Farrell Fritz, P.C.

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# Focus on Franchising

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## Welcome!

We are pleased to be sending you this inaugural issue of our quarterly newsletter, in which we hope to explore topical issues affecting the business of franchising. This is *your* newsletter - intended to provide you with relevant and timely information to help your franchising efforts. Your comments about articles and suggestions for future topics are welcome. Contact us at info@farrellfritz.com.

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## Inside



## Thou Shall 'Obey All Laws'

**By James M. Wicks**

An "obey all laws" provision is commonplace in franchise agreements. Breach of that obligation may justify termination of the franchise, so long as the violation is deemed to undermine the franchise relationship or gives rise to a good faith belief on the part of the franchisor that the franchisee is untrustworthy.

What if, however, the franchisor has a basis to believe the franchisee is violating federal income tax laws (*e.g., tax evasion*), even though the franchisee has not admitted to the crime or is not otherwise convicted, charged or indicted? A federal court in Florida recently held that Dunkin' Donuts sufficiently established the violation of law, and that such violation undermined the franchised relationship, so as to justify termination. The court concluded that the "obey all laws" provision in Dunkin' Donuts' franchise agreement does not require an admission of guilt or a conviction to justify termination. The franchisor need only prove that the franchisee violated the law in order to enforce its contractual right to terminate. The court went one step further and found that the franchisees' violation of the tax laws was also injurious or prejudicial to the goodwill associated with Dunkin' Donuts' proprietary marks and system, thus breaching another clause in the parties' agreement.


This holding is consistent with other cases that have not required an admission of guilt or conviction to terminate a franchisee, and the broad view of such clause by the courts. In fact, in another recent case, a franchisee was terminated on the basis of violating the "obey all laws" clause when he was charged with drug offenses and money laundering. The court there rejected the franchisee's claim that the "obey all laws" clause relates only to health, safety and sanitation laws.

Given the court's broad consideration of the "obey all laws" clauses, franchisees should not overlook that clause when terminating a franchise.

By Harold L. Kestenbaum, Esq.

### FTC Rule Update

As you may know, the FTC has proposed some significant changes to its long standing Rule governing Franchising. In fact, these changes have been in discussion for nearly five years! Where are they now, you ask? Well, the latest rumor has it that by the middle of 2004 the Rule changes should be approved and issued, thereby commencing the expensive and time consuming process of re-writing all UFOC documents (to be renamed Franchise Disclosure Document). The Rule changes will impact all franchisors. We will keep everyone apprised of the timing regarding the making of the changes in our upcoming newsletters.

### International Update

For those of you contemplating selling franchises outside of the US, be aware that the nations of South Korea and Italy have tightened their already existing franchise laws. Both require Pre-Sale disclosure, but in Italy for example, unless a company has been operating for one year with a pilot operation in Italy,

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# Is There Ever A Fiduciary Relationship Between Franchisor and Franchisee?

By Eric W. Penzer

In franchise litigation, it is not uncommon for franchisees to argue that a fiduciary relationship exists between them and their franchisors. This argument is most often made by a franchisee in an effort to impose duties on the franchisor that do not appear in the franchise agreement, such as the requirement for the franchisor to advise the franchisee of a sale. A fiduciary duty, generally speaking, does not result from an arms-length business relationship. Applying that principle, the vast majority of state and federal courts - in New York and elsewhere - have generally held that a franchise relationship is *not* fiduciary in nature. Like any general rule, however, there are exceptions to the rule, and some courts have found that a fiduciary relationship *does* exist between a franchisor and franchisee.

Although New York courts have been more willing to permit claims of fiduciary duty in cases involving manufacturer-distributor relationships, in the franchise realm, a fiduciary relationship was found to exist in only one reported lower court decision in New York. In that case, the franchisees were a family of Taiwanese immigrants with no business background, who alleged that the franchisor discouraged them from seeking independent legal advice in connection with their purchase of the franchise. Notably, that case has been limited to its facts by every New York court that has analyzed it.

What should you do to avoid a dispute over this issue? A provision expressly disclaiming the existence of a fiduciary relationship can be written into the franchise agreement. Those provisions - in conjunction with provisions in which the franchisee disclaims reliance on unwritten representations made by the franchisor - should be helpful in defeating claims for breach of fiduciary duty, as well as claims relating to alleged misrepresentations or failures to disclose in connection with the sale of the franchise. Fundamentally, however, when deciding this issue, the courts look to the level of domination and control over the franchise.

By Michael J.Healy

# Arbitration Clauses: Do They Make Sense In Franchise Agreements?

Litigation of franchise disputes, like litigation in general, can be expensive, frustrating, lengthy and inefficient. Arbitration, a form of alternative dispute resolution, is becoming an increasingly popular alternative for avoiding litigation altogether. But do arbitration clauses in franchise agreements make sense for franchisors?

Arbitration is, in essence, a legal process that takes place outside of the court system, yet results nonetheless in a final and legally binding decision similar to a court judgment. It can offer a franchisor many benefits. By agreeing in the franchise agreement to arbitrate the disputes, a franchisor can have its dispute with a franchisee resolved by a neutral third party arbitrator, usually experienced in the subject matter, in a faster, less expensive and more informal proceeding than going to court. And it also has the advantage of being private and confidential, unlike legal proceedings.

But other considerations need also to be weighed by franchisors. Including an arbitration clause in a franchise agreement may not make sense where a franchisor believes the franchisee will be less able to withstand expensive and protractive litigation, thus giving the franchisor added leverage over a franchisee through court litigation. An especially important consideration for franchisors, moreover, are the in-term and post-term covenants not to compete that prohibit franchisees from operating, directly or indirectly, competing businesses. These covenants can only be enforced through court-issued temporary restraining orders and injunctions - remedies typically not available in the arbitration proceedings. Unless specifically carved out of the arbitration clause, these types of remedies would be deemed waived by the parties, leaving only a money damage claim to be arbitrated. Thus, if electing to include an arbitration clause in a franchise agreement, the franchisor must ensure that the arbitration clause provides an exception for injunctive remedies, stating that the parties may seek to obtain court-issued injunctions, while arbitration proceedings are pending, to enforce certain provisions of the franchise agreement.

A variety of other factors - like selection of the arbitrator, prohibiting awards of punitive damages, the sharing of expenses of the arbitrator, and how much discovery should be employed in an arbitration proceeding - also enter into the equation. Ultimately, a franchisor should consult counsel in deciding whether an arbitration clause is in its best interests, and, if so, what type of arbitration clause makes the most sense.

# Events Calendar

**November 13**
New York State Bar Association program on Franchising. For further information, go to www.nysba.org

**December 5**
Farrell Fritz Quarterly Franchise Forum. To reserve a place, contact Helen Rajcooar: phone, 516.227.0720; e-mail, hrajcooar@farrellfritz.com

**Spring 2004**
Nassau County Bar Association program on Franchising. See future issues of this newsletter for more information.

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they will be barred from selling franchises in Italy. South Korea has become a full fledged disclosure country, requiring a UFOC-type document to be delivered prior to making any franchise sales.

It is worth repeating here, for those of you contemplating selling north of the border. There are two provinces in Canada that have franchise laws, Alberta and Ontario. Alberta requires a filing and registration, Ontario does not. However in Ontario, your UFOC will not be acceptable, thus requiring an Ontario UFOC to be prepared and disseminated.

### California Changes

The state of California has passed several changes to its franchise regulations. First, the regulations have finally exempted Internet advertising from the Pre-Sale registration requirements. In addition, in all California State Addenda, language must be inserted which states that if the Franchise Agreement requires arbitration, "all franchise prospects are encouraged to consult legal counsel to determine the applicability of federal and state laws to any provisions in the agreement requiring venue outside of California."