy for Business Format Franchises*, 27 ARIZ. L. REV. 341, 344, 351 (1985) (same); Note, *A Clarification and Reformulation of Prevailing Approaches to Product Separability in Franchise Tie-In Sales*, 67 MINN. L. REV. 1165, 1175 n.49 (1983) (The free-rider principle states that "[a]ny customer dissatisfied with an individual franchise will associate his or her dissatisfaction with all of the franchises. The low quality individual franchisee, however, can still rely on the quality of all other franchises to maintain the public perception of its quality."); Comment, *A New Approach to the Legality of Franchising Tie-Ins*, 129 U. PA. L. REV. 1267, 1296 n.180 (1981) ("In a system of franchised retail or distribution outlets, each franchisee has an incentive to reduce the quality of service he provides below the optimal level, because the level of patronage he receives is determined by the reputation of the

chisee, other franchisees may conclude that they can reduce their costs, albeit at the expense of quality, with little risk of franchisor retaliation. In such cases, the franchisor should be able to take immediate, strong measures, including perhaps termination.<sup>225</sup>

A "good cause" standard with regard to breach thus appears to impose no additional burdens on the franchisor besides those expressly or implicitly found in the contract itself. If challenged, the franchisor should have little difficulty in proving "good cause" for cases of material breach. Rather, the "good cause" requirement affords some protection to the franchisees from opportunistic franchisors that wish to usurp economic benefits established at the risk and expense of a threatened or terminated franchisee. Most franchisors seem to recognize this point; they generally do not permit termination, except for good cause, until after the expiration of a grace period for franchisees to correct a breach of the franchise agreement.<sup>226</sup>

Without some limits on the franchisor's power to terminate franchises—whether grace periods or "good cause" standards—the franchisor simply has too much control over the franchisee's business life. A prime example of the franchisor's capacity to abuse its powers of termination is presented in *Corenswet, Inc. v. Amana Refrigeration, Inc.*<sup>227</sup> In *Corenswet*, a franchise for the distribution of major appliances was subject to termination "at any time for any reason" upon ten days' notice to the other party.<sup>228</sup> The franchisee, Corenswet, spent considerable time, effort,

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enterprise as a whole as well as the reputation of his individual operation. Each franchisee thus has an incentive to 'free ride' on the goodwill associated with the trademark.").

Free-riding is potentially most severe at locations (e.g., along an interstate highway) where the probability of repeat sales to that same customer is quite low. *Klein & Saft, supra*, at 350 n.20. Courts have recognized this problem, *see, e.g., Kentucky Fried Chicken Corp. v. Diversified Packaging Corp.*, 549 F.2d 368, 380 (1977), but refuse to adopt an expansive view of free-riding that might undermine the purposes of the antitrust laws, *see, e.g., Eastman Kodak Co. v. Image Technical Servs., Inc.*, 112 S. Ct. 2072, 2092 (1992) (refusing to accept defendant Kodak's arguments that plaintiffs, who repaired office equipment, were free-riders because they failed to enter the equipment and parts market; to do so, the court held, would support the very evil proscribed by the antitrust laws—entry barriers—by requiring competitors to enter two markets simultaneously).

225. *Infra* app. §§ B-4-i to k (reporting that 60% of the surveyed contracts explicitly provide that the franchisee will immediately cease operations upon the franchise's termination, 54% extend to the franchisor an option to purchase the terminated franchise's equipment, and 11% expressly give the franchisor a right to purchase the entire franchised business upon termination).

226. *Infra* app. § B-4-h (88% of the surveyed contracts, with a median grace period of 30 days). Another interpretation would be that franchisees have some leverage, not that franchisors simply recognize the grace period implications arising out of a "good cause" standard. This alternative viewpoint is as follows: The franchisee's power to insist on a grace period results from a statutory and case law trend toward providing greater franchisee protection from arbitrary termination.

227. 594 F.2d 129, 131-33 (5th Cir.), *cert. denied*, 444 U.S. 938 (1979).

228. *Id.* at 132. The franchise was of indefinite duration, and originally the termination clause read "with or without cause" instead of "for any reason." *Id.* at 131.



and money on the franchise,<sup>229</sup> and thereby greatly enlarged the franchisor's market coverage.<sup>230</sup> Nonetheless, despite Corenswet's compliance with every franchisor request concerning Corenswet's financial security, the franchisor terminated the franchise on the grounds that Corenswet was underfinanced.<sup>231</sup>

Franchisor Amana had begun negotiating with another entity long before Corenswet was notified of termination.<sup>232</sup> The trial court concluded that the real reason for the termination was not finances, but franchisor animosity toward the president of the franchisee's parent company.<sup>233</sup> While unprepared to require a good cause limitation on terminations "for any reason," the trial court required *some* reason for the franchisor's actions. The trial court thus issued a preliminary injunction against the termination.<sup>234</sup>

The Court of Appeals for the Fifth Circuit overturned the trial court's decision.<sup>235</sup> It found no support for implying a term barring termination without cause when the franchise agreement expressly allowed such terminations.<sup>236</sup> One wonders, though, why it is an undue burden on franchisors to have some objectively reasonable basis for terminating or failing to renew a long-term franchise in which the franchisee has invested so much work and money.<sup>237</sup> Indeed, numerous legislatures have enacted laws against franchise termination or nonrenewal except for "good cause."<sup>238</sup>

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229. Corenswet spent more than \$1.5 million during the course of the franchise relationship. *Id.* at 132.

230. *Id.*

231. *Id.*

232. *Id.* at 133.

233. *Id.*

234. *Id.*

235. *Id.* at 131.

236. *Id.* at 138. The appellate court expressed its strong doubts that public policy "frowns on any and all contract clauses permitting termination without cause." *Id.*

237. Courts generally have declined to adopt a "good cause" requirement for franchise terminations in the face of express contractual provisions allowing a termination. *See* Pennington's, Inc. v. Brown-Forman Corp., Bus. Franchise Guide (CCH) ¶ 10,022, at 23,267 & n.3 (D. Mont. Dec. 2, 1991). However, they might accept arguments of unconscionability to overturn such an express clause. *Id.* at 23,268 (citing *DeTraville v. Outboard Marine Corp.*, 439 F.2d 1099 (4th Cir. 1971), for the proposition that a contract provision giving the franchisor a right to terminate without cause on 30 days' notice was barred as contrary to equity and good conscience).

238. *Supra* note 112 and accompanying text.

## 5. Miscellaneous Provisions

Franchise contracts often include clauses that concern prices;<sup>239</sup> require purchases from the franchisor or approved suppliers;<sup>240</sup> impose mandatory minimal hours of operation and full-time participation of the franchisee;<sup>241</sup> require franchisor approval of and specifications for the franchised business manager and other employees;<sup>242</sup> grant the franchisor rights to inspect the franchisee's business operations<sup>243</sup> and conduct internal audits;<sup>244</sup> and permit the franchisor to waive franchisee breaches.<sup>245</sup> Courts should scrutinize these clauses more carefully than they would under simple contract law. Courts should ask whether "good cause" existed for the franchisor to impose and enforce this condition upon the franchisee. For example, if customer "traffic" does not justify keeping a franchised outlet open twenty-four hours a day, a franchisor who requires those hours appears to lack "good cause."<sup>246</sup> The same holds true if a franchisor is unable to "back up" a requirement by providing the supplies, training, or other

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239. *Infra* app. § B-5-a-1 (stating that although no surveyed contracts place price restrictions on items sold by the franchisee, nine percent provide that the franchisor might advise the franchisee about pricing).

240. *Infra* app. § B-5-a-2 to a-4 (reporting that 84% of surveyed agreements require franchisee purchases from the franchisor or franchisor-approved vendors).

241. *Infra* app. § B-5-b (reporting that 44% of surveyed contracts provide for specified hours of operation by the franchised outlet; 30% require that franchisees work full-time for the franchised business, and 5% mandate that the franchisee work at least 15 to 20 hours per week at the franchised business).

242. *Infra* app. § B-5-c (reporting that 30% of surveyed contracts provide that the franchisor has a right of approval over the franchised business' manager, and 56% state franchisor specifications about the franchisee's employees).

243. *Infra* app. § B-5-d (91% of surveyed contracts).

244. *Infra* app. § B-5-e (90% of surveyed contracts).

245. *Infra* app. § B-5-f (reporting that 87% of surveyed contracts provide that there is no franchisor waiver of franchisee default). Franchisors must be aware of the potential for a waiver whenever they try to "work with" a franchisee rather than simply enforce a contractual requirement. See Stephen Horn & Robert L. Zisk, *Practical Considerations in Enforcing Standards*, 12 FRANCHISE L.J. 97, 118 (1993) (citing *Frisch's Restaurants, Inc. v. Elby's Big Boy of Steubenville, Inc.*, 670 F.2d 642, 651 (6th Cir.), cert. denied, 459 U.S. 916 (1982)). Because some states prohibit discrimination against similarly situated franchisees, either in a franchise contract's terms or in the enforcement of those terms, a "waiver" for one franchisee may result in a "waiver" for all. Horn & Zisk, *supra*, at 118; see also *supra* notes 160, 163-65 and accompanying text (discussing franchisor discrimination against franchisees). Perhaps the problem can be solved by: (1) a franchisor's sending "new day" notices informing all of its franchisees that from that point on, the heretofore waived contractual standards will be enforced, and (2) when the first new violation occurs, a franchisor's quickly responding to force compliance or obtain other remedies. Horn & Zisk, *supra*, at 120.

246. Franchisors may argue that the need for franchise uniformity creates a "good cause," especially if 24-hour service is part of the system's image.

support the franchisee needs.<sup>247</sup> In all of these cases, the franchisor wields considerable discretionary power and the franchisee reasonably expects the franchisor not to abuse its power. Imposing a "good cause" standard on the interpretation of these provisions not only acts as a safeguard against possible franchisor opportunism but is also consistent with law and policy trends in many states.<sup>248</sup>

*D. "Arm's Length" Clauses: Applying No More Than the General, Implied Covenant of Good Faith and Fair Dealing*

The common law imposes on the parties an implied obligation of good faith and fair dealing in the performance and enforcement of a contract.<sup>249</sup> The duty of good faith and fair dealing limits either party's use of discretionary powers or other advantages over the other party, but this implied limit may be contradicted—and, in effect, overturned—by a directly contravening express term in the contract.<sup>250</sup>

Under "ordinary" contract principles a court may, in evaluating the parties' good faith, consider their subjective intent. The concept of good faith naturally encompasses the manner in which parties actually have used the powers created by their agreement, not simply the parties' relative strength, as is often the focus of fiduciary analysis. The burden, in effect, remains on a plaintiff-franchisee to demonstrate that a franchisor's actions were in bad faith.

Certain clauses are constant and do not invite the degree of franchisor discretion as do the clauses requiring a fiduciary relationship or "good cause".<sup>251</sup> These "constant," common-law contract clauses usually involve terms fixed or otherwise determinable at the outset of the agreement and are not subject to later negotiations and possible franchisor "power plays." Although franchisors and franchisees may never have truly equal bargaining power,<sup>252</sup> these clauses are agreed on before the franchisee spends its

247. In *Arnott v. American Oil Co.*, 609 F.2d 873, 881 (8th Cir. 1979), *cert. denied*, 446 U.S. 918 (1980), the franchisee was allowed to ignore a 24 hours-per-day provision because the franchisor could not supply sufficient petroleum products to sustain that many operating hours.

248. For articles citing and discussing the numerous franchise relationship laws states have enacted, including numerous "good cause" laws, see Emerson, *supra* note 1, *passim*; Pitegoff, *supra* note 16, *passim*.

249. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

250. That is, the implied terms of good faith and fair dealing disappear because the express term supersedes them.

251. See *supra* notes 121-248 and accompanying text.

252. See generally Harold Brown, *Franchising: Punitive Damages and Contractual Arbitration*, N.Y. L.J., Jan. 28, 1993, at 3, 29 (discussing adhesion contracts, an absence of equal bargaining power, and the unfair provisions that "overbearing" franchisors include in their contracts against the franchisees' interests); Robert L. Purvin, Jr., *Comments on Proposed Federal Regulation of Franchising*, 12 FRANCHISE L.J. 12, 12 (1992) (noting attorney Purvin's Congressional

capital and otherwise incurs substantial costs. Other clauses may appear to have been agreed upon at a similarly early date, but they are—through the discretionary powers vested in the franchisor and by the very nature of such clauses—much more susceptible to franchisor manipulation throughout the life of a franchise agreement. Also, for many of these other clauses—concerning such topics as site selection, training, renewals, and operating procedures—the franchisee may reasonably believe (and even be led by the franchisor to believe) that its interests and those of the franchisor coincide or are at least similar. By contrast, under the common-law contract clauses each party's interests manifestly are adverse.<sup>253</sup>

When negotiating these fixed, common-law contract provisions, the franchisee presumably realizes that they involve franchisor interests completely different from its own interests. Thus, the franchisee has the chance to reject the franchisor's offer as unfair or one-sided before the franchisee's own investment in the enterprise leaves it at a disadvantage.<sup>254</sup> The parties should be allowed to negotiate these provisions freely, with an expectation that—should the matter be litigated—a court will consider this portion of the contracting process as negotiated at arm's length.

### 1. Royalties and Other Franchise Fees

Other than the initial franchise fee, which is generally a set amount ranging from a few thousand dollars to tens of thousands of dollars,<sup>255</sup> royalties and other franchise fees are usually a percentage of gross sales.<sup>256</sup> The percentage is fixed in the initial franchise agreement. Before potential franchisees spend substantial capital, they can decide whether the fee structure is acceptable. Because the rates are part of a system-wide fee scale,

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committee testimony that he "had never written or read a franchise agreement that [he] would recommend a franchisee sign").

253. For example, the franchisee wants to pay the lowest royalty possible, while the franchisor wants to receive the highest royalty possible.

254. Even commentators sympathetic to franchisee claims of franchisor abuse have recognized that the potential franchisee generally faces less pressure than the existing franchisee. *See, e.g.,* Emerson, *supra* note 1, at 1509 n.21 (discussing the inequity of many franchise agreements, but noting that potential franchisees tend to "shop" for the best franchise available); Hadfield, *supra* note 57, at 951-55 (explaining that franchisors can indulge in opportunistic behavior once the parties have entered into a franchise agreement, but not when they are still negotiating the agreement).

255. *Infra* app. § C-1-a (finding that 100% of surveyed contracts include an initial franchise fee, at a median amount of \$20,000).

256. *Infra* app. §§ C-1-b to -c (reporting that 100% of surveyed contracts include royalty fees, at a median amount of five percent of gross sales; 12% of the contracts specify a minimum amount to be paid regardless of gross sales, at a median amount of \$500 per month). Special fees, usually for a fixed amount, include: a renewal fee (23% of the surveyed agreements at a median amount of \$3,000), a relocation of franchise fee (11% of the surveyed agreements at a median amount of \$3,500), and a transfer fee for shifting the franchise to a new franchisee (78% of the surveyed agreements at a median amount of \$5,000). *Infra* app. § C-1-d to -f.

franchisors effectively have little, if any, discretion to alter the rates for one party. Also, information about fees, including royalties, is widely available from "how-to" books<sup>257</sup> and offering circulars<sup>258</sup> long before a potential franchisee may see a sample franchise agreement.

## 2. Franchise Time Periods, Arbitration and Venue Stipulations, and Insurance Requirements<sup>259</sup>

Franchise time periods, arbitration and venue stipulations, and insurance requirements typically are rather straightforward provisions. Franchisees would have difficulty arguing that these clauses, while drafted by the franchisor, were meant to be in the franchisees' best interests.<sup>260</sup> The plain meaning of these clauses controls over any argument about franchisor bargaining power generally.<sup>261</sup> Moreover, these clauses are definite and complete.<sup>262</sup> They neither require flexibility in interpretation or enforcement, nor do they call for an inquiry into the parties' subjective intent or expecta-

257. *E.g.*, ROBERT L. PERRY, *THE 50 BEST LOW-INVESTMENT, HIGH-PROFIT FRANCHISES* (1990); *Companies Offering Franchises*, *FRANCHISE HANDBOOK*, Spring 1994, at 45-211.

258. This information is required by both the FTC Rule, 16 C.F.R. §§ 436.1-436.3 (1992), and by the Uniform Franchise Offering Circular Guidelines adopted by a number of states. *See* Emerson, *supra* note 1, at 1512-13 & nn.34-36.

259. *Infra* app. § C-2.

260. In other words, these clauses would not qualify for interpretation under a franchisor-as-fiduciary test.

261. For instance, courts typically experience little difficulty enforcing an arbitration clause against a franchisee. They tend to ignore the alleged disparities of power between franchisor and franchisee and instead resolve any doubts about the scope of arbitrable issues in favor of arbitration. *See* Kroll v. Doctor's Assocs., Inc., Bus. Franchise Guide (CCH) ¶ 10,122, at 23,867-68 (W.D. Wis. Oct. 23, 1992) (reviewing the claims of a terminated franchisee and finding that the duty to arbitrate those claims "survive[d] the termination of a [franchise] contract").

262. The following are sample clauses.

### *Time Period*

CBC grants to FRANCHISEE AND FRANCHISEE accepts a franchise for a period of Twenty (20) years to use the CBC Systems and the CBC Marks only in the operation of a Casey's Beef Cafe ("Franchised Restaurant") at — more fully described in Exhibit 'A' ("premises"). The term of this Agreement shall commence on the date the Franchised Restaurant opens for business (the "Commencement Date") and shall expire Twenty (20) years thereafter (the "Term") unless sooner terminated in accordance with the provisions of this Agreement. FRANCHISEE agrees to operate the Franchised Restaurant at the specified location for the entire Twenty (20) year Term. FRANCHISEE accepts this franchise with the full and complete understanding that the franchise grant contains no promise or assurance of renewal.

BROWN, *supra* note 213, § 8.01, at 8-4.

### *Arbitration*

Except as otherwise provided herein, any controversy or claim regarding one or more of the following matters shall be settled by arbitration in accordance with the Commercial Arbitration Rules of the American Arbitration Association: (1) Restrictions on or designation of sources of supply for any food, products or equipment used by franchisees; (2) Compliance with franchisor's minimum standards of design, quality, or appearance for franchisees; (3) Geographical definition of franchisee's exclusive territory; (4)

tions; thus, these clauses do not meet the good cause standard. When dealing with these clauses, there simply is no empiric or policy basis for holding franchisors to a higher standard than that imposed under ordinary contract law. If any disputes arise under these clauses, implied covenants and general rules of construction<sup>263</sup> should provide authority for resolving these disagreements.

### 3. Declarations About the Ownership of Intellectual Property

Generally, franchising concepts can develop into a franchise system only via the licensing of trademarks or other intellectual property.<sup>264</sup> The franchisee's trademark license often is the heart of its franchise. Contractual clauses concerning intellectual property are quite commonplace, and are, in fact, rather routine in wording and operation. In essence, these clauses remind the franchisee of the obvious: that the franchisor owns the intellectual property that it licenses the franchisee to use,<sup>265</sup> that this property's use is restricted to purposes related to the maintenance of the

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Compliance with restrictive covenants; or (5) Payment of royalties or advertising contributions.

*Id.* § 8.01, at 8-59 to 8-60.

#### *Venue*

Any cause of action, claim, suit or demand allegedly arising from or related to the terms of this Agreement or the relationship of the parties shall be brought in the Federal Court for the District of Minnesota or in Hennepin County District Court, Fourth Judicial District, Minneapolis, Minnesota.

Dairy Queen Operating Agreement, February 1992, at 27-28, Section 14, para. H.

#### *Insurance*

FRANCHISEE agrees to carry at his expense during the Term of this Agreement Comprehensive General Liability insurance, including Products Liability and Broad Form Contractual Liability, in an amount of not less than ONE MILLION (\$1,000,000) DOLLARS per occurrence for bodily injury and FIVE HUNDRED THOUSAND (\$500,000) DOLLARS per occurrence for property damage, or in such increased amounts as [the franchisor] may reasonably request from time to time during the Term of this Agreement. Each policy will name [the franchisor] as additional insureds, will provide that the policy cannot be canceled without Thirty (30) days prior written notice to [the franchisor], and shall insure the contractual liability of FRANCHISEE [as specified in another section of the Agreement]. Prior to the Commencement Date, FRANCHISEE shall furnish to [the franchisor] a Certificate of Insurance reflecting that the insurance coverage is in effect. All policies shall be renewed, and a renewal Certificate of Insurance mailed to [the franchisor] prior to the expiration date of the policies.

BROWN, *supra* note 213, § 8.01, at 8-34.

263. For example, most courts construe ambiguous, written terms in favor of the party not responsible for drafting the agreement. RESTATEMENT (SECOND) OF CONTRACTS § 206 (1981) (stating the general rule that when a term or promise has several possible meanings, it will be interpreted against the party who supplied the contract or the term).

264. See *supra* note 1 for a definition of franchising.

265. See, e.g., *infra* app. § C-3-a (90% of surveyed contracts).

franchised business,<sup>266</sup> and that—on the franchise's termination—all of the property rights remain with the franchisor.<sup>267</sup>

These intellectual property clauses tend to involve terms fixed or otherwise determinable at the outset of the agreement and are not subject to later negotiations. As with franchise fees, the intellectual property clauses generally must be uniform throughout the system, and franchisors effectively have little if any discretion to alter them for a particular franchisee. These clauses are definite and complete.<sup>268</sup> Unlike the good cause or fiduciary clauses, they neither necessitate franchisor flexibility in interpretation or enforcement nor require any analysis other than a review of the plain meaning of the contractual language.<sup>269</sup>

#### 4. Declarations About the Franchisee's Review of the Franchise Contract Before Signing It

A number of statements found in franchise agreements essentially serve as documentary evidence that the franchisee was apprised of certain information and that it obtained the independent advice necessary to evalu-

266. See, e.g., *infra* app. § C-3-b (reporting that 95% of surveyed contracts contain trademark restrictions).

267. *Infra* app. § C-3-c (78% of surveyed contracts).

268. The following is a sample clause covering trademarks, trade names, service marks, and trade secrets:

FRANCHISEE acknowledges that ownership of all right, title and interest to the CBC System and the CBC Marks, are and shall remain vested solely in CBC [the franchisor], and FRANCHISEE disclaims any right or interest therein or the goodwill derived therefrom. FRANCHISEE agrees that all materials loaned or otherwise made available to him and all disclosures made to FRANCHISEE and not to the general public by or at the direction of CBC at any time before or during the Term of this Agreement relating to the CBC System, including, without limitation, the Manual in its entirety, financial information, marketing strategy and marketing programs are to be considered trade secrets of CBC for purposes of this Agreement and shall be kept confidential and used by FRANCHISEE only in connection with the operation of the Franchised Restaurant and other franchised [CBC] Restaurants. FRANCHISEE agrees not to divulge any of the trade secrets to any person other than his employees and then only to the extent necessary for the operation of the Franchised Restaurant and, specifically, that FRANCHISEE will not, nor permit anyone to, reproduce, copy or exhibit any portion of the Manual or any other trade secrets of CBC. [FRANCHISEE shall not] cause to be done any act or thing disputing, attacking or in any way impairing or tending to impair CBC's right, title or interest in the CBC Marks of the CBC System. FRANCHISEE shall immediately notify CBC of all infringements or limitations of the CBC Marks which come to his attention or challenges to FRANCHISEE's use of any of the CBC Marks.

BROWN, *supra* note 213, § 8.01, at 8-30 to 8-31.

269. The only intellectual property concept that may require a higher standard of franchisor care involves the franchisee's work product. See *infra* app. § C-3-d (reporting that 3% of surveyed contracts expressly state that all franchisee concepts become the franchisor's exclusive property). The general problem of fraud, ignorance, or the like masking the true value of the intellectual property is distinct and has no effect on the need for trademarks themselves to be accorded better protection.

ate the proposed franchising arrangement. These provisions often include statements that the franchisee was advised to obtain legal counsel concerning the franchise contract<sup>270</sup> and that the franchisee, in fact, obtained advice from independent legal, accounting, and other advisors prior to signing the franchise agreement.<sup>271</sup> The vast majority of contracts surveyed by the author contain the following provisions: (1) a statement that the franchisee has received no guarantees, representations, warranties or the like as to the profitability of the franchise being purchased, and that the franchisee has conducted its own independent investigation of the merits of its investment;<sup>272</sup> (2) a proviso that the franchisee is an independent contractor rather than an agent of the franchisor;<sup>273</sup> and (3) a merger clause, for purposes of the parol evidence rule.<sup>274</sup> Again, these straightforward clauses are complete, definite, and call for no discretionary judgments on the part of the franchisor. They should be judged by the ordinary principles of contract law.<sup>275</sup>

#### IV. IMPLEMENTATION

Courts should consider two issues when analyzing the franchising relationship. First, courts should consider the type of relationship that applies to the particular clause in question. The nature of the franchise relationship should depend on the clause at issue. Some clauses require a fiduciary relationship, while others are best suited to a contractual analysis bolstered by the affirmative obligation to show good cause for the action taken; still other clauses should be analyzed according to common-law contract principles—including the implied covenants of good faith and fair dealing—but nothing more.<sup>276</sup> Second, the court should ask what the particular relation-

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270. *Infra* app. § C-4-a (25% of surveyed agreements). Seven percent of the agreements also include the declaration that the franchisee had the opportunity to obtain clarification about any aspects of the proposed franchise. *Id.* § C-4-b.

271. *Infra* app. § C-4-c (14% of surveyed contracts).

272. *Infra* app. § C-4-d (85%).

273. *Infra* app. § C-5 (91%).

274. *Infra* app. § C-7 (79%). An "integrated agreement" is a writing that constitutes "a final expression of one or more terms of an agreement." *RESTATEMENT (SECOND) OF CONTRACTS* § 209(1) (1981). Under the parol evidence rule, the effect is as follows: "A binding integrated agreement discharges prior agreements to the extent that it is inconsistent with them. . . . [or] to the extent that they are within its scope." *Id.* § 213(1)-(2). "Where there is a binding agreement, either completely or partially integrated, evidence of prior or contemporaneous agreements or negotiations is not admissible in evidence to contradict a term of the writing." *Id.* § 215; *accord* *BLACK'S LAW DICTIONARY* 1117 (6th ed. 1990) (discussing the parol evidence rule).

275. Certainly, there could be fraud, mistake, or some other "external" problem with the practical application of these declarations. *See, e.g.,* *BROWN, supra* note 213, §§ 4.01-4.02. However, the declarations themselves are straightforward and, absent one or more external factors, can be interpreted according to ordinary contract law.

276. *See supra* notes 61-117 and accompanying text.



ship requires of the parties. While state courts could handle this matter independently, the more efficient approach would be to create a uniform, national law.<sup>277</sup> Some even argue that the maze of state law *necessitates* federal regulation.<sup>278</sup>

A well-crafted, national law could take into account differences in the franchise relationship depending upon the particular contract clause.<sup>279</sup> A

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277. See, e.g., W. Michael Garner, *Editor's Column: Live by the Sword . . .*, 12 FRANCHISE L.J. 2, 17 (1992) (contending that United States franchisors and franchisees "need a national standard requiring good cause for termination").

278. Throughout the past three decades, federal franchise relationship statutes have been proposed and then stymied. STAFF OF HOUSE COMM. ON SMALL BUSINESS, *supra* note 49, at 60 & n.125. For example, a 1971 proposal went nowhere, and a comprehensive study released that same year, THE ECONOMIC EFFECTS OF FRANCHISING, *supra* note 20, produced no concrete results. Other full-scale attempts at federal legislation—the Fair Franchise Practices and Distribution Practices Reform Act, H.R. 9144, 95th Cong., 1st Sess. (1977), and the Franchising Termination Practices Reform Act, H.R. 5016, 95th Cong., 1st Sess. (1977)—likewise were defeated. See also Pitegoff, *supra* note 16, at 291 & n.8 (discussing the defeat of the proposed federal acts). As recently as 1992 and 1993, new proposals have been put forward. See, e.g., H.R. 5232, 102d Cong., 2d Sess. (1992) (proposed Fair Franchise Disclosure and Consumer Protection Act); H.R. 5233, 102d Cong., 2d Sess. (1992) (proposed Federal Fair Franchise Practices Act); H.R. 5961, 102d Cong., 2d Sess. (1992) (proposed, but unenacted, Federal Fair Franchising Practices Act, submitted by Representative James H. Scheuer); Tannenbaum, *supra* note 187, at B2 (reporting that Representative John J. LaFalce, chairman of the House Small Business Committee, had introduced three franchising bills, with more than a dozen co-sponsors for each); see also Jeffrey A. Tannenbaum, *Focus on Franchising: Briefs*, WALL ST. J., Dec. 11, 1992, at B2 ("The International Franchise Association, a trade group for franchisors, says it will form a franchise council aimed at increasing understanding between franchisors and franchisees."). But it is still unclear whether any of these bills could pass and what form they would have after making it through both houses of Congress. Telephone Interview with Dean M. Sagar, Professional Staff Member, U.S. House Comm. on Small Business (Aug. 30, 1993) (stating that the legislative process is highly uncertain); David J. Kaufmann, *Franchising Law: Legislation and Cases in 1993*, N.Y. L.J., Dec. 23, 1993, at 3, 3 (noting that while several hearings were held and a number of co-sponsors secured, the proposed federal franchise relationship law resubmitted by Rep. John LaFalce (D-N.Y.) in 1993 "has yet to be taken up by any House committee which possesses legislative authority" and has not been considered by the Senate; instead, it simply seems that in 1994 additional hearings may be held by the House of Representatives' Committee on Small Business, which has no legislative power); David J. Kaufmann, *Outside Counsel: Franchising News and Notes*, N.Y. L.J., Nov. 16, 1993, at 3, 3 (reporting that an anticipated upsurge in state "franchise relationship" legislation as well as substantial progress toward enacting a federal franchise relationship law failed to materialize in 1993); see also David J. Kaufmann, *Franchising: Legislative and Judicial Update*, N.Y. L.J., Jan. 7, 1992, at 1, 7 ("[S]ignals from Washington, D.C., regarding the possible enactment of federal franchise legislation are mixed: at times the Small Business Committee appears aggressive, and at other times the subject appears to be on the back burner."). But see Tannenbaum, *supra*, at B2 ("[T]here now is a specter of a broad based, bipartisan coalition supporting some kind of franchise legislation" (quoting Neil A. Simon, a Washington lawyer for franchisors)).

279. About one-third of the states have enacted franchise relationship laws that require a showing of "good cause," *supra* note 112 and accompanying text, while others rely on judicially created covenants of good faith and fair dealing, see *supra* notes 94-98 and accompanying text. Franchisors and franchisees have an extremely difficult time, however, predicting outcomes of disputes due to inconsistent statutes and case law. See generally Pitegoff, *supra* note 16, at

recent federal proposal attempted to apply a fiduciary duty to franchisor bookkeeping, collection, payroll, accounting, and advertising services on behalf of franchisees.<sup>280</sup> It also placed upon franchisors a duty of due care, requiring them to exercise the "skill and knowledge normally possessed by franchisors in good standing in the same or similar types of business."<sup>281</sup> This duty, however, might have had an unintended, anticompetitive effect, as "start-up franchisors" could have been "scared away from considering franchising as a method of expansion if they [were] to be held to the standard of mature franchisors."<sup>282</sup> In addition, the bill permitted franchisors to disclaim the due care duty; if the bill had become law, most franchisors probably would have taken that option.<sup>283</sup> Finally, the proposal had no "bright line standards"; businesses and courts simply would not have known when a duty arose.<sup>284</sup> A much more workable approach would be to take the actual, typical clauses found in a franchise agreement and assign them an already well-established interpretative standard.<sup>285</sup> With such a basic approach in place nationally or at least in most states, dispute resolution between franchisors and franchisees would produce far more consistent results.

To apprise prospective franchisees of their rights, statutory provisions setting forth the fiduciary and good cause standards for certain parts of franchise contracts should be included in the required disclosures made

292-319 (arguing that franchise relationship laws often reflect political outcomes rather than a uniform approach to franchising).

280. H.R. 5233, 102d Cong., 2d Sess. § 4(c) (1992) (proposed Federal Fair Franchise Practices Act).

281. *Id.* § 4(b). The standard is modeled after the common-law duty of due care for professionals—blacksmiths, plumbers, lawyers, doctors, and others—found in the RESTATEMENT (SECOND) OF TORTS § 299A (1977). Andrew C. Selden, *LaFalce Proposals Challenge Franchising*, 12 FRANCHISE L.J. 13, 13 (1992). The standard presents extremely complex definitional problems, however. Richard M. Asbil, *Franchise Commentary*, 12 FRANCHISE L.J. 1, 8-9 (1992); H. Bret Lowell, *Comments on Federal Franchise Disclosure and Relationship Bills*, 12 FRANCHISE L.J. 10, 11 (1992).

282. L. Seth Stadfeld, *Comment on Proposed U.S. Franchise Legislation: A Search for Balance*, 97 COM. L.J. 540, 561-62 (1992).

283. Asbil, *supra* note 281, at 9. Many commentators have criticized this due care provision. For instance, franchise attorney L. Seth Stadfeld commended the goal—eliminating from the marketplace incompetent franchisors—while lambasting the proposal for setting "a standard which is too high" and "would accomplish more harm than good." Stadfeld, *supra* note 282, at 561.

284. *See* Lowell, *supra* note 281, at 11.

285. This approach would be used instead of a tort standard—the "duty of due care," *see supra* note 281 and accompanying text—which has not often been found in court interpretations of the franchise relationship. The suggested approach, because it readily fits the contract law interpretations already in place, seems both more useful and more readily adopted. *See generally* Selden, *supra* note 281, at 13 (noting the reluctance of parties and courts to apply tort law standards to franchising, probably because "many have regarded [franchising] as an exclusively contractual relationship").

under the FTC Rule.<sup>286</sup> Statutory and regulatory coverage must include the general franchise relationship. In other words, franchisors should not be able to evade the statutory or regulatory standards by placing certain subjects outside the formal franchise agreement signed by the parties.

Congress may decide that some topics or clauses should be susceptible to disclaimer or limitation, if placed conspicuously in the documents provided to the prospective franchisee.<sup>287</sup> With an explicit waiver by the prospective franchisee, perhaps a fiduciary standard could be "reduced" to good cause. Any waiver should include statements to the effect that the franchisee is familiar with the protective statute whose possible future assistance it has forsworn and that the franchisor or its agents have made no representations, oral or written, about the quality of care to be furnished in the disclaimed subject area.

Prior federal proposals, as well as state laws or model enactments, may serve as the pattern for specific statutory language.<sup>288</sup> A key provision—one that should be emphasized in the mandated disclosure to prospective franchisees<sup>289</sup>—is that the franchise relationship is not defined solely by the written franchise agreement. Over the course of a long-term business relationship, the terms of the parties' written contract can be modified by subsequent conduct.<sup>290</sup> Franchisees, especially, must realize that courts will look at what the parties have said and done throughout their relationship, not just at the documents they signed when the relationship began. On the other hand, just as post-signing conduct may bring statutory standards into play, so an earlier contract—one entered into before the law was enacted—may shelter the franchisee from some or all of the new law. Giving the law a prospective effect may occasionally result in cases involving

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286. See generally *supra* notes 6-7 (discussing the FTC Rule, 16 C.F.R. § 436.1-3 (1993)).

287. That is an "out" currently permitted under the proposed Federal Fair Franchise Practices Act. See *supra* note 283 and accompanying text.

288. For example, the recently enacted Iowa law on franchising provides that a franchisor's "good cause" to take some action against the franchisee's interests "is cause based upon a legitimate business reason" and not arbitrary or capricious when compared to the franchisor's actions in other, similar circumstances. IOWA CODE § 523H.7(1) (1993); see also *Kealey Pharmacy & Home Care Serv., Inc. v. Walgreen Co.*, 761 F.2d 345, 348-50 (7th Cir. 1985) (holding that the franchisor's termination of all franchises while preserving the company-owned outlets, although expressly permitted in the franchise agreement, lacked "good cause"). The Iowa statute declares that a franchisor's good cause to take action includes the franchisee's failure to comply with a material, legal requirement in the franchise contract. IOWA CODE § 523H.7(1).

289. See *supra* note 286 and accompanying text.

290. UNIF. FRANCHISE AND BUSINESS OPPORTUNITIES ACT § 105 cmt., 7A U.L.A. 116 (Supp. 1993).

"grandfathered" contract clauses, but such an approach appears to be the only constitutional and feasible method of adoption.<sup>291</sup>

If a federal statute or regulation were impossible, then state legislatures or courts still could adopt the three-standard analysis presented in this Article. Although one may argue that the methodology suggested herein would lead to court battles over which standard governs which clauses, most clauses can easily be placed within one of the three classifications,<sup>292</sup> and the present situation already entails numerous interpretative fights over franchise relationship standards. Recognizing that the contract typically cannot be treated as a whole—that instead each pertinent clause must be considered separately—should leave courts and legislatures with a more manageable task.

## V. CONCLUSION

The courts' varying approaches to the interpretation of franchise agreements illustrate that the franchise relationship remains poorly defined. Courts and legislatures have drawn from contract principles, added good cause provisions, and even attempted to apply a fiduciary relationship to franchises. The problem is that these and other approaches try to treat a comprehensive, continuing relationship as if the parties' expectations, any issues of enforcement, and the relative strengths of the parties are substantially similar for all portions of an extremely lengthy franchise agreement.

Which courts and legislatures treat franchise relationships the fairest? Many of the various approaches adopted by courts and legislatures have merit, depending on the contractual clause in dispute. Individually, however, the various approaches provide little direction for businesspersons who try to interpret the basis and scope of the franchising relationship. For instance, is the nature of the relationship the same for all provisions in the franchise contract, or should there be, as suggested in this Article, recognized differences in the franchisor's duty of care to franchisees?

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291. The proposed federal laws would be prospective. Stadfeld, *supra* note 282, at 565. In other words, these bills would, if enacted, "apply only to franchise agreements entered into, amended, exchanged or renewed after [the bills'] enactment." *Id.*

In *McDonald's Corp. v. Nelson*, 822 F. Supp. 597 (S.D. Iowa 1993), the court held that the Iowa Franchise Act of 1992 violated the Contract Clauses of both the United States Constitution and the Iowa Constitution insofar as the Iowa Franchise Act substantially impaired the plaintiff-franchisors' contractual rights. *Id.* at 609. Such rights included those expectations that "played an integral role in the pricing of the [franchised] licenses" and that were present when the franchise parties, long before the Act was passed, executed their license agreements. *Id.* at 606.

292. The fight probably would be more systemic than case-by-case. It would involve debate over the policies underlying the suggested categories, as well as the judicial or legislative delineation of which clauses fall under which category, rather than disputes over what type of clause (site selection, royalties, etc.) is before the court in a particular case.

Unlike simpler contracts, a franchise agreement deals with a complex, ongoing, evolving relationship. As a result, the agreement cannot possibly contemplate all the situations it may eventually govern. For example, many franchise agreements allow the franchisor to amend the specifications for the franchise facility.<sup>293</sup> Most notably in the 1970s, fast-food franchisees had to adjust to the addition of drive-through windows.<sup>294</sup> Questions arose about both the financing and construction of these improvements.<sup>295</sup> Courts had to address situations not necessarily considered by either party, even though the franchise contract itself tended to give rather blanket authority for franchisor actions.<sup>296</sup>

Because of its long-term, evolving consequences, a franchise relationship is much more than a written agreement.<sup>297</sup> There are numerous, additional examples of post-contract changes inadequately covered by the initial written arrangement. Franchise agreement provisions typically must, and do, afford the franchisor wide discretion in many areas.<sup>298</sup> This discretion, though, offers the franchisor the opportunity to act irresponsibly.<sup>299</sup>

The inability of most franchisees to negotiate many of the terms of the franchise agreement<sup>300</sup> may adversely affect their businesses. Franchisees invest capital to build these businesses, while franchisors retain the right to terminate the franchises.<sup>301</sup> In many instances, franchisors of necessity hold great discretionary power;<sup>302</sup> but potential exploitation<sup>303</sup> must be restrained. National or relatively uniform state laws defining and establishing the essential characteristics of the franchise relationship would enable both

293. *Infra* app. § A-2-d (59% of surveyed contracts).

294. See Gary Taylor, *Franchise Reform to Yield Feast: Experts Predict Boom Times for Lawyers*, NAT'L L.J., Jan. 20, 1992, at 1, 12 (recognizing "[t]he unique nature of the franchise relationship" and the potential problems that business law practices encounter); see also *supra* note 150.

295. Taylor, *supra* note 294, at 12.

296. Will the same type of cases arise in the 1990s as franchisors adopt no-smoking policies for some or all of their restaurants?

297. See, e.g., Selden, *supra* note 281, at 13 ("[A] franchise relationship in most cases really is (or is presented by the sales representative as involving) more than just a contract relationship.").

298. See *Burger King Corp. v. Austin*, 805 F. Supp. 1007, 1011 n.4 (S.D. Fla. 1992) (referring to franchisor Burger King's contractually provided "discretion over advertising spending" and citing cases involving other fast-food franchisors with the same powers); *supra* notes 176-79 and accompanying text; see also *supra* note 71 (sample advertising clause).

299. See Emerson, *supra* note 1, at 1522 n.84.

300. See, e.g., Emerson, *supra* note 1, at 1508-09 & nn.20-21; Hadfield, *supra* note 57, at 962; see also *supra* notes 114, 192 (describing the inequality in the bargaining relationship).

301. One commentator has labeled this ability as franchisor "opportunism." See *supra* note 119. Once a franchisee has invested its initial outlay of fixed or sunk costs, the franchisor is positioned to take advantage of that franchisee. Hadfield, *supra* note 57, at 951-52.

302. See *supra* note 71 and accompanying text.

303. For examples of actual exploitation, see Emerson, *supra* note 1, at 1522 n.84.

franchisees and franchisors to better understand their rights and duties. That understanding would lead to a greater sense of fair play in their dealings. By making the franchisor's duty of care contingent on the nature of the franchise relationship, as determined by the specific provision in question, the courts and legislatures would finally turn for guidance to the very criteria that gave rise to the relationship. That approach is not only logical, it is just.

## APPENDIX

Review of 100 Fast-Food, Restaurant, and Ice Cream Parlor Franchise Agreements Dated from February 1991 to January 1993.

*Summary of Headings in Appendix*

A. FIDUCIARY CLAUSES - Pages 967-68

- |                                      |  |
|--------------------------------------|--|
| 1. Site Selection                    | 5. Variance in Contractual Terms for Other Franchisees |
| 2. Layout                            | 6. Opening and Financing                               |
| 3. Franchisor Training of Franchisee | 7. Advertising   |
| 4. Operating Standards               |  |

B. "GOOD CAUSE" CLAUSES - Pages 968-72

- |   |   |
|---|---|
| 1. Territorial Development and Protection                     | 4. Franchise Terminations and Nonrenewals   |
| 2. Covenants that Franchisee Cannot Compete After Termination | 5. Prices, Supplies, Hours, Franchisee Full-time Status, Franchisee Employees, Inspections, Auditing, and Waiver of Franchisee Breaches |
| 3. Franchise Transfers and Franchisor Assignments             |   |

C. ORDINARY CONTRACT LAW CLAUSES - Pages 973-75

- |   |   |
|---|---|
| 1. Royalties and Other Franchise Fees   | 5. Provision that Franchisee is an Independent Contractor; No Agency Relationship             |
| 2. Franchise Time Periods, Arbitration and Venue Stipulations, and Insurance Requirements | 6. Statement That There Is No Fiduciary Relationship Between Franchisor and Franchisee        |
| 3. Intellectual Property  | 7. Merger Clause (for purposes of having an integrated writing under the Parol Evidence Rule) |
| 4. Declarations About the Franchisee's Review of the Franchise Contract Before Signing It |   |

*Comparable figures from a 1971 Study, supra* note 20, are listed for comparison under the heading "1971" when there are such figures (pages 201-56 of that Study). When there are no comparable figures in the 1971 Study, this fact is indicated by a "-".

UNLESS OTHERWISE INDICATED, THE NUMBERS BELOW REPRESENT THE PERCENTAGE (%) OF FRANCHISE AGREEMENTS CONTAINING PARTICULAR CLAUSES

	<u>1971</u>	<u>1993</u>
A. <u>FIDUCIARY CLAUSES</u>		
1. SITE SELECTION	45	71
a. Franchisee picks, with Franchisor approval required	-	53
b. Franchisor picks	-	18
c. Franchisee required to pay for Franchisor's services	-	8
2. LAYOUT		
a. Franchisor Approval of Franchised Business' Layout Required	64	73
b. Franchisor Actually Does the Layout Itself (not part of the 73%)	-	10
c. Specifically Requiring Franchisor Approval of All Alterations	36	11
d. Franchisor Right to Mandate Future Modifications of the Layout	-	59
(1) specifically providing that required remodelling cannot take place before a certain time period has lapsed (generally, five years)	-	8
(2) specifically providing that any mandated modifications are entirely at the expense of the Franchisee	-	16
3. FRANCHISOR TRAINING OF FRANCHISEE		
a. General Provision	-	100
b. Training expressly at Franchisee's expense	-	43
c. Franchisor performs consulting services for the Franchisee after the initial training	45	59
4. OPERATING STANDARDS		
a. Franchisor-issued operating manuals	61	98
b. Franchisor right to revise the franchise agreement/operating manual	38	59
c. Goods sold at the franchise outlet:		
(1) Quality control standards	82	92
(2) Product line control (what can be sold)	61	48



	<u>1971</u>	<u>1993</u>
5. VARIANCE IN CONTRACTUAL TERMS FOR OTHER FRANCHISEES		
a. General provision - franchise agreements may vary from franchise to franchise	-	26
6. OPENING AND FINANCING		
a. Franchisor assistance in franchised outlet's opening	45	50
b. Franchisor assistance to franchisee in obtaining financing	-	10
7. ADVERTISING		
a. Franchisor to Run Advertisements	29	62
b. Franchisor to Control and Manage the System's Advertising	53	77
c. Percentage of Gross Sales Revenue Franchisee Must Spend on Advertising (pay for franchisor-controlled ads and, sometimes, pay for local ads):		
(a) 5-7%	-	5
(b) 5%	-	15
(c) 4%	-	19
(d) 3%	-	15
(e) 2.5%	-	2
(f) 2%	-	32
(g) 1%	-	6
(In addition, of the above 94 agreements for 1993 requiring the franchisee to devote a percentage of sales revenue to advertising, 10 specified a minimal amount to spend on advertising regardless of how small the revenue base might be.)		
d. Franchisor Right to Enter Franchised Business Premises and Remove or Destroy Objectionable Sign or Advertising	13	29
e. Required Franchisee Expenditures on "Grand Opening" Advertising	-	64
(1) Median amount required	-	\$4,000
B. <u>"GOOD CAUSE" CLAUSES</u>		
1. TERRITORIAL DEVELOPMENT AND PROTECTION		
a. Exclusive territory granted to franchisee	60	46

	<u>1971</u>	<u>1993</u>
(1) Median radius of territory	-	1 mile
(2) Expressly stated that no exclusive territory	-	25
2. COVENANTS THAT FRANCHISEE CANNOT COMPETE AFTER TERMINATION		
a. General Provision	60	98
b. Competition against any existing franchise in the franchised system (sometimes even including planned franchises not yet operating)		
(1) For a certain time period after the franchise termination	-	62
(a) Median time frame	-	2 years
(2) For a certain geographic distance from any such franchisee	-	62
(a) Median distance	-	10 miles
c. Provision that noncompetition covers only the territory from which the terminated franchisee had his own operations		
(1) For a certain time period after the franchise termination	-	36
(a) Median time frame	-	2 years
(2) For a certain geographic distance from any such franchisee	-	36
(a) Median distance	-	20 miles
d. Provision that courts shall make a noncompetition clause reasonable rather than throw it out as too broad	-	23
e. Providing liquidated damages for a breach	-	10
f. Barring the hiring of the Franchisor's employees	-	13
(1) Median time frame	-	1 year
3. FRANCHISE TRANSFERS AND FRANCHISOR ASSIGNMENTS		
a. Franchise Transfer		
(1) Franchisor's Right of First Refusal on the franchisee's proposed transfer/sale of the franchise to another party	46	95

	<u>1971</u>	<u>1993</u>
(2) Requirement that Franchisee Obtain Franchisor's Approval before selling, assigning or otherwise transferring the franchise	83	93
(3) Right to inherit the franchise	64	89
(a) Heirs must meet franchise agreement terms	64	27
(b) Heirs must be approved by the Franchisor	-	60
(c) Franchisee can sell a less than 50% interest to family members without the Franchisor's approval	-	2
b. Franchisor Assignments		
(1) Franchisor has right to assign the franchise agreement to another party	-	66
4. FRANCHISE TERMINATIONS AND NONRENEWALS		
a. Any Franchisee violations of the franchise agreement are material	-	87
b. Franchisee right to terminate franchise	9	14
<p>(All of the 1993 agreements permitting termination by the Franchisee require that the Franchisee first give notice, with the required period usually being from 30 to 90 days, but as high as 2 years. Also, one agreement stated that the termination can only be for an uncontested material breach of the franchise contract by the Franchisor, and another provided liquidated damages for the Franchisor if inadequate notice was furnished—2 years' worth of royalties.)</p>		
c. Renewal Period Specified		
(1) Three or more periods	-	9
(a) Median time per period	-	10 years
(2) Two periods	-	12
(a) Median time per period	-	10 years
(3) One period	-	56
(a) Median time period	-	10 years
d. Renewal at the option of Franchisee	-	35
(1) Notice period specified	-	24
(a) Median time period for notice	-	6 to 12 mos.
e. Franchisor option to renew	-	38

	<u>1971</u>	<u>1993</u>
f. Franchisor Approval of Franchisee's Lease Required	18	21
g. Specified grounds for Franchisor termination of the franchise:	100	100
(1) Franchisee's insolvency and/or bankruptcy	79	91
(2) Franchisee's Loss of Lease	14	72
(3) Franchisee is no longer in business	-	65
(4) Franchisee is conducting an unlawful enterprise (no requirement that this be proven in criminal court)	-	32
(5) Franchisee has been found guilty of unlawful activity	-	32
(6) Franchisee abandonment of the business	-	13
(7) Franchisee denied Franchisor access to inspect the franchised business	-	9
h. Grace periods for the Franchisee to correct a breach	68	88
(median grace period for 1993 agreements with such provisions—30 days; often shorter periods for failure to make payments due to the Franchisor—such as 5, 7, 10, or 15 day periods)		
i. Provision that Franchisee shall immediately cease operations upon its termination	47	60
j. Franchisor right to purchase franchised business upon termination	-	11
k. Franchisor's option to purchase equipment of franchisee upon the franchise's termination	44	54
5. PRICES, SUPPLIES, HOURS, FRANCHISEE FULL-TIME STATUS, FRANCHISEE EMPLOYEES, INSPECTIONS, AUDITING, AND WAIVER OF FRANCHISEE BREACHES		
a. Prices and Supplies		
(1) Price restrictions on items sold by Franchisee	13	0

	<u>1971</u>	<u>1993</u>
(Of the 1993 agreements, 10% specifically stated that pricing was solely within the Franchisee's discretion, and 9% provided that the Franchisor might advise the Franchisee about pricing)		
(2) Required Franchisee purchases from the Franchisor	33-43	11
(3) Products that must be purchased either from the Franchisor or from Franchisor-approved vendors	-	13
(4) Required Franchisee purchases from Franchisor-approved vendors	43-53	60
b. Business Hours and Franchisee Full-time Status		
(1) Specified hours of operation for franchise outlet (10% of 1993 agreements require 24-hours-a-day, seven-days-a-week operations)	62	44
(2) Requirement that Franchisee work full-time concerning the franchised business	12	30
(3) Requirement that Franchisee work at least 15-20 hours per week concerning the franchised business	-	5
c. Franchisee Employees		
(1) Franchisor has right of approval over franchised business' manager	9	30
(2) Franchisor specifications about Franchisee employees	32	56
d. Inspections		
(1) Franchisor's right to inspect Franchisee's business premises, products, supplies, marketing methods, etc.	79	91
e. Auditing—Franchisor right to an accounting and an audit of the Franchisee's business	79	90
f. No Franchisor Waiver of Franchisee Default	74	87

19711993C. ORDINARY CONTRACT LAW CLAUSES

## 1. ROYALTIES AND OTHER FRANCHISE FEES

a.	General provision requiring Franchisee payment of an initial franchise fee	83	100
	(1) Median Amount	-	\$20,000
b.	General provision requiring Franchisee payment of royalties	90	100
	(1) Median Amount	-	5% of gross sales
c.	Specific minimal amount to be paid as royalties	-	12
	(1) Median Amount	-	\$500 per month
d.	Provision that renewed Franchisees pay a Renewal Fee	7	23
	(1) Median Amount	-	\$3,000
e.	Provision that Franchisees seeking to move must pay a Relocation of Franchise Fee	-	11
	(1) Median Amount	-	\$3,500
f.	Transfer Fee (shifting franchise to a new Franchisee)	-	78
	(1) Median Amount	-	\$5,000

## 2. FRANCHISE TIME PERIODS, ARBITRATION AND VENUE STIPULATIONS, AND INSURANCE REQUIREMENTS

a.	Length of Agreement:		
	(1) 20 Years	-	38
	(2) 15 Years	-	24
	(3) 10 Years	-	20
	(4) 5 Years	-	5
	(5) Unspecified	-	4
	(6) Other	-	3
b.	Venue stipulated	27	62
c.	Arbitration clause	23	31
d.	Mediation provision	-	3
e.	Comprehensive Liability Insurance (Franchisee required to have, at its expense)	88	100
	(1) \$300,000	-	2
	(2) \$500,000	-	1
	(3) \$1 Million	-	70

	<u>1971</u>	<u>1993</u>
(4) \$1.5 Million	-	4
(5) \$2 Million	-	15
(6) \$1-\$3 Million	-	2
(7) No less than customary for the Franchisees generally	-	6
f. Hold Harmless provision (Franchisee indemnifying Franchisor)	64	89
3. INTELLECTUAL PROPERTY		
a. Franchisor acknowledged as owner of Confidential information which has been disclosed to the Franchisee and which is not to be disclosed to unauthorized persons	64	90
b. Trademark Restrictions (on use of trademark by Franchisee)	77	95
c. Requirement that terminated Franchisee return to the Franchisor all trademarked supplies, signs, stationery, forms, or other materials	25	78
d. All Franchisee concepts become Franchisor's exclusive property	-	3
4. DECLARATIONS ABOUT THE FRAN- CHISEE'S REVIEW OF THE FRANCHISE CONTRACT BEFORE SIGNING IT		
a. Statement advising Franchisee to obtain legal counsel about the franchise contract	-	25
b. Provision that Franchisee has had the opportunity to obtain clarification about any aspects of the proposed franchise	-	7
c. Statement that Franchisee obtained the advice of independent legal, accounting, and/or other advisors prior to signing the franchise agreement	-	14

19711993

d.	Statement that Franchisee has received no guarantees, representations, warranties or the like as to the profitability of the franchise being purchased, and that Franchisee has conducted its own independent investigation of the merits of this investment	-	85
5.	PROVISION THAT FRANCHISEE IS AN INDEPENDENT CONTRACTOR; NO AGENCY RELATIONSHIP	64	91
a.	Franchisee required to post notices informing public of its independent status	-	21
6.	STATEMENT THAT THERE IS NO FIDUCIARY RELATIONSHIP BETWEEN FRANCHISOR AND FRANCHISEE	-	10
7.	MERGER CLAUSE (FOR PURPOSES OF HAVING AN INTEGRATED WRITING UNDER THE PAROL EVIDENCE RULE)	-	79



