

# INTRODUCTION

*By Kenneth R. Costello*

Franchisors and counsel must grapple countless practical and legal issues beyond core franchise registration, disclosure, and relationship statutes and rules. This monograph presents a compilation of detailed articles by experienced practitioners offering important insights into these collateral issues. By using the word *collateral*, we by no means suggest that these issues are subordinate or less important. In fact, they affect most or all franchisors and are often given inadequate attention. These issues can result in substantial exposure if overlooked or misunderstood. Each of the chapters addresses a particular category of concerns and offers insightful analysis of important aspects of the franchisor-franchisee relationship.

Chapter 1 explores the implications and challenges presented by the rise of the Internet, which has transformed the landscape and dynamics of franchising. As a new and rapidly changing medium for communication on a global scale, social commerce is something that must be understood by franchisors and counsel. Moreover, they must develop a proactive approach to cultivating an online presence, secure domain name registrations, combat cybersquatting, stake out a presence on social media Web sites, and defend the franchisor's turf from interlopers, gripe sites, and the like. Keith Klein deploys his experience in start-up and emerging-growth companies, collaborating with Matt Fojut, who has been general counsel for several Internet-based companies including MySpace, to explore the implications of the Digital Millennium Copyright Act, the Communications Decency Act and Children's Online Privacy Protection Act, and the way in which online branding works in the real world. They also cover key topics such as Web site terms of use and privacy policies, social media Web pages, search engine optimization and

marketing, and potential exposure under the recent Federal Trade Commission's *Guidelines Concerning the Use of Endorsements and Testimonials in Advertising*

In Chapter 2, Marisa Faunce and Christina Noyes cover issues related to the franchise sales process. They address confidentiality and nondisclosure agreements, the use of letters of intent, rights of first refusal, and first offer agreements. They also examine the different types of lead referral sources and the key provisions of lead referral agreements, lead generation agreements, franchise broker agreements, area representative and development agent agreements, and master franchise agreements. They offer keen insight into these franchise sales relationships, discussing the advantages and disadvantages, and registration and disclosure implications of these relationships.

Chapter 3 discusses unique, or nontraditional, franchise venues, such as hotels, casinos, tribal locations, universities, sports facilities, airports, supermarkets, and shopping center food courts, among others. Author Jeff Brimer discusses how territorial rights may differ from those granted to traditional venues, and associated contractual, regulatory, and disclosure implications when franchising unique venues. He also explains how to deal with the complex franchisee ownership structures common to franchising these types of sites, and addresses specific nonfranchise legal concerns that may apply to nontraditional venues, such as sovereign immunity and related dispute resolution issues associated with franchising on tribal properties. Jeff also delves into the esoteric issues and implications of franchising on military bases and "PX Exchanges," and provides detailed information regarding Non-Appropriated Funds (NAFs), Non-Appropriated Funds Instrumentalities (NAFIs), Federal Acquisition Regulations, Defense Federal Acquisition Regulations, and related governmental procurement policies.

No book on collateral issues and franchising would be complete without addressing third-party financing, including real estate sale-leaseback financing; equipment loans and capital leases; senior, subordinated, and mezzanine debt; securitizations; construction loans; and unsecured lines of credit. In Chapter 4, Ken Freed deftly focuses on issues involved in various franchisor and franchisee financing transactions; explains how to reconcile the conflicting interests of the lender, the franchisor, and the franchisee; and examines the different approaches employed by franchisors in franchise financing deals, from simple consents and "comfort letters" to detailed intercreditor agreements allowing a lender to take a security interest in franchise agreements.

In Chapter 5, David Gurnick discusses issues related to a franchisor's corporate and business structure and intellectual property, from the perspective of start-up as well as seasoned franchisors. He considers the pros and cons of using multiple business entities to develop company-owned operations and franchised

operations, and to own the copyrights, trademarks, and other intellectual properties licensed to franchisees. These structural considerations can have an impact on the franchisor's credibility with prospective franchisees, the ability of each to raise capital through third-party lenders, and the protection of the franchise system's intellectual property against unanticipated risks.

As the saying goes, the three most important ingredients in a successful franchise operation are location, location, and location. In Chapter 6, Mark Shapiro examines franchise real estate issues, including the essential provisions that should be contained in every franchisee's lease. Control over the real property is a critical component of a strong franchise program and the nuances are often misunderstood or overlooked by franchisors, both new and experienced. The author examines not only the lease provisions, but also the corresponding franchise agreement and operations manual provisions that need to be crafted carefully to minimize surprises and conflicts during the franchise relationship. The issues include zoning, permits, building code compliance, signs, environmental issues and due diligence, real estate financing, and bankruptcy and termination considerations.

Consumer advertising by franchisors and franchisees is essential to the success of any franchise system. In Chapter 7, Gary Batenhorst examines the legal issues facing franchisors in establishing and administering its advertising programs. He addresses the thorny issues relating to the receipt of payments from approved vendors; advertising-specific laws relating to comparative advertising, advertising to children, unsolicited e-mail marketing, telemarketing, the specific marketing terms such as the word *free* and claims of environmental *green*; and sweepstakes and contest promotions, gift certificates, and gift cards. The author also explores matters such as governance of national and regional marketing funds and marketing cooperatives, and dealing with consumer advertising laws that have an impact on marketing programs. He also discusses important provisions in franchise agreements and operations manuals relating to marketing, and reviews case law dealing with the franchisor's disclosure and other legal obligations relating to development and execution of marketing strategies.

Franchise systems require careful supply chain management to obtain competitive advantages and consistent, high-quality products. Chapter 8 examines the logistics of negotiating the acquisition of raw materials from manufacturers and vendors through storing and moving these goods and services from the manufacturer to the end user or to distribution centers and warehouses. In this chapter, Joyce Mazero, Suzanne Trigg, and Emma Ricaurte Harker examine third-party and fourth-party logistic providers, and the practical, business, regulatory, and disclosure issues associated with designated, approved, and captive suppliers,

as well as the advantages and disadvantages of establishing purchasing cooperatives. They discuss the franchisor's ongoing role and relationship, and how to manage rebates and a franchise disclosure document obligations with respect to franchise system supply chain matters. This chapter also offers practical guidance concerning the legal framework and relevant agreements and key contract provisions of master supply agreements among the franchisor, manufacturers, and producers supplying proprietary and other core items to the franchise system, and the unit supply agreements between a manufacturer or producer and the franchisee at the unit level. As franchisors pursue international expansion, there are also issues in working with international supply chain partners. The authors examine international standards and contractual concerns, including risk of loss provisions such as Free On Board (FOB) or ExWorks (EXW), and how to deal with regional and local cultural differences, customs, religious laws, and other factors that can affect the quality, integrity, uniformity, and consistency of a franchisor's product offerings.

Chapter 9 of this monograph examines assignment, termination, and renewal of franchise relationships, including the franchisee's ability to exit the system, or to pass the business on to family members upon retirement or upon death or disability. Inadequate controls can jeopardize the franchisor's brand and the equally important interests of the remaining franchisees who want to preserve a strong and vibrant franchise system. Craig Tractenberg discusses key considerations in drafting franchise agreement assignment provisions, including defining legal limitations, requiring a seller to pay outstanding debts to trade creditors, explaining transfer fees, and training the successor franchisee, as well as ensuring that successor transferees meet current standards for approval. He also explores legal issues surrounding requirements for the franchisee to execute a release before a proposed transfer, provisions ensuring that the price paid by the buyer is not excessive, franchisor rights of first approval, and the effect of state relationship laws on the transfer process. Under what circumstances can a franchisor be liable for tortious interference when a transfer fails to occur? What are appropriate post-termination rights and remedies? How do state relationship statutes impact franchise agreement provisions? The author also examines statutory good cause and notice and cure opportunity requirements, anti-discrimination statutes, limitations on conditions to renewal, and available statutory damages and common law remedies that may apply.

Completing our examination of collateral issues in franchising, Chapter 10 by Robert Zisk and Jeff Karlin explores various ongoing challenges faced by franchisors. The authors discuss enforcement of royalty, advertising and other payment obligations of franchisees, practical considerations in detecting under-reporting,