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From the IFA's Legal Symposium

Negotiating Franchise Contracts

By Kevin Adler

In the last several years, private investment groups and wealthy, experienced business owners have showed increased interest in purchasing franchisees. At the same time, food and retail franchisors have moved more deeply into developing units at nontraditional locations, such as airports, colleges and hospitals. These twin developments have been, for the most part, highly positive for the franchising industry.

However, both trends have raised one major challenge for franchisors: negotiating contract terms that deviate from their standard FDD. In order to come to agreements with attractive franchisee prospects or to reflect the unique circumstances of nontraditional venues, franchisors have often had to abandon their take-it-or-leave-it attitude about their form contract. Moving on to the next candidate or the next venue in a tough economy isn't a recipe for brand growth. How franchisors can both satisfy their needs for standardization while meeting the circumstances that arise with sophisticated investors and in nontraditional venues was the subject of a session on advanced contract negotiating and drafting techniques at the IFA's 46th Annual Legal Symposium in May.

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Is California's 'Good Faith' Franchise Legislation Necessary or Meaningful?

By David L. Cahn

On May 28, the California Senate passed S.B. 610, which is an amendment to California's Franchise Relations Act (the "CFRA"). The bill has been introduced in California's General Assembly and was referred to that body's Judiciary Committee on June 10.

This legislation could provide some increased leverage and protections to existing franchisees, but it may come at a cost to franchising as a method of expanding brands and providing opportunities. This bill, if approved by the state's General Assembly and signed by Gov. Jerry Brown, would add the following relevant provisions to the CFRA:

> Without limiting the other provisions of this chapter, the following specific rights and prohibitions shall govern the relations between a franchisor, subfranchisor, and franchisee:
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> Section 20016:
>
> (a) (1) These parties shall deal with each other in good faith in the performance and enforcement of the franchise agreement.
>
> (2) "Good faith" for purposes of this subdivision means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.
>
> (b) A franchisor or subfranchisor shall not restrict the right of a franchisee to join or participate in an association of franchisees to the extent the restriction is prohibited by Section 31220 of the Corporations Code.
>
> Section 20017:
>
> (a) A franchisee may bring an action against a franchisor or subfranchisor who offers to sell, sells, fails to renew or transfer, or terminates a franchise in violation of Section 20016 for damages caused thereby, or for rescission or other relief deemed appropriate by the court. In addition, the court may in its discretion award reasonable costs and attorney's fees to a prevailing plaintiff.

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The CFRA already prohibits a franchisor from terminating a franchise relationship without good cause and restricts a franchisor's ability to refuse to renew a franchise at the end of its term or to restrict transfer of ownership to the franchisee's heirs following death. Moreover, the implied covenant of good faith and fair dealing applies to all contracts governed by California law and the law of many other states, and the language in Section 20016 is essentially the same as such an implied covenant as contained in the Uniform Commercial Code and under American "common law" as interpreted in the courts. Finally, Section 31220 of the Corporations Code makes it unlawful for a franchisor "to restrict or inhibit the right of franchisees to join a trade association or to prohibit the right of free association among franchisees for any lawful purpose," and Section 31302.5 of that statute provides a vigorous private right of action for a franchisee who proves violation of this provision.

So is this legislation really significant, and, if so, how?

Legislation's Possible Impact

From a franchisor's perspective, the legislation increases the risks of seeking to enforce its contract rights, principally because of liability for a franchisee's attorneys' fees if a franchisee wins a case under this statute. This may discourage franchisors from seeking to terminate franchises that are not upholding brand standards, which may result in a lower quality of goods and services being provided to consumers. For these reasons, the International Franchise Association has opposed the legislation, even as S.B. 610 represents a much less encompassing set of changes than did a bill introduced in the California legislature last year.

Franchisees, generally speaking, seem to favor the legislation. But an observer has to wonder if the impact would be more mixed for franchisees than they expect.

Its potential significance to existing franchisees is at least twofold. First, many franchise agreements are governed by the laws where the franchisor is located, and some large states (such as Texas) generally do not recognize an implied covenant of good faith and fair dealing that is applicable to franchise agreements. *See, e.g., Miller v. KFC Corporation*, 2001 U.S. Dist. LEXIS 8537 (N.D. Tex. 2001). For such franchisees, if a franchisor acts in a manner that technically is permitted by the contract, then the franchisee has no legal right to oppose it, even if the franchisor's action is opportunistic, unfair and/or overreaching in the commercial context.

Second, the CFRA does not specify damages that can be awarded to a franchisee that proves a violation of the statute, nor does it allow such a prevailing party to obtain reimbursement for its attorneys' fees and other costs in pursuing the claim. Moreover, many franchise agreements only give the franchisor the ability to obtain judgments for its attorneys' fees and costs if it enforces the contract (a "one way" clause), but this legislation would, in essence, convert those clauses to mutual "loser pays" provisions for most contract disputes. From a franchisee's perspective, particularly those in large, established franchise systems who may be more easily susceptible to franchisor oppression, these are helpful provisions. For example, certain hotel franchise systems have been notoriously aggressive in seeking to terminate franchises due to alleged service quality or facility maintenance deficiencies, and then seeking substantial liquidated damages judgments against the former franchisee. Even where the implied covenant of good faith is a part of the law of the contract, many of the largest chains have "one way" attorneys' fees clauses that make the franchisee's attempt to defeat the termination and damages claims extremely risky. S.B. 610 might encourage franchisees to fight against such franchisor efforts.

However, the legislation comes with several long-term policy costs:

1) It may make franchisors less willing to aggressively enforce their standards, particularly when deciding whether or not to consent to a franchisee's request to assign its agreement or to allow a franchisee to renew the franchise at the end of a contract term. These decisions can have critical impacts on the health of franchise systems and also on the welfare of consumers who patronize franchises. The prospect of having their decisions "second-guessed" by a jury or even an arbitrator may make franchisors more tentative in taking steps necessary to protect their brands, which would harm the ability of franchise systems to provide a consistent level of goods and services to consumers.

2) It provides another reason for companies to shy away from franchising as a growth method. The number of companies expanding through licensing continues to grow, and more companies than ever will seek to avoid being a "franchise" as a matter of law because of the burdens of complying with disclosure and relationship provisions. This matters because the putative licensee, sales representative or product dealer will not receive important information provided in the disclosure process, or be as fully protected from misrepresentations made by the putative licensor or supplier. While avoiding the franchise definition is easier said than done, legislation of this nature will encourage even more entrepreneurs to make the effort to do so.

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