A FEW CONTRACT AND COMPLIANCE TIPS FOR NEW FRANCHISE OWNERS

I. The Universal Franchisee Bill of Rights

A. What is it?

The Universal Franchisee Bill of Rights (www.franchiseebillofrights.org) represents the most recent collective effort among a group of franchisee associations and industry experts to advocate for positive change and greater balance in franchise relationships. This document memorializes the group's recommendations concerning one dozen basic franchise agreement provisions and principles that traditionally have heavily favored the franchisor. This is described as a "fairness doctrine."

Similar to the American Association of Franchisees and Dealers "Fair Franchising Standards" (www.aafd.org), the Universal Franchisee Bill of Rights is both an educational and advocacy effort. Will it result in meaningful, substantive change in franchising relationships? Only time will tell. Regardless, it is a useful exercise for franchisees to review these twelve principles and check to see how these issues are addressed in their own franchise agreements. At renewal time, these would be good issues to negotiate.

B. The Twelve Principles

1. Freedom of Association (flexibility to join franchisee associations)

2. Good Faith and Fair Dealing (ability to rely on franchisor's sense of fairness and exercise of reasonable care in administering the franchise system)

3. Uniform Application of Brand Standards (franchisor maintaining consistent operating standards)

4. Full Disclosure Regarding Fees Collected from Franchisees (e.g., marketing fees, rewards programs, rebates, and other fees paid by franchisees, vendors, suppliers, and others)

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5. Right to Price (the right of franchisees to set their own prices for the goods and services they sell)

6. Fair Sourcing of Goods and Services

7. Right to Renew the Franchise (no unreasonable costs or conditions)

8. Right to Transfer (no unreasonable transfer restrictions or fees)

9. Encroachment (i.e., specific market protection for franchisees)

10. Ample Notice of Significant Change; Franchisee Termination Rights

11. Default; Franchise Termination Rights (opportunity to cure problems, no liquidated damages)

12. Fairness in Dispute Resolution (allowing franchisees to elect to have dispute resolution proceedings occur in the franchisee's local venue; no mandatory binding arbitration)

II. Five Tips on Franchise Agreements

1. Limited Term. A franchise is basically a limited, nonexclusive license to use a franchisor's trade name, logo, business processes, and systems for a specific period of time. At the expiration of that stated term, all rights revert back to the franchisor, leaving the franchisee with nothing but fond (perhaps not so fond) memories. Most franchise agreements, however, contain provisions giving the franchisee one or more options to renew the franchise agreement for a new term.

2. Watch for Renewal Terms and Conditions. While most franchise agreements give one or more renewal options to franchisees, the renewal options typically come with strings attached. First, the renewal option must generally be exercised within a specific time frame during the final year of the then-current term. Miss a renewal notice deadline and your franchise agreement could terminate at the end of the term, effectively putting you out of business. Other renewal conditions include imposition of renewal fees, execution of releases, and signing a new franchise agreement on the franchisor's then-current form of agreement, which could be materially different from your original agreement.

3. Avoid Problems with Effective Communication. Too many franchising disputes erupt because the parties simply failed to communicate. If your business is struggling (i.e., if your business is not generating an operating profit after 18-24 months in business), then do not make the mistake of ignoring the problem or trying to conceal it from your franchisor. Communicate early and often. Demonstrate your commitment to the system and willingness to work hard to be a successful franchisee. Communicate regularly not just with the franchisor or your area developer, but other franchisees as well (your fellow franchisees will often be a tremendous resource).

4. Don't Get Too Entrepreneurial. Follow the system. Having access to an established business system is one of the main reasons you bought a franchised business, so don't lose faith in the system too quickly. If you are so independent and entrepreneurial that you struggle to follow someone else's rules, then franchising is not for you.

5. Understand Your Franchisor. Franchise systems subscribe to different management philosophies and strategies for dealing with franchisees (particularly underperforming ones). You should understand your franchisor's philosophy. Some rule with an iron fist and are quick to send out default notices for insignificant, technical breaches or to aggressively litigate against rogue franchisees to send a strong message to other franchisees. Other systems take a more permissive approach and exhibit more patience when dealing with their franchisees. These franchisors feel a more flexible approach is more conducive to the long-term health and sanctity of the franchise system. They also do not want prospective franchisees to be scared by lengthy franchise litigation disclosures in the Franchise disclosure Document.

III. A Few Thoughts on Lease Agreements

For franchisees that operate from a leased retail location or office space, your lease agreement is one of the two or three most important contracts you will sign. Some of the more significant lease provisions or issues for franchisees to consider include:

1. Use Restrictions. When negotiating, try to get as broad of a "permitted use" clause as possible to maximize your flexibility. During the lease term, be careful not to inadvertently violate this clause.

2. Renewal Options. Be careful not to miss a notice deadline or you could find yourself unexpectedly looking for a new location or, even worse, find yourself in default of your Franchise Agreement.

3. CAM Calculations. At any given shopping center of office park, CAM (common area maintenance) reimbursement provisions can vary from one tenant to another, so do not believe your landlord is incapable of making mistakes in calculating CAM charges. Double check periodically to confirm the calculations are being made as set forth in your lease.

4. Compliance with Franchise Agreement. It is common for franchise agreements to include requirements regarding the franchisee's lease to better protect the franchisor's interests, such as assignment clauses, notice provisions, additional insured provisions, and the like.

IV. Business Entity Maintenance

Observing proper business entity formalities and keeping your business entity in good standing with the Virginia State Corporation Commission ("SCC") are both relatively simple things to do, but well-intended business owners and managers make mistakes in this area all the time, and the potential consequences of noncompliance can be severe.

For all business entities, keeping accurate entity records and documenting key decisions in the manner set forth in the organizational documents (e.g., minutes from a board minutes, written consents in lieu of a meeting) are important to demonstrate that proper entity formalities are being observed and the separate legal existence of the entity is being respected.

When executing contracts with third parties, pay close attention to signature blocks and who are the named parties to the contract. A sample signature block would look something like this:

Worldwide Pants, Inc.,
a Virginia corporation

By: ____________________________
David Letterman, President

This signature block makes it very clear that the contracting party is a Virginia corporation and that David Letterman is signing the contract on behalf of the corporation in his capacity as President.

Virginia limited liability companies will stay in existence and in good standing with the SCC so long as they pay the annual $50 registration fee in a timely fashion. Depending upon the amount of authorized stock, the annual fee for corporations is slightly higher, and corporations are required to also file annual reports on a form provided by the SCC.

Failure to timely pay the required fee or file required reports will ultimately result in the SCC terminating the entity's existence. This could have bad consequences for franchisees for a few reasons. First, it could trigger defaults under many of the franchisee's contracts (e.g., franchise agreement, lease, loan agreement, etc.). Second, it is technically a crime in Virginia to present yourself to the public as conducting business as a business entity when no such entity exists. Third, the individual owners and officers of the business could potentially face personal liability for business debts and obligations if the entity's existence has been terminated.

Fortunately, the SCC offers a five-year reinstatement period, thus it is relatively easy to resurrect a terminated business entity and get back into good standing if the error is caught in time.

V. Agreements Between Business Partners

1. The Sad Reality. Statistics suggest that less than half of all business owners plan ahead for critical events in the life cycle of their business (e.g., disputes among owners, death or disability of an owner, and purchase offers from third parties, to name a few). A buy-sell agreement is a contract among a company and its owners that provides an opportunity to plan ahead, promote continuity among ownership, and accomplish other important goals.

2. Basic Types of Buy-Sell Agreements. As a general matter, there are three basic types of buy-sell mechanisms:

(a) The Redemption Approach. A redemption agreement is a contract between each owner and the company in which the company agrees to buy back or redeem an owner's interest in the company under certain circumstances.

(b) The Cross-Purchase Approach. A cross-purchase agreement is a contract among the owners in which they each agree to purchase another owner's interest in the company under certain circumstances.

(c) The Hybrid Approach. This approach combines both redemption and cross-purchase features into the overall structure.

3. Promoting Fairness and Harmony Among Owners. A buy-sell agreement can reduce the likelihood of owner disputes ending up in court. The typical business relationship has a life span of approximately seven years, so it is good business practice to plan ahead for mechanisms that will fairly and efficiently wind down a business relationship. Business owners should never underestimate the exorbitant economic cost of litigation, as well as the psychological and emotional toll of being involved in a lawsuit against business partners. The best time to identify and address buy-sell issues is during the early stage of a business relationship when everyone has an optimistic and cooperative attitude.

4. Providing Liquidity. Ownership interests in a privately held company are illiquid securities. That is to say, there is no open market through which an owner can immediately sell his interest in the company. A buy-sell agreement, however, can create a market for what is otherwise an unmarketable asset.

5. Promoting Smooth Transitions. A buy-sell agreement can serve as a road map for a fair and efficient ownership transfer via an agreed-upon price (or mechanism for establishing a price) and set of closing procedures. These mechanisms can promote the long-term success of the company by proving clarity and structure during what might otherwise be a tumultuous time for the company and its owners (such as upon the death of a shareholder or when the company terminates the employment of an executive/shareholder).

6. Playing a Significant Role in Estate Planning. A buy-sell agreement can reduce the financial burden on the heirs of a deceased business owner (e.g., estate taxes and other expenses) by providing for a mandatory purchase of the decedent's shares. This mechanism also serves to protect the surviving owners from suddenly being business partners with the decedent's spouse or other heirs. A buy-sell agreement may also serve as evidence of valuation of the business for estate and gift tax purposes.

7. Solving Phantom Income Problems. Most buy-sell agreements involving pass-through entities--such as "S" corporations, limited liability companies, and partnerships--include language providing a mechanism requiring the company to make distributions sufficient to cover the income tax obligations of the owners stemming from their allocable shares of company income. Without such a contractual arrangement, company owners could find themselves owing

income tax on income they never actually received. This is often referred to as the phantom income dilemma.

8. Preserving "S" Corporation Status. For companies organized and operated as "S" corporations, there are a variety of restrictions on ownership imposed by the Internal Revenue Code (e.g., limits on the number of shareholders, restrictions on who can own stock, and the "one class of stock" rule). A buy-sell agreement can include language restricting the shareholders from transferring their shares to an individual or entity that would be ineligible to own shares of an "S" corporation. The agreement can also set forth the mechanics for making certain elections available to "S" corporations and their shareholders with respect to income and loss allocations when a shareholder terminates his entire interest in the "S" corporation or the corporation ceases to be an "S" corporation.

9. Understand the Attorney's Role. When utilizing the services of a business attorney for preparing a buy-sell agreement, be sure to understand who it is the attorney is representing—the company, some or all of the owners, or both. It is not unusual for one attorney to jointly represent both the owners and the company, but while that may seem like a cost-effective approach, the owners should understand there are conflicts inherent with such dual representation. Ideally, each party to the agreement would have his own legal counsel representing his individual interests.

10. Be Wary of Form Documents. An effective buy-sell agreement should be tailored to the specific objectives of the owners of the company. A "fill-in-the-blank" form printed off the Internet will generally prove to be of limited value in the long run. These agreements do not have to be complicated from a legal perspective, but they are vitally important from a business perspective and should be drafted with care.

VI. Noncompete Issues

Restrictive covenants (noncompete, confidentiality, and nonsolicitation issues) are an important part of the franchise relationship. Rarely will you find a franchise agreement that does not contain some form of noncompete provision. As a franchisee, it is critical to understand noncompete issues and how your ability to earn a living could be impacted following the termination of a franchise agreement.

A. Enforceability

Restrictive covenants are generally disfavored by courts because they restrain trade, but courts will enforce them under certain circumstances. Noncompete law can vary quite a bit from one state to another. Most franchise agreements contain a "choice of law" provision establishing which state's laws will apply to the enforcement and interpretation of the agreement. The balance of this discussion will based upon Virginia law.

B. Key Factors

There are two sets of factors that courts focus on in this context. The first set of guidelines used by courts to assess the reasonableness of the restrictive covenants includes answering the following questions:

1. Is the restraint, from the standpoint of the franchisor, reasonable in the sense that it is no greater than necessary to protect some legitimate business interest of the franchisor?

2. Is the restraint, from the standpoint of the franchisee, reasonable in the sense that it is not unduly harsh or oppressive in curtailing his or her legitimate efforts to earn a living?

3. Is the restraint reasonable from a public policy standpoint?

A related set of criteria is applied to assess the reasonableness of the restrictive covenants:

1. Duration of the restriction
2. Geographic scope of the restriction
3. Scope or breadth of the activities being restricted

C. <u>Other Important Things to Know About Noncompete Agreements</u>

1. Restrictive covenants are strictly construed against the party who drafted them. In other words, courts will construe any ambiguities in favor of the franchisee.

2. Disputes concerning noncompete issues are driven by the facts and circumstances of the particular situation, thus general conclusions are difficult to draw in this area of law. Litigating a noncompete case can be very time-consuming and extremely expensive.

3. A reasonable duration for a noncompete agreement in Virginia appears to be in the range of 2-3 years, although in a few cases, Virginia courts have upheld longer noncompete periods where other restrictions were carefully and narrowly drafted.

4. Virginia courts will look at how competitive your local market or industry is (among other factors) in determining whether to enforce a noncompete agreement.

5. It is not settled under Virginia law whether courts will reform or modify an overbroad noncompete agreement to fit within their view of what is reasonable (also known as "blue penciling"). Generally, Virginia courts are reluctant to rewrite the parties' agreement.

6. Understand the potential “chilling effect” a noncompete might have on prospective employers or business partners interested in working with you.