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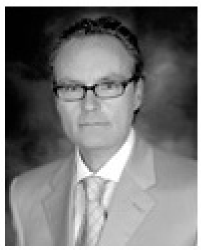

Message from the Chair
The Forum's Austin Meeting: The Fruits of Hard Work (and a Lot of Planning Ahead)

By Edward Wood Dunham
Forum Chair

The 31st Annual Forum on Franchising was a great success. Highlights included Brian Garner's witty, instructive plenary on legal writing, the dynamic first-time speakers who brought refreshing energy and new perspectives to their presentations, and awesome performances from some of the finest talent in the Live Music Capital of the World. In particular, Forum members lucky enough to attend Marsha Ball's extraordinary Friday night show at Anton's shared an experience that that they will never forget. The music at other events was sometimes a little too loud for conversation, and a few workshop speakers, riveted to their seats (and their scripts), did not engage their audiences to the extent we had hoped. But the program's strengths were far more numerous than its very modest flaws.

This year's program chairs, Peter Klarfeld and Joe Fittante - with Kelly Rodenberg providing her usual superb support - deserve enormous credit for their organizational talent, creativity and unflappability. Some Forum members may not fully appreciate how early Joe and Peter began to bring those skills to bear in conceiving and executing the meeting, and how much effort they dedicated to those tasks. I therefore thought that I should take this opportunity to provide an overview of the multi-year process that culminates in the Forum's annual meeting.

My predecessor as Forum Chair, Dennis Wieczorek chose Peter and Joe as the 2008 program chairs in 2006. That Fall, shortly after the 29th Annual Forum in Boston, they spent a long weekend in Phoenix at the planning session for the 2007 annual meeting. Peter and Joe road the bus with the other planning committee members, visiting potential venues for social events, and helped dissect and thereby strengthen Leslie Smith and Harris Chernow's initial program proposal for the 30th Annual Forum.

Throughout 2007, Joe and Peter kept their eyes and ears open for potential topics and speakers for 2008; they were undoubtedly among the most attentive observers at the 2007 Forum, assessing what worked well (a lot) and what could be improved (not much) at a meeting that set a new attendance record and received outstanding evaluations for both program content and social activities. Just a few weeks after the Phoenix meeting, Peter, Joe and the other members of the planning committee (the Forum Chair and Immediate Past Chair, the 2007 annual meeting program chairs, and the 2009 annual meeting program chairs) gathered in Austin to visit potential sites for dinners and receptions, and Joe and Peter presented their initial program proposal. As happens every year, the chairs' carefully considered draft program was closely scrutinized, first by the planning committee and then by the entire Forum Governing Committee at our winter meeting. This is sometimes a daunting gauntlet to run, but the feedback is always constructive and collegial, and Peter and Joe (and everyone else who has chaired an annual meeting) would readily acknowledge that this collaborative process greatly strengthens the program.

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Once the program was finalized, Peter and Joe moved on to the next phases of their job – first, lining up speakers and then, working with program directors from the Governing Committee, supervising the preparation, from outline through finished product, of 26 scholarly papers and the Annual Franchise and Distribution Law Developments book. This months-long effort was interrupted by the occasional crisis – a speaker bowing out because of illness or other commitments, a meeting room or catering curveball from the hotel – each of which this year's program chairs efficiently resolved with admirable equanimity.

I get tired just writing about all this hard work! When that work is done as well as Peter and Joe did it, the actual meeting is (relatively speaking) a cakewalk.

This annual cycle of advance planning and hard work is already underway again, for our 2009 annual meeting in Toronto. The program-chairs, Kerry Bundy and Larry Weinberg, with the other members of the planning committee (this time including Kathy Kotel and Deb Coldwell, program chairs of the 2010 annual meeting at the Hotel Del Coronado in San Diego, and Forum Chair Elect Ron Gardner) have already visited Toronto. I can't spill the details yet, but the social events will be at great venues, and Kerry and Larry's program proposal was first rate.

To state the painfully obvious, 2009 will be a challenging year economically, and many law firms and corporate law departments have already cut back on all kinds of expenditures, including travel and tuition for CLE programs. Notwithstanding this tough environment, I urge every franchise law practitioner to press the case for attending the Toronto Forum. The price will still be a bargain compared to the vast majority of legal seminars, and the program content and networking opportunities will remain unsurpassed.

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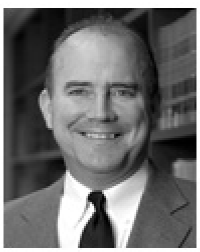

Avoiding Comments When Preparing FDDs in 2009: Top Twelve Traps

By John Fitzgerald and Elizabeth Dillon

Gray Plant Mooty

For most franchisors, the always-festive holiday season is followed all too closely by the not-so-festive franchise renewal season. The goal of this article is to lessen those "Bah! Humbug!" feelings about the renewal season by offering some tips that should help reduce the length of those comment letters no one enjoys, franchisors, franchise lawyers and state examiners alike. These tips should also help improve the overall disclosure provided to prospective franchisees, furthering the stated purpose of the Rule to provide the material information necessary to make an informed purchasing decision, as well as alert their attorneys to what state examiners expect to see in FDDs under the Amended Rule.

Franchisors with recent fiscal year ends are, or soon will be, preparing their annual franchise renewal filings and, for most, it will be only their second year filing franchise disclosure documents ("FDDs") under the amended FTC Franchise Rule ("Amended Rule"). Last year at this time, the Amended Rule was still relatively new and franchisors, franchise lawyers and state examiners were grappling with how to interpret many aspects of it. This year, however, things are different. Not only do franchisors and state examiners have the benefit of one year of practice, many excellent seminars and workshops on the Amended Rule, and lively exchanges on the listserve, but the FTC and the North American Securities Administrators Association ("NASAA") have provided helpful additional guidance.

The FTC has continued to post on its website (http://www.ftc.gov/bcp/franchise/amended-rule-faqs.shtml) its responses to frequently asked questions ("FTC FAQs") on the Amended Rule and, in May 2008, the FTC published its much-anticipated compliance guide ("Compliance Guide"). In addition, NASAA published franchise registration and disclosure guidelines that took effect on July 1, 2008 ("NASAA Guidelines"), and, in September 2008, NASAA issued a proposed draft of its commentary to the Amended Rule ("NASAA Commentary"). Although NASAA had not finalized the NASAA Commentary as of the date the authors submitted this article, it will likely be similar to the draft version.

Taking into account all of the clarifications that the FTC, NASAA and state examiners have provided, as well as experience gathered from our firm and other practitioners, this article highlights some potential disclosure traps to help franchisors better comply with the required disclosures under the Amended Rule and avoid comments from state examiners in 2009.

1. Item 3 - Franchisors Must Disclose All *Material* Civil Actions. The Amended Rule requires that franchisors make certain disclosures in Item 3 if a franchisor was "held liable" in a civil action involving certain allegations. Franchisors have been uncertain whether they had to disclose all actions or only material actions. The NASAA Commentary answers the question by requiring disclosure of completed civil actions only if a franchisor is required to pay a material amount or provide material other consideration, or if a franchisor's rights are materially restricted. (NASAA Commentary 3.5.) In addition, franchisors must not forget to disclose all material civil actions involving the "franchise relationship" filed during the previous fiscal year, even if a franchisee (and not the franchisor) brought the action and the action does not allege a violation of franchise, antitrust or securities law, nor allege fraud, unfair or deceptive practices or comparable allegations (for example, a simple breach of contract claim). Further, if a franchisor discloses predecessor litigation and the predecessor is no longer affiliated with the franchisor, the franchisor must make a good faith effort to obtain updated information from the predecessor, court documents or other public sources. If a franchisor is unable to obtain that information, it may note that fact in Item 3. (NASAA Commentary 3.2 and Compliance Guide, pg. 39.)

2. Item 8 - Do Not Disclose an Officer's Indirect or *De Minimis* Interest in a Supplier. Item 8 of the Amended Rule requires franchisors to disclose whether its officers own an interest in a supplier. Franchisors need only disclose material interests and do not need to disclose an officer's interest in a mutual fund or similar investment vehicle where the officer does not have control over the investment. (FTC FAQ #18 and Compliance Guide, pg. 53.) In addition, franchisors do not need to identify the specific officers that own an interest. However, franchisors cannot use an overly general disclosure, such as "one or more of our officers own an interest in one or more of our suppliers." A similar statement referring to a *de minimis* interest may also receive a comment. It is interesting to note that, under the Compliance Guide, the term "officer" should include any person with management or policy-making authority, which extends the disclosure obligation beyond just the actual officers of the franchisor.

3. Item 11 – Disclose Trainers' Relevant Experience. Though it seems efficient, it may not be enough to simply refer to Item 2 as a means for describing the experience of a trainer in Item 11. The trainer's experience must include both the length of relevant experience in the field and with the franchisor, which may not be described sufficiently in Item 2. Alternatively, based on a welcome FTC clarification, if a franchisor's training staff is large or changes frequently, the franchisor can provide a general description of the background and experience of the staff, instead of providing the background and experience of every member of the training staff. (Compliance Guide, pg. 68.)

4. Item 12 – Use the Required Language Only When No Exclusive Territory is Granted. There has been some confusion among franchisors as to when they must include the required, boilerplate disclosure regarding an exclusive territory. If a franchisor does not grant any protected territory (for example, the franchisor grants a site-only franchise), it is clear that a franchisor must include the disclosure. It also is clear that the disclosure is not required if a franchisor grants a territory that is completely exclusive. In many instances, however, the issue is not so black and white, and a franchisor may reserve certain rights to itself within a limited protected territory. For example, a franchisor may promise not to put an identical business under the same mark in the franchisee's territory, but carve out the franchisor's right to distribute its products or services through alternative channels of distribution or operate similar businesses at special sites, such as universities, airports or stadiums. Is the boilerplate disclosure necessary in those situations? The FTC FAQs clarify that issue stating that no disclosure is necessary if franchisors simply reserve the right to use alternative channels of distribution or develop competitive brands. (FTC FAQ #25.) On the other hand, if a franchisor operates a similar business under the same marks, even from special sites such as universities, airports or stadiums, the franchisor must include the boilerplate disclosure. (FTC FAQ #25.)

5. Item 17 – Delete the Franchise Relationship Law Cites. In the past, franchisors were required to include citations to different state franchise relationship laws immediately following the Item 17 chart. This reference is no longer necessary and franchisors must delete the citations in Item 17. (NASAA Commentary 17.1.)

6. Item 19 – FPRs: Draft Carefully and Understand the Limits. Financial performance representations ("FPRs") continue to attract comments. Here are some tips to avoid those comments and to help eliminate later Franchisee actions:

- The Amended Rule requires franchisors that make an FPR to provide a "clear and conspicuous admonition that a new franchisee's individual results may differ from the results stated in the financial performance representation." The FTC and NASAA provide franchisors with form language to use to express this admonition. (Compliance Guide, pg. 92 and NASAA Commentary 19.3.)

- On the other hand, franchisors may not include warnings or disclaimers in the FPR that disclaim the information provided or state that the franchisee may not rely on the information. (NASAA Commentary 19.3.) This is not to say, however, that franchisors should discontinue the practice of including clarifying "notes" in FPRs that detail how the circumstances of the units described in the FPRs may be different than new franchised units. As a result, franchisors must draft FPRs carefully to provide full disclosure to a prospective franchisee, adequately protect themselves, and avoid comments by not including prohibited or what some examiners believe are inappropriate warnings or disclosures.

- Similarly, franchisors should avoid using bold or all capitalized letters in FPRs unless specifically required because some examiners take issue with this practice.

- Costs, standing alone, are no longer included within the definition of FPRs. If a franchisor discloses costs outside of an FPR, it should be remembered that the franchisor may not express those expenses as a percentage of revenue. (NASAA Commentary 19.1.)

- For franchisors that elect not to provide an FPR, franchisors must include the disclaimer provided in Item 19 under the Amended Rule and nothing more.

- If franchisors use data from a subset of franchisees for their FPR, they must also clearly state the total number of franchisees in the system during the time period the data was collected.

7. Item 20 – Include all Tables and Disclose All Franchisees. The FTC and NASAA also have provided franchisors with clarification on the disclosures required under Item 20:

- In addition to the list of operating franchisees as of fiscal year end, franchisors must provide a list of those franchisees who have signed a franchise agreement but who are not operating a franchise. However, this information should only be included in Table 5 under the heading "Franchise Agreements Signed But Outlet Not Open." (Compliance Guide, pg. 102 and FTC FAQ # 19.)

- The franchisee lists must be grouped alphabetically by state, and then alphabetically by city, within each state. This requirement applies to both the list of current franchisees and former franchisees. (NASAA Commentary 20.5.)

- All Item 20 tables must be included even if there are no franchises operating. It is sufficient to simply include the "Total" row with zeros. In addition, franchisors should delete the rows for states where they have nothing to disclose. (NASAA Commentary 20.8 and 20.9.)

8. Item 20 – Include Subfranchisors, but Exclude Area Developers. Subfranchisors (or master franchisees) must include two sets of Item 20 tables – one set that includes the subfranchisor's outlets only and one set that includes all of the outlets in the franchise system. (NASAA Commentary 20.4.) On the other hand, franchisors that have area developers (or multiple unit franchise agreements) do not need to include separate charts for the area developers. (NASAA Commentary 20.2.)

9. Item 20 – State Whether There Are Confidentiality Agreements and Define Confidentiality Agreements Narrowly. In Item 20, franchisors must state whether or not franchisees have signed confidentiality clauses during the last three fiscal years. If franchisees have signed confidentiality clauses, then franchisors also must include the required disclosure under the Amended Rule. (NASAA Commentary 20.10.) The Compliance Guide also provides guidance on what is considered a confidentiality agreement and instructs franchisors to define "confidentiality agreements" narrowly. In addition to clauses designed to protect a franchisor's trademarks or operations manuals, a franchisor may exclude confidentiality clauses designed to keep the terms of a settlement confidential but do not otherwise restrict a franchisee's ability to discuss its experience in the franchise system. (Compliance Guide, pg. 108.)

10. State Quirks – Don't Assume All States Are the Same. Although the FTC and NASAA have provided franchisors with significant clarification on the interpretation of the Amended Rule, it is important to keep in mind that many of the franchise registration states still have distinct and sometimes unique requirements, such as the following:

- Although the NASAA Guidelines state that the registration states want the FDDs filed with both hard copies and electronic copies on CD-Rom, some registration states will accept a hard copy only and some want only an electronic copy on CD-Rom. (NASAA Guidelines, pg. 2.) For example, California, New York, Virginia and Washington still accept only paper copies of the FDDs (although California and Virginia also accept an electronic copy on CD-Rom in addition to the paper copy). In contrast, Rhode Island and Indiana only want electronic copies of the FDDs on CD-Rom.

- Similarly, the registration states continue to differ on the number and types of FDDs required. For example, when a franchisor renews in Maryland, it must submit complete clean and redlined copies of the FDD (both hard copies and electronic copies on CD-Rom). In contrast, Minnesota wants only a redlined copy of the FDD (both hard copy and an electronic copy on CD-Rom). (NASAA Guidelines, pg. 2.)

- The signature documents and filing forms NASAA created are accepted by the registration states, but certain states, including California, Hawaii, Minnesota, New York and Washington, still want all signature documents notarized. (NASAA Guidelines, pgs. 7-14.)

- While the FTC Rule eliminated the need for franchisors to disclose information about brokers in Item 2, many states require that franchisors submit franchise seller forms for brokers, including California, Illinois, Maryland, Minnesota and Rhode Island. As a result, franchisors will continue to struggle with obtaining and submitting franchise seller forms for large broker networks. Also, if a franchisor plans to use a broker, it is important not to forget the broker warning on the state cover page. (NASAA Guidelines, pg. 17.)

- Be sure that the receipt pages include the state-specific disclosure periods, which include the list of states that still require a 10 business-day waiting period or require that franchisors provide the FDD at the first personal meeting. (NASAA Guidelines, pgs. 25-26.)

- If you are filing in Virginia, remember that Virginia requires a slight modification to the cover page and the receipt pages; the language must say "in connection with the proposed franchise sale *or grant*." (Emphasis added.)

11. Integration Provisions – Do Not Disclaim Representations in the FDD. Franchisors should review the integration provision of their franchise agreements and any closing acknowledgments or questionnaires to ensure that they do not disclaim, or require a prospective franchisee to waive reliance on, any representation made in the FDD (including exhibits). It is not sufficient to put a modified integration clause in the state addenda as the FTC and state examiners view the limitation on the scope of any integration clause to be a requirement under the Amended Rule and not a state-specific requirement.

12. General Observations – Follow the Amended Rule in Both Substance and Form. In addition to the guidance above, it is important that franchisors keep some general observations in mind as they update their FDDs in 2009:

- Use bold text and all capitalized letters <u>only</u> when required under the Amended Rule.

- Franchisors must include all disclosures that the Amended Rule or a state requires, but should avoid making additional or optional disclosures. The one exception is in Item 11, where franchisors can include optional assistance if they make it clear that the assistance is truly optional. (Compliance Guide, pg. 65.)

- Use the form responses or disclosures provided by NASAA or by the FTC. In particular, NASAA has published form responses to Items 3, 4, 10 and 20. (NASAA Commentary 3.4, 4.1, 10.3, and 20.11.)

As franchisors and their lawyers prepare to file FDDs in 2009, it is important that they review them closely to ensure that they comply with the Amended Rule as interpreted by the Compliance Guide, NASAA Commentary and NASAA Guidelines. It is clearly a mistake to think that just because state examiners did not comment on a particular section of an FDD last year, no comments will be received on that same section this year. By taking the time to review these resources and the tips outlined in this article, franchisors can lower their chances of receiving comments, saving themselves (and state examiners) the cost and frustration of dealing with lengthy comment letters, and, in many cases, provide even better disclosure to prospective franchisees.

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Use of an In-house Litigation Team to Handle a Company's Litigation Needs: Good Idea or Bad?

The concept of using in-house counsel to litigate in the franchise context is nothing new. Franchisors routinely designate an in-house lawyer or group of lawyers to monitor litigation affecting the company. The size of the staff and the degree of participation by such in-house litigation counsel varies from company to company and depends in large part on the amount of litigation that a company faces on an ongoing basis and the other responsibilities placed by the company on the in-house lawyers.

Reasonable minds can and do differ on whether the use of in-house counsel to handle most or even all of a company's litigation needs is a good thing or a bad thing. The two articles that follow from two experienced in-house counsel contain two very different perspectives on this timely and interesting topic. This continues the discussion raised in the presentation by Marcus Banks, Michael Einbinder and James A Goniea in Cost Containment Strategies for Franchise Disputes at the 2008 Annual Forum. We hope what follows will provoke some continuing thought and dialogue among members of the Forum on Franchising.

The "Do It Yourself" Solution To Franchise Litigation

By James Goniea

Today's challenging economic times have placed tremendous pressure on in-house counsel to limit the expense of dispute resolution and litigation. A large portion of those expenses take the form of outside counsel fees. One of the most effective, but least utilized, methods of achieving litigation cost containment is hiring in-house counsel with the competence and experience necessary to prosecute and defend cases on behalf of the franchisor (or, in appropriate cases, a large franchisee) with little or no assistance from outside counsel.

A. Cost Containment

In purely economic terms, in franchise systems that are large enough to be able to anticipate a relatively constant flow of litigation, it can be more cost effective to keep one or more litigation specialists on staff than to continuously employ the assistance of outside counsel that predominantly bill on an “hourly fee” basis. The same may be true even in smaller systems if the system is one in which litigation is prevalent. In addition, the “fixed fee” nature of salary-based in-house counsel permits the company’s legal department to exercise greater control over litigation cost containment and to meaningfully budget legal expenses even when the nature and amount of litigation the company is likely to encounter on a year-by-year basis is an unknown.

B. Increased Settlement Leverage

The benefits associated with internalizing the litigation function are not limited to the direct savings associated with minimizing outside counsel fees. There are indirect savings as well. When attempting to settle a dispute, each party must evaluate whether the potential risk and cost of proceeding with litigation exceeds the cost of the proposed settlement. One major factor contributing to this risk/benefit analysis is the expense associated with paying outside attorneys to defend against the claims, or to enforce the rights, in question. The lower the cost, the better positioned the litigant will be to hold out for more favorable settlement terms. The higher the cost, the more likely the litigant will be forced to compromise and to accept less favorable settlement terms.

Where the attorney defending the franchisor or franchisee against the other party’s claims, or enforcing the terms of the franchise agreement, is part of that entity’s overhead, the party’s settlement leverage is increased and the opponent’s settlement leverage is diminished. Simply put, the transactional costs of engaging in prolonged litigation are frequently as important, if not more important, than the potential exposure or benefit associated with the claims asserted in the litigation. When the parties to a dispute know that one party is not incurring those transactional costs (e.g., outside attorneys’ fees) because the matter is being handled entirely by in-house litigation counsel, while the other party continues to incur those expenses, settlement leverage shifts in favor of the party with the in-house litigation counsel. As a result, the party with in-house litigation counsel is better positioned to hold out for favorable settlement terms. From a franchisor’s perspective, this indirect savings to the franchisor’s system is multiplied by the number of disputes that the franchisor is successful at resolving without the cost of employing outside counsel.

Additionally, the litigation leverage created by the elimination of outside counsel fees increases with the level of contentiousness of the litigation. In other words, if the litigation is highly contentious (involving, for example, extensive discovery, discovery disputes, and motion practice), the attorneys’ fees incurred by the party or parties without in-house litigation counsel will quickly pile up while the attorneys’ fees incurred by the party or parties utilizing in-house litigation counsel will remain at zero. This, of course, creates a disincentive for opposing counsel to be overly contentious or to make unreasonable litigation demands (which also indirectly benefits the party with the in-house litigation counsel).

Finally, although perhaps there is no reliable way to measure it, the increased litigation leverage associated with the use of in-house litigators might actually create sufficient disincentive to dissuade an opposing party from initiating a prolonged litigation in the first place. A party who knows that its opponent employs competent in-house litigation counsel and is well positioned to engage in a “war of attrition,” without additional incremental cost, might decide to forgo litigation altogether and explore less aggressive (and less expensive) mechanisms for resolving the dispute.

C. Overcoming Impediments

Use of in-house litigators in lieu of outside litigators is not without its challenges. Controlling the venue of litigation is critical. Use of in-house litigators obviously is facilitated by a litigation venue local to the headquarters of the party employing the in-house litigation team. If venue over a dispute exists somewhere other than where in-house counsel is admitted to practice, employment of local counsel may be required. While adding some cost to the litigation process, pro hac vice motions and discriminating use of outside counsel can result in cost savings even when the litigation is in a foreign venue. In addition, even where employing local counsel is necessary, there is no reason why functions like brief writing, drafting of pleadings and preparation of discovery responses can not preliminarily be performed by in-house attorneys and then reviewed by local counsel.

Completely eliminating expenses associated with dispute resolution and litigation is impossible for most franchise systems. However, employment of competent in-house litigators may be an extremely effective mechanism for minimizing such expenses. Use of in-house litigators in lieu of outside counsel also has many intangible benefits. Given the pressures of the present economic recession, franchise legal departments should evaluate whether use of in-house litigators is a cost containment strategy that could work for their system.

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The Pitfalls Of Handling Litigation In-house

By Andra Terrell

Current economic stresses have caused all in-house counsel to revisit what is, most likely, one of the least-liked areas of our job – controlling costs. One of the first areas scrutinized for cost savings is litigation cost, probably because litigation generally receives the lion's share of any in-house legal budget. Some large companies, such as Ford Motor Company and JC Penney, believe that a way to reduce the costs of litigation is for in-house counsel to handle much, if not all, of the litigation themselves and claim to have had great success with the process. Others have tried the concept with limited to dismal success due in large part to hidden pitfalls that are not always carefully considered by companies electing to use in-house litigation counsel to handle all or substantially all of a company's litigation work. This piece will focus on some of those hidden pitfalls.

A. Relationship With Franchisees and In-House Counsel

In-house counsel hold a unique position, especially in franchising, which requires a productive in-house counsel to have a good relationship with franchisees, franchisee associations, and cross-functional business partners within the organization, in order to work together to achieve the objectives of the business. For example, if the organization has a new objective, such as a value menu, good in-house counsel will be able to reach out to the franchisees to help create a program that is good for the business and the franchisees, and which will be accepted and utilized by the franchisees with minimal disruptions. In this type of arrangement, it is especially difficult to maintain that kind of relationship while at the same time suing the very franchisees you must work with to achieve the objectives of the business. In fact, it is not too hard to imagine that the franchisee being sued in that situation might purposefully block any initiative a franchisor might advance just to create issues and marginalize your usefulness to the organization.

B. Lack of Expertise

Most lawyers have an area of specialty, even in-house counsel. Franchising, being the melting pot that it is, allows lawyers specializing in the field to become familiar with other areas of law, such as trademark, contract, general corporate, and litigation, (and yes, sometimes even criminal), without becoming a specialist in any of those areas. This can often lead to franchise lawyers knowing just enough to be more than just a little dangerous, especially in the world of high stakes litigation in which we now find ourselves.

For example, what do you do if your company has an employment case before the EEOC? Do your in-house lawyers know how to answer a charge or appear in front of that administrative agency? One can only imagine the detrimental impact that ignorance of applicable rules could have on the outcome of such a case if handled by someone who knows just enough to be dangerous. Companies considering the use of in-house litigation staff to handle all of their litigation needs must consider whether they are prepared to lose a case in order to save a few pennies on hiring competent outside counsel with the relevant expertise to ensure that things are done right.

C. Strain on Resources

One of the hardest parts of the in-house job is being a jack-of-all-trades; called suddenly to attend critical meetings and give sage legal advice instantaneously, helping business folks to figure out the best means to achieve their objectives, sometimes in areas of first impression. Litigation, however, is an unforgiving practice. It does not matter how many meetings need to attended, or what critical budget revision needs to be on someone's desk before close of business; in litigation, a party often has only one shot to get it right by a court-imposed deadline that often cannot be changed. This means that in-house litigation counsel must take time away from other areas of his/her in-house practice in order to make sure everything in the litigation is handled properly, a point which is often not appreciated by business partners who often prefer to have their in-house counsel devoted to revenue-generating activities.

To avoid the strain on attorney time, an overworked in-house litigation counsel might attempt to transfer some of the workload to experienced paralegals or newly-minted lawyers. And this might help, to a point. However, as most of us have learned the hard way, it is rare that an in-house attorney is able to transfer all of the work on a case to a paralegal or other attorney who will handle that case completely on his/her own without some involvement by the referring attorney. In addition, finding enough paralegals or new attorneys with sufficient free time to devote to an additional project is a rarity in these lean times when in-house legal staffs are being stretched to their limits.

D. Potential Lack of Objectivity

In-house attorneys owe a duty of utmost loyalty to their employer. With this loyalty sometimes comes the potential risk of losing objectivity about the merits of a particular legal position or the strengths and weaknesses of company witnesses and documents. It is not easy to tell the CFO of a company that signs your paycheck that he/she will make a terrible witness in a court proceeding, that the document he/she authored or circulated may be the "smoking gun" that opposing counsel will rely on at trial, or that you cannot advance a position the company would like you to take without creating litigation risks that outweigh the benefits of that position. With outside counsel, it is sometimes easier to speak the truth to those in power and ensure that cases with potential warts on them are handled properly.

E. Hidden Costs

Another consideration, whether a company is attempting to bring more work in-house or to outsource, are the hidden costs associated with doing so. Increased telephone calls, copying costs, mailing costs, and data storage issues are just a few of the costs that are rarely considered before transferring case responsibility.

For example, I once worked in a legal department that attempted to handle a class action settlement in house. No one anticipated how difficult it would be to mail and collect all the ballots or how difficult it would be to maintain an accurate count. The copying and mailing costs alone caused the legal department to be called on the carpet about costs that had not been projected in the budget.

F. Jurisdictional Restrictions

A final potential pitfall associated with using in-house litigation counsel is jursidiction. In some jurisdictions counsel must be admitted to the local bar, and some go so far as to require that counsel have appeared before the court a certain number of times before the court will allow the attorney to argue the case. Some judges will also not take kindly to a lawyer's repeated requests for Pro Hac Vice admission to appear in a particular case instead of becoming a member of the local bar. For this reason, even if a company's desire to handle all cases with its in-house legal staff is there, from a practical standpoint, the company may not be able to do so.

While it is a noble idea for in-house counsel to attempt to handle all litigation for their employers in-house, before committing to do so, such in-house counsel should think long and hard about whether they have enough experience in the law governing the case, whether handling the case in-house will create too much of a strain on the department's existing resources, whether bringing the case in-house will cause a litigation department to blow its budget on hidden costs, and whether the court where the case will be heard will allow the in-house counsel to appear.

Andra Terrell is Senior Franchise Counsel for Pearle Vision, Inc.

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So What's the Worst That Can Happen? Franchise Law Compliance in Tough Economic Times

By Isabel Davis and Jayne Westlake

As funding options for prospective franchisees become few and far between in a deeply distressed economy, many franchisors are setting their sights on expansion opportunities outside of their home jurisdictions in order to reach out to new franchisee prospects. At the same time, the downturn in the economy has tempted some of those franchisors considering expansion to tighten their legal budgets. While such cost-saving measures may seem to be unavoidable, it is still important for franchisors to be well-informed of the franchise disclosure and/or registration requirements of the jurisdictions into which they wish to expand. As franchisors struggle to establish practical, cost-effective compliance strategies to accompany their expansion plans, it is helpful for them to be aware of the worst case scenarios that may result if they fail to comply with such requirements. Franchisees too are wise to be aware of these consequences, particularly in tough economic times, in order to recognize whether or not their franchisor has met its obligations; the prospects may wonder whether their non-compliant franchisor has cut back in other areas as well, such as franchisee support. Franchisees also need to be aware of the remedies available to them if their franchisor has not complied. This article examines some of these worst case scenarios in the United States and Canada.

Franchise Legislation in the United States and Canada: An Overview

Franchise law in the United States is rooted in the Federal Trade Commission Rule (the "FTC Rule"), which was recently amended, and which requires franchisors to furnish prospective franchisees with 23 disclosure items. Under the FTC Rule, no registration requirement is imposed upon franchisors.

In addition, 15 different states have adopted franchise investment legislation requiring franchisors to provide certain state-specific, pre-sale disclosures to prospects. These states include California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. Thirteen of these states (California, Hawaii, Illinois, Indiana, Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin) require franchisors to file their franchise disclosure documents ("FDDs") with the responsible state agency.

In Canada, there is no federal franchise law comparable to the FTC Rule. Instead, the provinces of Alberta, Ontario and Prince Edward Island have adopted their own provincial franchise laws. New Brunswick has also passed franchise legislation, but it has not yet come into effect because the regulations have not been finalized. The Alberta, Ontario and Prince Edward Island statutes each impose significant disclosure obligations, but no registration requirements. The disclosure document required under each of these statutes must contain, among other things, all material facts relating to the franchisor and the franchise system.

This article focuses on the FTC Rule and the state and provincial franchise laws outlined above. Franchisors should be aware, however, that there are other federal, state and provincial laws, including industry-specific legislation, business opportunity laws, little FTC Acts, and laws prohibiting misrepresentations and unfair and deceptive business practices, that may also subject them to liability for non-compliance.

Franchisor "Worst Case Scenarios": Criminal Fines to Imprisonment

Neither the FTC Rule nor provincial franchise laws in Canada provide for criminal sanctions. However, with the exception of Oregon, franchisors who fail to comply with state franchise laws could face criminal penalties. The violations that have the potential to attract criminal penalties vary from state to state. They range from a franchisor willfully making untrue statements or omissions in a disclosure document, to a franchisor failing to deliver a disclosure document to a prospective franchisee. (See Table 1 for a summary of criminal provisions in United States franchise laws.)

Potential maximum criminal fines for these violations range from $1,000 in New York to $100,000 in California. Maximum terms of imprisonment range from one year in New York and California, to 10 years in Washington, where individuals may not be imprisoned for a violation if they prove that they had no knowledge of the applicable rule or order.

While criminal sanctions are rarely imposed, the case of *State of Maryland v. Martin Baum* (Md. Cir. Ct., Prince George's County; cited in *CCH Business Franchise Guide*, 1985-1986 New Developments Transfer Binder, ¶ 8384) sets a surprising precedent for their application in the franchise context. In this case, the defendant franchisor made false earning projections and was subsequently charged criminally with failing to register a franchise and fraud in the sale of a franchise.

Although the FTC Rule does not explicitly provide for criminal sanctions, it has served as a foundation for criminal sanctions to be imposed against non-compliant franchisors. In the Florida case of *U.S. v. Lawrence E. Jaspon, et. al.* (*Business Franchise Guide* (*CCH* ¶ 9773-9774)), Mr. Jaspon, the main promoter of "Mr. Tuff Tire," misrepresented and failed to disclose certain required information to prospective franchisees. He was charged with criminal conspiracy to violate the FTC Rule, convicted and sentenced to three years in prison.

Franchisor "Worst Case Scenarios": Damages to Rescission

In addition to criminal sanctions, another "worst case scenario" for a franchisor who fails to comply with registration and disclosure requirements is a civil action brought by a franchisee or a group of franchisees. Franchisors should be aware that all provincial and state-specific franchise statutes contain a private right of action which allows harmed individuals to bring a civil claim against those who fail to comply with the statute.

The laws in South Dakota and Washington explicitly state that franchisees can claim punitive damages of up to three times the actual damages sustained. Even in states that do not specifically provide for punitive damages in their franchise laws, courts may still impose such damages upon franchisors, as was illustrated in *Cox v. Doctor's Assocs.*, 245 Ill. App. 3d 186 (Ill. App. Ct. 5th Dist. 1993). In this case, the Subway® sandwich shop franchisor made fraudulent misrepresentations to a potential franchisee regarding territorial restrictions and the number of shops the franchisee could buy from the franchisor. The franchisee was awarded $200,000 in actual damages and $1 million in punitive damages.

In addition to a claim for damages, all provinces and states with franchise legislation (except Virginia and Indiana) make available a civil claim for rescission. Under many state-level franchise laws in the United States, in order for the franchisee to be entitled to rescission, the court must find that the franchisor's violation was willful, as was the case in *Dollar Systems, Inc. v. Avcar Leasing Systems, Inc.*, 890 F.2d 165 (9th Cir. Cal. 1989).

In contrast, provincial franchise legislation in Canada gives franchisees an automatic claim for rescission in certain circumstances. A franchisee may rescind its franchise agreement within two years from its execution, if the franchisor does not provide a disclosure document, or within 60 days from the date the franchisee receives a disclosure document, if that disclosure document is incomplete. In *1518628 Ontario Inc. v. Tutor Time Learning Centres, LLC* [2006] O.J. No. 3011, the franchisee successfully made a claim for rescission based on a finding that the franchisor did not disclose under Ontario law, despite the fact that the franchisor provided the Ontario prospective franchisee with a U.S. disclosure document. This demonstrates that, under Ontario law at least, a disclosure document that fails to substantially comply with the requirements of Ontario law may be deemed to be no disclosure document at all, even if that disclosure document complies with the law of another jurisdiction.

Remedies for Franchisees Outside the Legislative Umbrella

Even in jurisdictions where there is no state or provincial franchise legislation, franchisees may have access to other remedies. While there is no private right of action under the FTC Rule, franchisees can file a complaint with the FTC for alleged FTC Rule violations. This means that a franchisor who fails to comply with its disclosure obligations not only opens itself up to franchisees commencing a civil action against it, but also to franchisees notifying governmental authorities of its non-compliance. The FTC may seek penalties of $11,000 per violation or pursue monetary redress on behalf of franchisees who have lost money as a result of a franchisor's violation. In *FTC v. Namer*, 781 F. Supp. 1136, 1144 (E.D. La. 1991), the FTC successfully claimed over $3 million in consumer redress on behalf of franchisees who relied on misrepresentations by the franchisor when entering franchise agreements. Similarly and more recently, in *FTC v. Minuteman Press et* *al.*, Civ. No. 93-CV-2496 (E.D.N.Y. 1998), the FTC successfully claimed almost $3.5 million in consumer redress on behalf of franchisees who relied on the false and unsubstantiated earnings claims made by their franchisors, who also failed to disclose a significant training/transfer fee imposed on franchisees. The Chairman of the two franchisors had actual knowledge of the franchisors' illegal activities and accordingly was also found liable as a defendant in this case.

In Canadian provinces without franchise legislation, franchisees may bring a civil claim against a franchisor under common law for misrepresentation, breach of contract or breach of duty of good faith. In *Ismail v. Treats Inc.* [2004] N.S.J. No. 21 (Sup. Crt.), the franchisee recovered his initial investment of $32,000 and over $48,000 in damages from the franchisor as a result of the franchisor's negligent misrepresentation of the franchisee's expected profits. Similarly, civil actions may be brought in states without state-specific franchise legislation, and such claims have often relied on other laws that deal with issues such as fraud, misrepresentation and unfair business practices (see *Gentle Laser Solutions, Inc. v. Sona Int'l Corp.*, 2008 U.S. Dist. LEXIS 47645 (D.N.J. June 19, 2008).

Personal Liability of "Franchisor's Associate" and "Franchise Seller"

In addition to the penalties outlined above that may be imposed against a corporate franchisor, individuals who are involved in the sale of franchises, or who are officers or directors of a franchisor, may also be held liable for the franchisor's failure to comply with disclosure and/or registration requirements. Under the laws of Ontario and Prince Edward Island, for example, the term "franchisor's associate" is used to describe a person who, among other things, (a) controls or is controlled by the franchisor, (b) is directly involved in the grant of a franchise, or (c) exercises significant operational control over the franchisee and to whom the franchisee has a continuing financial obligation with respect to the franchise. Under these laws, a franchisee has a private right of action in the event that it suffers a loss due to a misrepresentation contained in the disclosure document against not only the franchisor, but also against the franchisor's associate, the franchisor's broker and every person who signed the disclosure document. The Alberta statute also provides the franchisee with a private right of action against not only the franchisor, but also every person who signed the disclosure document.

The amended FTC Rule defines a franchise seller as a "person that offers for sale, sells, or arranges for the sale of a franchise. It includes the franchisor and the franchisor's employees, representatives, agents, subfranchisors, and third-party brokers who are involved in franchise sales activities." While the FTC Rule itself does not provide for a private right of action against franchise sellers (or franchisors, for that matter), most states with franchise statutes have created a right of action against any "person" who violates that statute in the course of selling a franchise, presumably, all individuals captured by the FTC's definition of "franchise seller." This seems to suggest that, as in the three Canadian provinces with franchise laws, franchise sellers could find themselves personally named in a suit by a franchisee for state franchise law violations and subject to damages.

Practically Speaking…

While this description of the potential penalties for a franchisor's failure to comply with its disclosure and registration requirements may leave franchisors feeling as though they should stay within their home borders, it is important for those franchisors considering expansion to keep things in perspective. First, although various state franchise statutes provide for criminal sanctions and stiff penalties, those severe remedies have not been frequently or recently sought or imposed, especially where the franchisor has made a concerted effort to comply with its disclosure and/or registration obligations. Second, various state franchise laws include measures to protect franchisors against severe civil penalties by requiring an element of knowledge or willfulness in their wrongful conduct. Under New York's law, for example, franchisors can be found liable under the Act only if they *intentionally* omit a material fact from the FDD. Similarly, under Washington's law, a remedy of rescission is not available to the franchisee where the defendant proves that, for example, the defendant exercised reasonable care and did not have knowledge of the "untruth" or omission. Case law has also developed to reinforce the limitation of liability on franchisors in certain circumstances, such as the absence of the franchisee's reliance on the franchisor's false statements, as in the case of *Hacienda Mexican Restaurant v. Hacienda Franchise Group*, 641 N.E.2d 1036 (Ind. Ct. App. 1994).

Similarly, in the Canadian context, the franchise laws in Ontario, Alberta and Prince Edward Island all provide that persons other than a franchisor are not liable in a civil action if they can prove that, among other things, they had no reasonable grounds to believe that there was a misrepresentation made in the disclosure document. Further, the lack of federal franchise legislation creates an environment that indirectly favors the franchisor. In addition, having provincial franchise legislation in force as of the date of publication in only three out of 13 Canadian provinces and territories, also creates a slightly more franchisor-friendly atmosphere.

All of these practical considerations seem to suggest that good faith efforts to comply with local franchise laws will at the very least minimize the likelihood of franchisors, franchise sellers and franchisor's associates being the subject of the worst-case scenarios described in this article. That said, the franchisor must keep in mind that certain civil penalties for a failure to comply with franchise disclosure and/or registration requirements can also be rather significant, and certain conduct may trigger repercussions outside the scope of the federal, state and provincial franchise statutes, such as common law claims or alleged violations of unfair business practices legislation.

Today's economic climate leaves many franchisors wary about adding expenditures to their already tight budgets. The economic climate has many businesses (franchised and otherwise) closing their doors, and franchisees who are faced with having to shut down may be looking for options to exit their respective franchise system and mitigate their losses. For franchisors looking to expand outside of their home jurisdiction, it may seem difficult to justify the expense of full compliance with the disclosure and/or registration requirements of their target jurisdiction. However, this will undoubtedly be money well spent given the range of civil and criminal penalties that could potentially be imposed against such franchisors. In light of the fact that struggling franchisees may be heightening their awareness of franchisors' obligations in order to rescind the franchise agreement and perhaps seek damages, franchisors may not be well served by "cutting corners" in striking a balance between full compliance and budgetary constraints. Despite tough economic times, in establishing legal budgets to accompany expansion plans, these franchisors should be mindful of all of their franchise disclosure and/or registration obligations in order to avoid the worst case scenarios down the road.

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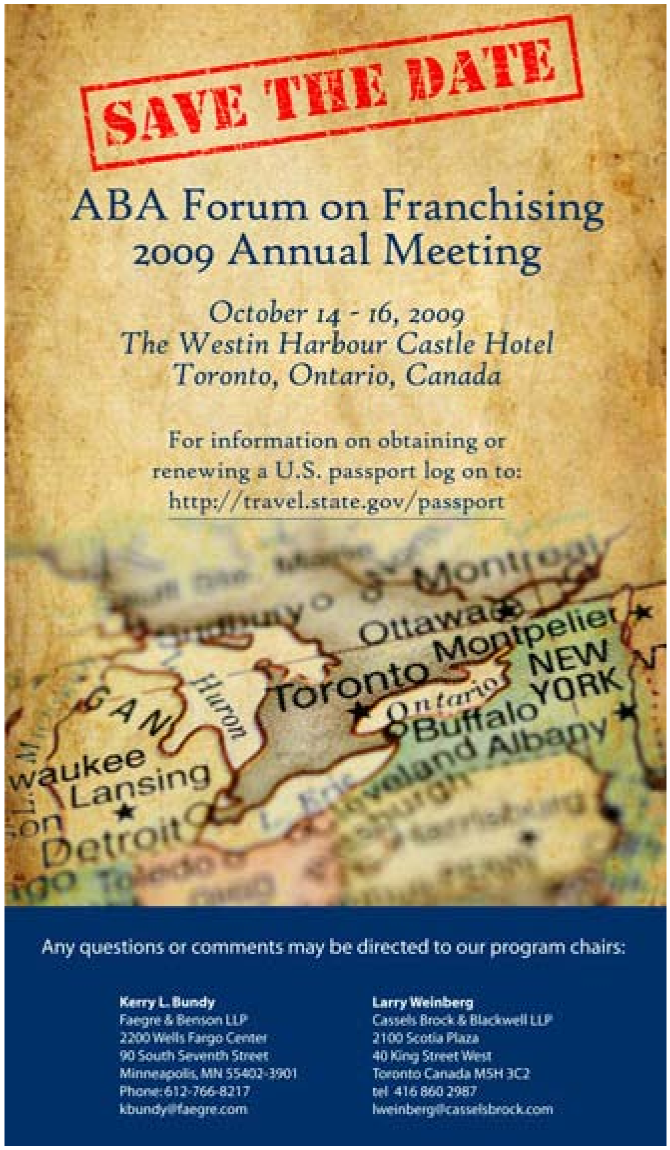

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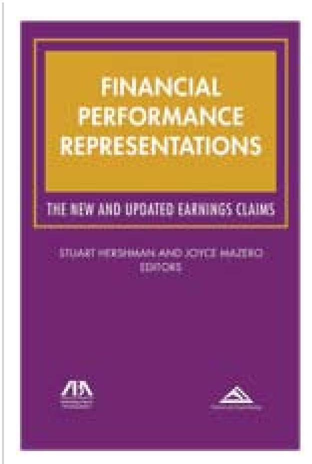

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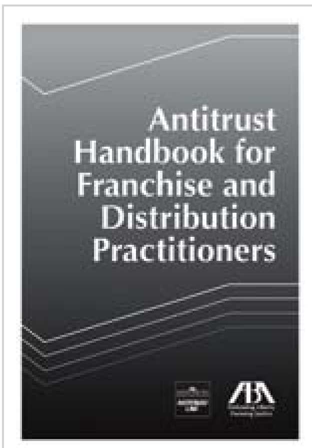

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