



# Focus **on** Franchising

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## Welcome!

Spring is here, so it's time for our third edition of Focus on Franchising. We hope that you find this newsletter as helpful and informative as our previous ones. We want to thank you for your continued input and, more importantly, your continued support. As always, contact us at [franchise@farrellfritz.com](mailto:franchise@farrellfritz.com).

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## **WARNING SIGNS:** How To Spot Trouble Before It Gets Out Of Hand

*By Russ Moserowitz*

Problems rarely spring up out of nowhere. Typically, when a company gets into trouble, there were warning signs well in advance that went unnoticed. Knowing what to watch for and then taking prompt corrective action can prevent a minor issue from turning into a major problem.



Once a problem is identified, it's critical to address it while it's still manageable. Too many franchise companies wait to react to a problem until it has reached crisis proportions. You need to take action before the relationship with your franchisees begins to erode. Watch for the warning signs, and be proactive at the very first inkling of trouble. In the case of a franchise company, the warning signs include:

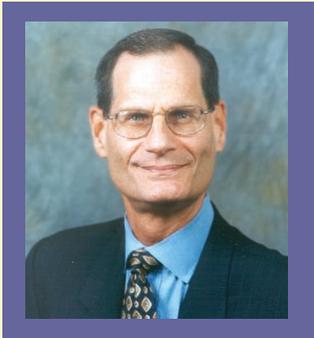
**Franchisee unrest.** When franchisees are disgruntled, complaining, challenging the corporate staff and policies, and expressing a lack of confidence in the franchisor, you've got a problem. Things won't get better without intervention. You need to sit down with the franchisees, find out what is driving their discontent, and develop a plan to address it.

**Misguided advisory board.** If your franchisee advisory board is acting more like an adversary than an advocate, it is not performing its function. A misdirected advisory board will do far more harm than good. Embrace your board and challenge them to channel their energies toward finding a solution as opposed to simply affixing blame.

**Declining franchisee revenue.** Beyond the obvious moves of alternative revenue generation or cost containment measures, the real key is to take your service to the franchisee to unprecedented levels. Realistically, you may not be able to generate more business for them immediately. But you can show them that you are behind them every step of the way through what is a very trying time.

**Finger-pointing at any level.** Whether it's employees at the corporate level or the franchisees or both, when you see a pattern of blaming and people trying to protect

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By Harold L. Kestenbaum, Esq.

### IFA Report: Know Your FACs

Having just returned from the largest International Franchise Association Convention, I can report the franchising buzz is as loud as ever. Every company attending seemed to be extraordinarily upbeat and excited about the future of franchising both domestically and, surprisingly, internationally. There seems to be little reluctance of some franchisors to take their program beyond the borders of the United States. The thing that I did notice was that more middle-sized companies were eyeing the international marketplace.

I conducted a roundtable on Enforcing System Standards and heard about some diverse issues and solutions from the smallest (two units) to some of the largest (5,000 units) franchisors. The problems and issues are not significantly different; it's just a matter of the size of the problems and complexity of the issues. The recurring theme among these franchisors was communication (where have we heard that before?). By and large, these franchisors were strong advocates of creating franchise advisory councils ("FAC").

For those of our readers who do not have FACs, it is something to strongly consider. The FAC gives franchisees some input into what policies are created and makes them feel a part of the policymaking decisions of the system. Although they only have the ability to recommend, at least they speak for their franchisee peers. FACs are an excellent way to find out what your franchisees would like to see happen in your system.

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## Are Arbitration Provisions Enforceable?



By Eric W. Penzer, Esq.

Franchise agreements sometimes require the arbitration of some or all disputes that might arise between franchisor and franchisee. Often there is a "carve out" for claims asserted by the franchisor seeking injunctive relief. It is not uncommon, however, for franchisees to argue that arbitration provisions are unconscionable because they are contained in agreements provided to them on a "take it or leave it" basis, without negotiation. In addressing such arguments courts sometimes reach conflicting

results, as demonstrated by two recent decisions.

In a recent California state court case involving a real estate agency franchisor, the franchise agreement required that disputes between the franchisor and franchisee be submitted to binding arbitration. However, the agreement also provided that the franchisor was not required to arbitrate claims against the franchisee. In response to the franchisor's application to compel arbitration, the court found the arbitration clause to be "unconscionable" because, first, it was a contract of adhesion offered to the franchisee on a "take it or leave it" basis and, second, because it was not mutual in its effect. The court rejected the franchisor's arguments that the franchisee voluntarily elected to enter into the franchise system for his own potential pecuniary gain, despite other alternatives.

In another case, however, the court reached a contrary result. That case, decided by the United States Court of Appeals for the Fourth Circuit, involved a hotel franchise agreement. The franchisee had filed suit seeking to compel reinstatement of the franchise agreement, and the franchisor sought to compel arbitration. The initial suit was withdrawn and the arbitration proceeding ensued. Ultimately, after two days of hearings, the arbitrator issued an award in favor of the franchisor for several hundred thousand dollars.

In seeking to set aside the arbitration award, the franchisee argued that the arbitration provision was an unenforceable contract of adhesion. The appellate court, applying Maryland law, explained that a contract of adhesion is one that is drafted unilaterally by the dominant party and then presented on a "take it or leave it" basis to the weaker party, who has no real opportunity to bargain about its terms. The appellate court noted the lower court's findings of fact to the effect that the franchisee was not an unsophisticated consumer, but an experienced hotel franchise owner, having purchased at least one other franchise in the past. The lower court also found that the franchisee failed to demonstrate that it had no viable alternatives, or that it faced the possibility of being excluded from the hotel franchise business altogether if it had refused such an arbitration contract. On the contrary, the court noted that the facts suggested that the franchisee made a conscious decision to enter into the franchise agreement because it would increase his profitability. On these facts, the appellate court rejected the franchisee's argument, agreeing with the lower court that the arbitration provision was not a contract of adhesion or otherwise unconscionable.

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By James M. Wicks

# 7 'Tools' To Avoid Unnecessary Litigation

Certain disputes between a franchisor and franchisee are destined for court. Even with 20-20 hindsight, nothing could have been done to avert litigation – a cancer in the system. For example, a franchisee who defrauds the system by intentionally underreporting or secretly having an interest in a competing brand leaves the franchisor no choice but to terminate.

Other less significant disputes, on the other hand, could and should be resolved without going to court. It is with these disputes that a franchisor has the power to avoid litigation. But how?

"The best defense is a good offense" is an often-employed litigation strategy. This can also be an effective strategy used to *avoid* litigation. By being proactive and taking certain simple affirmative steps, a franchisor may very well be able to control this risk.

Luckily, there are some basic, yet effective "dispute avoidance" tools at your disposal. None of these "tools" should come as a surprise, yet use of any of them is likely to put you in a favorable light if the dispute ends up in court:

- 1. Manage expectations.** Be clear and consistent at the outset and throughout the relationship as to what is expected and why. Clearly state and define the roles and obligations of each (in your agreements, operations manual, training sessions, etc.). Follow through in enforcing these expectations with franchisees and in carrying out the franchisor's obligations. Take steps to ensure all in the system understand the responsibilities everyone has.
- 2. Clear, direct communication.** Address issues clearly and directly – be decisive and forthright. Unclear or mixed messages to your franchisees inevitably lead to dissatisfaction and further disputes.

- 3. Timely communications.** Don't let issues fester; address them as they arise. Deal with the issues, then move on. Don't revisit issues dealt with in the past.

- 4. Be consistent.** Treat all franchisees in the system consistently; don't play favorites and give one franchisee "breaks," while insisting on strict enforcement for others. As everyone knows, word gets out quickly.

- 5. Confess mistakes.** Don't be afraid to admit errors or mistakes – it gives you credibility in the eyes of franchisees (and courts).

- 6. Address problems with a team approach.** Take a team approach toward dealing with problems as they arise (how can we solve this . . .); not an "us vs. them" approach. Consider creating a Franchise Advisory Committee.

- 7. Understand the cause of the problem.** Try to learn why the problem arose – this may help you collectively solve it. For example, is the franchisee's non-payment due to a short-term cash shortage or a fundamental flaw in the franchisee's business practices?

## LITIGATION NOTES

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The decision whether to include an arbitration provision in a franchise agreement is one that must be approached with caution. Not only does such a provision affect the rights of the parties to resolve their conflicts, it is subject to conflicting interpretation in the courts.

## Kudos!

Harold Kestenbaum was named one of the top 100 franchise attorneys in North America in an annual survey conducted by *Franchise Times*, a monthly publication for the franchising industry. The publication asked attorneys and clients to choose the "franchise lawyers at the top of their game; the rainmakers; the go-to lawyers; the ethical problem-solvers who are respected by their peers, adversaries and clients alike." Survey results were published in the April 2004 issue. Congratulations, Harold!

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## A Note on Earnings Claims

In January, the FTC issued an interesting Advisory Opinion regarding the dissemination of earnings claims via the Internet. For those companies with an Item 19 Earnings claim, and even for those without one, the FTC says that providing your earnings claim in an Internet advertisement or in an email does not satisfy the requirements of the FTC Rule, even if you subsequently provide the UFOC containing the Item 19 claim. The moral here is don't mention the actual earnings claims in these or any media, but simply state that an earnings claim will be provided when the UFOC is delivered.

## More On Growth Strategies

In our last issue, I began a discussion on multi-unit expansion and which seems to be the method "de jour." At the convention and in my travels, I've noted a general consensus that, for domestic growth, Master Franchising is not the method of choice. Most franchisors are utilizing the traditional area development method, where one entity commits to open multiple units over a negotiated development schedule. However, as I mentioned last time, the Area Representative or Development Agent methodology has been gaining in popularity. My caveat on this method is that you need to be quite diligent and selective in whom you grant these to. The other caveat is that this method is costlier to institute, from a registration and legal perspective, and requires the franchisor to be much more diligent about compliance practices.

## Events Calendar

### April 30 - May 2

IFE Expo 2004. For further information, go to [www.FranchiseExpo.com](http://www.FranchiseExpo.com)

### June 18

Farrell Fritz Quarterly Franchise Forum. To reserve a place, contact Helen Rajcooar: phone, 516-227-0641; email, [hrajcooar@farrellfritz.com](mailto:hrajcooar@farrellfritz.com)

## WARNING SIGNS

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themselves and their particular turf, something is wrong. Get to the root of the problem and correct it before your organization suffers any further.

**Employee morale problems at corporate.** If franchisees are unhappy, the frontline corporate staff will likely be the first ones to know – and if they're getting "beat up" by franchisees on a regular basis, it's going to affect their morale. From there, it's a downward spiral. Your most valuable asset is your team. The staff can help you identify franchisee problems more accurately than any other single source and in all likelihood have significant insight to what the franchisee wants and needs. Seek their input and resolve the problem as quickly as possible. The trickle-down effect will include improved employee morale.

**And the most effective solution: communication.** It is critical to communicate with your system. Do not allow problems or perceived problems to go without discussions with your corporate staff and more importantly with your franchisees. Franchisees want to hear from corporate; they do not want to be left in the dark. They are paying their royalties for a reason, and since they are the lifeblood of all franchise systems, they must be spoken to on a daily basis, even if it is via your company's intranet. Also, the attitude at corporate sends messages to your system. If your staff is polite, courteous and friendly, it will send the right message to your franchisees. But, if your staff is curt, offensive and not polite, the wrong messages are sent and resentment will abound throughout your system. An attitude of "them against us" is the wrong attitude and one that can only lead to serious problems down the road. This is one team and everyone has to be a team player, since that is the only way to have a win-win situation for your system.

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