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Franchising: Strategies, Issues And Answers

*The Editor interviews **David A. Reif**, Litigation Partner, McCarter & English, LLP.*

David A. Reif

Editor: Please tell us about your background and experience.

Reif: I am a litigation partner in the Hartford office of McCarter & English where I chair the franchise, distribution and trade regulation group. Since the mid '70s, I have been doing litigation and dispute resolution with a focus, although not exclusively, on franchising and distribution. My emphasis is not really on a particular line of products, although I probably do more beverage franchising work than anything else. This coming year, I will chair the Connecticut Bar Association's Franchise and Distribution Section.

Editor: What are the essential components of franchise systems?

Reif: Franchising in its broadest basis is a way of distributing goods and services through a network of franchisees that are independent entities who are not employees or pure licensees. This network presents the franchisor's product in the marketplace under standards imposed by the franchisor using the method of marketing imposed by the franchisor and in return for which the franchisor gets a royalty.

There is a Federal Trade Commission requirement for issuance of a franchise disclosure document. The situation is further complicated for franchisors because there are numerous states that impose their own definitions of a franchise and several states that have their own disclosure requirements.

Editor: Do franchisors often encounter conflicts between state requirements and federal requirements?

Reif: It is not really a conflict. The federal requirements are the minimum and, in some states, simply being compliant with the federal statute is sufficient. Other states have supplemental requirements. For example, when you look at the franchise disclosure document of a national franchisor, you will see state-specific pages.

Editor: Please discuss the responsibilities of franchisors for protecting and maintaining the brand.

Reif: New franchisors tend to forget the necessity of policing the brand. Part of what you're selling to someone who comes in to buy a product in a franchise business is the experience. When you walk into a quick service restaurant in Kansas, the franchisor wants you to have a good experience that will cause you to stop at the franchised restaurant if you're driving through Connecticut. This means that a franchisor should have people in the field who will check to make sure that quality requirements are complied with. If the franchisor doesn't do that, it is exposing itself to liability to its franchisees.

Franchisees buy into the concept that they're going to get experienced help from the franchisor in running their businesses, so that there's a consistently positive response. There was recently a case in Quebec in which a group of franchisees were awarded substantial damages against a food service franchisor for not maintaining the brand.

Editor: What role does advertising play and who is responsible?

Reif: Franchisors will handle brand advertising in two ways: Most major franchisors will have an advertising fund. Franchisees will contribute a particular amount to that advertising fund. The franchise documents will also often provide that the franchisee, depending on the kind of product, is required to spend a certain percentage of its sales advertising locally as well.

Editor: What requirements does the FTC impose?

Reif: The FTC requires franchisors to provide the prospective franchisee with a franchise disclosure document. It's something that cannot be taken lightly. An FTC regulation lays out in painstaking detail the requirements for the franchise disclosure document. It requires, among many other items, litigation history, the anticipated cost of setting up the franchise, who your existing franchisees are and those whom you have terminated or who have withdrawn their franchise during a particular period of time.

If you are going to make earnings representations, the disclosure document requires that those earnings representations be set forth in the format required by the regulation. If you are not making any earnings representations, you must say that in the disclosure document. That's where franchisors tend to get into the most trouble. Back in January, there was a trial court decision here in Connecticut in which a large judgment was rendered against the seller of a franchise operation. It involved a classic meeting in a hotel, in which the court found a whole lot of numbers were given to the proposed franchisees by the franchisor, which the court found were not accurate. Whoever is drafting the franchise disclosure docu-

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ment needs to spend a significant amount of time understanding the business.

Editor: Are there antitrust and pricing issues that affect franchising?

Reif: One of the hottest issues is the impact of the *Leegin* case. In that 2007 case, the U.S. Supreme Court overturned the rule that it's a per se violation of the antitrust laws for a manufacturer to require that its products not be sold below a specific resale price. This change means that, in the absence of contrary state law, a franchisor and franchisee can agree to set a minimum resale price as long as it complies with the rule of reason, which is a very vague and forgiving standard. But, in Maryland and several other states, minimum resale price maintenance remains a per se violation of state antitrust laws. Consequently, the law remains in flux.

Editor: What considerations are involved on the part of a purchaser of a franchise network?

Reif: Whether franchise networks are assignable depends on the language of the franchise agreement. Generally they are assignable by the franchisor, because a franchisor's exit plan may well be to build up the franchise network for sale. If you're buying a franchisor, you need to drill down and look at the body of franchise agreements.

You should determine whether the franchisees are in states where registration is required and, if so, whether the franchise is registered and therefore authorized to sell. You should also look at the franchise disclosure document and make sure it complies with the law and will not be a source of future litigation.

In doing its due diligence, the acquirer will want to be sure that it will be able to carry out its plans for the franchisor. It may want to terminate some franchisees. It may want to expand into new states or even expand overseas. It needs to be sure that applicable local laws allow those activities.

Editor: To what extent can franchisors change their product mixes or other aspects of their business?

Reif: Franchisors in the food business, for example, discovered that in addition to selling through franchises in the soft ice-cream business, there was also an opportunity to sell their product to grocery stores. Currently, there may be opportunities to sell their product on the Internet. Whether this can be done centers on the intent of the parties when they entered in to the franchising contract. Currently, many contracts with franchisees include a very specific reservation to the franchisor of the right to go into other lines.

Although the franchisee may have an exclusive in a particular territory, the agreement may not specifically address whether the franchisor can come up with new concepts, which would not be available to existing franchisees. In such cases, the risk for the franchisor is that its new line of products may overlap with products sold by existing franchisees such that you are in violation of the agreement.

Issues can also arise, and this is more in distribution than it is in franchise, where, for example, you may have separate distributors serving each of five Southwestern states. You may decide that it makes more sense for you to have one distributor who can service the whole territory because it can do it more efficiently, and you may be able to offer a lower commission rate so that more of the sales come back in to you.

Therefore, if what you want to do is to terminate four of the five and give all of that territory to the fifth, you need to look at the existing agreements. Does the agreement allow you to terminate people without cause? Or does state law impact how you implement your desire to change the way in which you sell your product. For example, some states require good cause to terminate the agreement, and a good business reason may be sufficient. So you need to start off with your contract and you then need to look at state law. As I mentioned earlier, the states define franchisors in different ways. So if you are under the law of one of these five states in the Southwest, does this distributorship constitute a franchise, and if so, what protections if any is the franchisor given?

Editor: What are the most common causes of disputes arising from franchising and distribution agreements?

Reif: One falls into the overall bucket of termination and that really runs in two ways. First of all, if you are looking at it from the franchisor end of the telescope, has what the franchisee done given you a valid reason to terminate either under your agreement or under state law? An example just came up in New Jersey, which allows termination of a franchise for criminal conduct that affects the franchise relationship. A franchisee was terminated because of charges related to endangering the welfare of a child. In June, the U.S. District Court of New Jersey denied the franchisor's petition to terminate the franchise immediately. The judge said, even if there was criminal conduct, it's not criminal conduct that affected the franchise and therefore denied the injunction.

From the franchisee's side, the hot issue is really constructive termination. If the franchisor has taken some action which in effect makes it economically impossible for the franchisee to run its business, is that a termination? In *Mac's Shell,* a gas station case brought under the Petroleum Marketing Practices Act, the Supreme Court held that there was not a constructive termination because the dealer was still able to do business, but just not as profitably. A recent Illinois case held that even though distributors were not able to sell products to all of the places where they previously had sold, it didn't constitute a constructive termination.

Another issue that arises with terminations is the scope of a non-compete because almost all franchise agreements include a non-compete covering its term and for some period post-term. Most often they restrict the terminated franchisee from entering into a competing business within a certain radius of the franchised business. The issue that you often encounter is whether the non-compete has been violated because the franchisee has gone into a similar business, but which may or may not actually compete with the franchisor, or whether the restrictions may be unreasonably constraining.

Another issue relates to changes in the franchise system that cost the franchisees something to implement – where, for example, the franchisor changes the trade dress from red to green with a different sign and requires the franchisee to bear the expense. Is the franchisee responsible?

One of the other issues you frequently encounter is misrepresentation. If the business doesn't thrive as the franchisee expected, the first place a franchisee looks is to the franchisor. That's where the franchise disclosure document becomes important. Since reliance is one of the elements of a misrepresentation case, statements made in the franchise disclosure document can be extremely significant.

Editor: Talk about the complexity of litigated disputes. I understand that some involve numerous state or federal jurisdictions and simultaneous litigation.

Reif: A distributor or franchisor may undertake a really significant change in its method of distribution, either nationally or over a large region. For example, we represented a beverage business that acquired another line of beverages. To reduce costs, it wanted to have the new line carried on the same trucks as the old line. This would have had the effect of terminating the distribution rights of the companies that used to carry the old line. Injunctive relief was sought in at least three different jurisdictions essentially all at the same time by old distributors claiming that they were, in fact, franchisees under state law and that our client couldn't terminate those distribution rights. One of the complexities you encounter when you're doing a major set of terminations is that you need to be able to react very quickly to requests for injunctive relief under a number of different state laws.

Another issue that's particularly interesting and difficult is the valuation question. If the franchisor or manufacturer has an obligation to pay fair market value for a brand and the method of valuation and how and by whom it is to be determined is not covered in your agreement, the outcome can be very uncertain.

Editor: What drives judicial decisions that affect franchise-related business interests?

Reif: We tend to forget often that judges are people that bring their own life experience with them. However they take very seriously an agreement signed by the parties to a dispute. I think probably the best advice is that when you're sitting down to draft or revise a franchise, distribution or licensing agreement, you need to work closely with your business people and talk to them about the business options that they may want in the future. I try to emphasize that I want to build that flexibility into the agreement for you.

For example, a franchisor may wish to draft an arbitration clause in the franchise agreement in a manner that would prevent a franchisee from bringing a class arbitration. Otherwise, a franchisee with a very small claim might mount a class action on behalf of all franchisees.

The Supreme Court has clearly held that you need to have an intent expressed in the agreement if you're going to allow class arbitrations. There was a case called *Stolt-Nielsen* that the Supreme Court decided back in 2010 in which everybody on the franchisor side took a lot of solace. That's beginning to be cut back or fleshed out in some of the more recent district and circuit court cases. The First Circuit has just issued an opinion involving a haircutting franchise. It said that, even after looking at the agreement considered in light of the *Stolt-Nielsen* case, it still left open the issue of whether there could be a class arbitration and, even more significantly, held that was an issue for the arbitrator to determine. Looking at the situation from a franchisor and the franchisee perspective, it still looks like something of a crapshoot without a whole lot of predictability.