



**March Dinner Meeting
March 18, 2008**

**Legal and Legislative
UPDATE**

LEGISLATIVE

- **Franchisee Associations and the New Franchise Disclosure Rule**

- The new Franchise Disclosure Rule, which took optional effect on July 1, 2007 and will become mandatory as of July 1, 2008, requires that a franchisor include in its Disclosure Document the name, address, telephone number, email address and web address of any trademark-specific franchisee association within the franchise system that is either (a) created, sponsored or endorsed by the franchisor, or (b) incorporated and asks to be included in the disclosure document for the next fiscal year.
- Note: In the case of (b), that request must be renewed in writing each year within 60 days of the end of the franchisor's fiscal year.
- This new disclosure rule will provide prospective franchisees access to vital information about the franchise system that will allow them to fully investigate a franchise.
- Access to a franchisee trade association is already statutorily provided for in eleven states: Arkansas, California, Hawaii, Illinois, Iowa, Michigan, Minnesota, Nebraska, New Jersey, Rhode Island and Washington.
- The current legal climate favors sanctions for franchisors when the franchisor has treated a member or leader of a franchisee trade association differently than non-members, particularly when that treatment is perceived as a retaliatory response to membership in the franchisee trade association.

- **California State Department of Corporations: Release No. 18-F: Franchisors, Subfranchisors and Development Agents.**

- The Federal Trade Commission (FTC) had amended 16. C.F.R. Part 436 to respond to changes in technology and conditions of the franchise market. Under 16 C.F.R. 436.1, a franchisor is defined as "any person who grants a franchise and participates in the franchise relationship...For



purposes of this definition, a ‘subfranchisor’ means a person who functions as a franchisor by engaging in both pre-sale...and post sale activities.”

- Under California Franchise Investment Law (CFIL) § 31008.5, “subfranchise” is defined as “any contract or agreement between a franchisor and a subfranchisor whereby the subfranchisor is granted the right, for consideration give in whole or in part for that right, to sell or negotiate the sale of franchises in the name or on behalf of the franchisor.”
- The question arises as to whether development agents should be treated as subfranchisors because they provide post-sales services to franchisees, which require the inclusion of financial statements in the disclosure document.
- The FTC’s response: even if a person performs post-sale activities on behalf of a franchisor, that person is not a subfranchisor under the amended Rule UNLESS that person is a party to the franchise agreement or to another agreement involved in the franchise. A subfranchisor is a person who functions as a franchisor, by either granting or participating in the franchise relationship and who also must have the authority to enter into a franchise agreement and as a result, be obligated to perform after the purchase of the franchise is consummated.
- Under CFIL, consider the following factors when determining whether the services of a development agent constitutes a subfranchisor:
 - To be considered a subfranchisor, a development agent must have the authority to enter into a franchise agreement (i.e. be a party to the franchise agreement) and be obligated, as a result, to perform franchise obligations.
 - An agent who does not perform post-sale obligations required by a franchise agreement is not a subfranchisor but may be a franchise sales person. Additionally, performance of post-sale obligations required under the agreement, without additional duties, does not render the agent a subfranchisor.



- An agent who is granted the right to receive compensation for referrals to a franchisor or subfranchisor or receives compensation for acting as a sales agent is not considered a party to the franchise agreement.
- Finally, analysis of subfranchisor status should emphasize functions of the agent rather than what title is assigned to the agent.

COURT DECISIONS

- **Bray v. QFA Royalties LLC (US District Court of Colorado, May 3, 2007)**
 - Franchisor Quiznos served immediate notice of termination of franchise rights on several franchisees, who served or were connected to a franchisee association, Toasted Subs Franchise Association, Inc. (TSFA), who posted a suicide note on its website of a Quiznos employee who ended his life amidst protracted litigation with Quiznos. The Franchisees asked the court to prohibit Quiznos from terminating their agreements.
 - Quiznos terminated the franchise rights under a section of its agreement that provided for the termination of the rights of Franchisees who engaged in “conduct that, in the **sole judgment** of Franchisor, materially impairs the goodwill associated with the [trademark].”
 - The court rejected Quiznos argument that its use of the term “sole judgment” gave it an unfettered right to decide whether Franchisees’ conduct materially impaired the goodwill associated with the trademark. Instead, the court found that the use of the word “judgment” implied the use of a discerning cognitive process that would involve investigation of the facts at hand. In the absence of this process and the failure to investigate, the court held that Quiznos’ decision was “impulsive” and “retaliatory.” The preliminary injunction was granted for the Franchisees.



- **The Michigan Dairy Queen Operators' Association v. International Dairy Queen, Inc. (District Court of Michigan, January 14, 2008)**
 - Litigation is pending in the District Court of Michigan for International Dairy Queen. The Michigan Dairy Queen Operators Association (the "MDQOA") has brought a complaint on behalf of those franchisee associations, who do not have franchise agreements with arbitration clauses, to block Dairy Queen's expensive conversion program which would require old Dairy Queen franchises to convert to a DQ Grill & Chill or DQ/Orange Julius operations.
 - Franchisees claim that certain surcharges have been added to the price of products and must be credited against Franchisee advertising contribution requirement because the imposition of these surcharges violate the terms of the franchise agreements.
 - The MDQOA seeks declaratory and injunctive relief to prohibit defendants from "forcing their Member Franchisees to make an expensive conversion...on terms that are commercially unreasonable in view of the expense, on the one hand, and the lack of a reasonable rate of return, on the other hand."
 - MDQOA claims that the attempted conversion is a material breach of the franchise agreement and a breach of the duty of good faith and fair dealing implicit in the contract.
 - Without relief, the Franchisees will continue to suffer damages through the actual or threatened loss of "(i) their coerced investment in the brand conversions; (ii) the business and goodwill that they have developed and nurtured as Dairy Queen franchisees and; (iii) the opportunity to realize the equity in their Dairy Queen franchises by sale."
 - Finally, MDQOA will address the surcharges on certain products, like brand name cookies, that are sold to the public. They seek declaratory and injunctive relief that the surcharges are not permitted under the current franchise agreements and as a result, the Franchisors must credit

those charges against the Franchisees' monthly sales and promotion program fees.

- An answer has yet to be filed by International Dairy Queen, Inc.
- **Tutor Time Learning Centers, LLC v. Larzak, Inc. (US District Court of Indiana, July 6, 2007)**
 - Child care provider Franchisee sought to avoid a covenant not to compete provision in the franchise agreement on the grounds that the Franchisor breached various provisions of the agreement over the ten year period.
 - Franchisee maintained that such breaches of the franchise agreement occurred when Franchisor failed to provide software upgrades and sufficient support and assistance from the Franchisor's personnel over the term of the agreement. However, Franchisee never issued notice of any kind upon Franchisor that Franchisor was in breach of the agreement.
 - The language of the Notice Provision was as follows: "In the event that Franchisor breaches this Franchise Agreement and fails to cure such breach within thirty (30) days after **written notice** of Franchisee's intent to terminate is delivered to the Franchisor, then the Franchisee may terminate this agreement for cause and shall have all the remedies at law and equity available to it. **The franchisee may not terminate this agreement in any other way or manner.**"
 - The court held that in light of the clear and unambiguous language of the agreement, written notice was required for Franchisee to terminate the agreement. As Franchisee continued to operate over the ten year period of the agreement, the Franchisee could not assert the invalidity of the agreement after the fact. Summary judgment for breach of the covenant not to compete for the Franchisor was granted.

ISSUE UPDATES

- **Gift Cards May Lose Value When Stores Face Financial Trouble**

- Consumers holding gift cards to a store may be the ones to suffer if that store has financial difficulties. When a business files for a Chapter 11 bankruptcy, the gift cards are treated as a loan to the company, and the cardholder is treated as a creditor of the company. Unfortunately, these consumers are considered unsecured creditors, which means they have low priority in comparison to other creditors that have secured themselves, such as through collateral.
- A recent example is Sharper Image. The company filed for bankruptcy and had suspended the acceptance of gift cards. Recently however, the company started redeeming its cards again but only if card holders both redeem the full value of the card and purchase merchandise worth twice the value of the gift card. Meanwhile, its competitor, Brookstone, is offering the Sharper Image cardholders 25% off their entire purchase in redemption for the cards.

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