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BUSINESS LAW

Ten ways for a franchisor to get sued by its franchisees

Franchise business relationships exist in approximately 75 different industries.

This article concerns business format franchises, which generally speaking, involve one party (the "franchisor") granting a third party (the "franchisee") the right to operate a business: (1) substantially associated with a trademark controlled by the franchisor, and (2) under a marketing plan or system prescribed by the franchisor, in exchange for (3) franchisee's payment of a fee to franchisor.

By David L. Cahn

Given the ubiquitous nature of franchises, and certain inherent tensions in franchisor-franchisee relationships, disputes between such parties are not uncommon. The following are 10 actions that a franchisor can do that will make franchisees' litigation attorneys salivate:

Sell a franchise without providing disclosures: Under regulations issued by the Federal Trade Commission, any person who offers a franchise must provide the prospective franchisee with a disclosure document that contains certain types of information. Thirteen states, including Maryland, require that, before a franchisor offers a franchise for sale in the state, a state administrator review the franchise disclosure document. The administrator must find that the franchisor has provided the information required under the Uniform Franchise Offering Circular Guidelines before authorizing the sale of such franchises in the state.

Failure to comply with disclosure and registration laws can lead to civil or criminal sanctions if pursued by a state attorney general or the FTC. In addition, such violations may allow a franchisee to end the franchise relationship and get a refund of all funds paid to the franchisor or, potentially, close the business entirely, force the franchisor to assume responsibility for all debts and refund the franchisee its entire investment in the business.

Provide financial performance representations outside the UFOC: Among the most central rules governing franchise sales is that, if a franchisor wants to provide a prospective franchisee with information about the revenues or profits of operating franchises, such information must be provided in a specified format in the UFOC as an "earnings claim." If a franchisor chooses not to provide an earnings claim, and therefore issue what is called a "negative disclosure," its salespeople cannot provide such information orally or in writing.

Therefore, a franchisee's attorney would be excited to learn that a franchisor has made a negative disclosure in its UFOC and then allowed its salespeople to provide written earnings data on operating franchises. The excitement level would increase if the data given was cursory; enough to make the franchisee enthusiastic about the opportunity, but not enough to make him aware that he might not achieve the results stated.

Guestimate the initial investment costs: A franchisor must provide a detailed breakdown of a franchisee's expected initial investment costs in the UFOC. In addition to the initial franchise fee, the franchisor must estimate highly variable costs such as real estate; furnishing, fixtures and equipment; signage; initial inventory; and working capital for the first three months of operations.

The franchisee's attorney will be interested if the franchisee's actual costs to start the franchise business substantially exceeded the franchisor's estimate. That attorney will be even more excited if he can prove that the franchisor estimated initial investment costs: (1) without developing and operating any units of the franchised business itself, while (2) allowing franchises to operate from a wide variety of physical locations, with variable inventory and equipment and myriad of business plans, and (3) does not obtain data from franchisees as to their costs to open the business and to operate it during the first three months.

Hide prior failures in the same market: In Item 20 of the UFOC, the franchisor is required to provide a chart detailing the number of franchisees in each state, along with the numbers of franchises that have left the franchise system during the prior three years. The UFOC guidelines do not require a disclosure of prior failures of franchises in the market area of the prospective franchisee. However, this is a question asked by a substantial number of prospective franchisees, because prior failures can be a drag on the brand in the eyes of consumers. Therefore, a franchisee attorney would be interested to learn that the franchisor told his client that they would be the first franchisee in the market area, when in fact the franchisor had a franchisee open and close in that market within the past 10 years.

Take rebates from vendors without full disclosure: The textbook model of franchising is for the franchisor to prosper due to increasing franchisee revenue — thereby growing its royalties. However, some franchisors also make profits by extracting payments ("rebates") from vendors who they allow to sell supplies to franchises. A franchisor's receipt of rebates is not illegal, provided that it fully discloses the practice in its UFOC.

However, a franchisee attorney's ears will perk up if he learns that the franchisor provided little or no disclosure of its activities in seeking or obtaining rebates in its UFOC, and then solicits and receives rebates from approved suppliers as a condition of allowing them access to the franchisees. Such an attorney will really be interested if the franchisor did not place any restrictions on dispute resolution procedures that preclude a franchisee class action.

Directly compete against your franchisees without notice: Generally speaking, a franchisor wants as few restrictions on its operations in a market as possible, so that it can own competing chains and take advantage of alternative methods of product or service delivery. A franchisee, on the other hand, wants to restrict competition in its market wherever possible.

Therefore, a franchisee's attorney will find a matter attractive where the franchise agreement grants the franchisee "exclusive rights" in a geographic area, without any reservation to the franchisor of the right to engage in alternative methods of distribution, and then the franchisor begins selling branded product to customers in the territory through the Internet or through other retailers.

Use advertising fund fees for franchisor's operating expenses: Most franchisees pay periodic advertising fees to their franchisor. Most franchise agreements give the franchisor wide discretion on the use of such funds.

However, a franchisee's attorney would be interested to learn that a franchisor was not using advertising fees for marketing or promotion of the brand in any manner. A franchisor that does not segregate advertising fees and periodically account to their franchisees for the use of those funds is courting a dispute.

Never visit your franchisees: Most franchisors tout their high quality standards and the operating support they provide their franchise owners. However, most franchise agreements place few clear obligations upon the franchisor to supervise or support their operating franchisees. One sign of a deficient system is if no representative of the franchisor has visited the franchisee for more than one year. While not worthy of a claim by itself, such neglect of franchisees, combined with other problems, can make a successful case for a franchisee's attorney.

Discriminate against the leader of a franchisee association: Only a few states have statutes protecting the rights of franchisees to form an association to address issues of common concern regarding their franchise system and/or franchisor. Moreover, the ability of franchisees to assert general constitutional principles of free association to protect their rights to form an association is not well tested in the courts.

Nevertheless, a franchisee attorney will be interested in a case where the franchisor deviates from its general practices when making decisions with regard to a perceived leader of an independent franchisee association. While franchisors have no legal duty to bargain or even consult with an independent franchisee association, franchisees have been successful in asserting that such discrimination violates the implied covenant of good faith and fair dealing in their relationship with their franchisor.

Deny a transfer to recapture a territory: Most franchise agreements give the franchisor the right to deny a proposed transfer of a franchise. Some courts have held that a franchisor can deny a transfer for any reason or no reason.

However, a franchisee's attorney would find a case interesting where the franchisor denies approval of a proposed transfer for absolutely no reason, then evicts the franchise and assumes control of the operating business due to a payment default that the franchisee would have cured with transfer proceeds. Of course, the case would really be juicy if the franchisor turned around and sold that franchise to the proposed transferee a few months later.

In summary, franchisors and franchisees can achieve great financial and personal rewards through a productive and fair relationship. However, if a practice appears unfair, a franchisor is courting trouble — may end up curbing the engine that should fuel its growth.

David L. Cahn, Esq., is an attorney with Lenrow, Kohn & Oliver, a business law firm in Baltimore. Cahn has represented franchisees or franchisors in more than 20 industry sectors, including quick-service and full-service restaurants, accounting, auto rental, dating service, tutoring, insurance sales, modeling, home health care, real estate brokerage, personnel placement, travel agency, truck stop and wholesale floor coverings. If you have any comments or questions, you can send him an e-mail at dcahn@lkho.com or call him at 410-962-0522.