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How Franchise Law is Screwed Up©

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Almost every week the firm gets calls from unhappy franchisees. Often there is not much we can do after the client has signed the franchise agreement. The reason is that franchise law is based on a model of economic freedom that does not really exist. Here are some of the problems.

1. Franchisors have a blanket rule not to negotiate the terms of the franchise agreement.[1] Thus, when a client asks us to review a franchise agreement the review is based on a checklist of items which a franchise agreement typically contains.[2] We can provide information and our advice, but unlike other agreements, we do not make revisions to the franchise agreement itself.

2. The law treats franchisees as having "freedom of contract," so if they sign the agreement, it is presumed they had the opportunity to review and accept it. But this is true only on a "take it or leave it" basis. There is no negotiation. This is extremely unusual in business, especially consumer business transactions. Even with commercial leases where property law and contract law greatly favor the landlord, the tenant can and almost always does negotiate and revise the lease.

3. In many states, e.g. Arizona, the franchisee is not treated as a consumer protected under consumer protection statutes. This is true even though the Federal Trade Commission, which regulates franchises, publishes a pamphlet entitled "A Consumer's Guide to Buying a Franchise."

4. While contract law still governs franchise agreements and the franchisor is bound by its promises, often the franchise agreement is long on standards required of the franchisee and short on performance promised by the franchisor.[3] The franchisor may set standards and restrictions for the franchisee, but does not do so for itself. And, often its duty is to "suggest" or provide aid "to the extent it deems appropriate.' These latter items are not promises at all; thus, not enforceable.

5. Under the terms of the franchise agreement the franchisor may require remodeling of the physical space, upgrades in equipment, and change the terms and procedures stated in the Operations Manual at will. The rationale is that the franchisee is buying operational expertise and these changes provide that. But this unfettered right of unilateral revision is questionable. Renovation can cost $100,000, new equipment may cost $10,000-$15,000 or more. The franchisee is asked to agree to these changes and costs in advance without knowing what they are, the timing or the cost. But if the new terms are not known they cannot be agreed to. Thus, the agreement to

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[1] Franchisors can argue there is a very good reason for this. Uniformity is necessary for the "System" to work. This point is true, but probably overstated because some terms, like renewal period, transfer fee, and franchisor duty to perform, could be negotiated without impacting the brand.

[2] As well as what to look for in the franchise itself. The firm represents helps clients become franchisors.

[3] Because a contract is by definition a "bargained for exchange," this raises the issue of "illusory" contract; that is, whether there is in fact a contract at all if performance is not actually promised.

allow revision is not the same thing as agreement to an unknown revision, i.e. the new terms. It should only mean that subsequent revision is not barred.

6. No matter how one-sided the franchise agreement, regardless of the complete lack of negotiation in the transaction, and in spite of, generally, the prospective franchisee's lack of business knowledge and experience (which is typically why they are buying a franchise) the fail-safe of "unconscionability" is not recognized in franchise law. Thus, the franchisor is free to impose whatever standards it wants, make any changes it wants, and generally operate the franchise and treat the franchisee badly with impunity, and there is virtually nothing the franchise can do about it.

7. The franchise model may not even work, and/or the franchisors may not know what they are doing, but franchisors are not subject to competency standards, except as may be argued under the covenant of good faith and fair dealing. But that covenant is primarily aimed at deliberate lack of honesty and the intent to impair a party's rights under an agreement, not the inability to do things correctly.

8. Courts have held that if the franchisor furnishes the service in question, e.g. training or marketing, it does not matter if the franchisee believes it is inadequate. This goes back to the previous point about the lack of a competency standard.

9. Under contract, not property, law a party's breach of a provision in the contract precludes its enforcement of the terms of the agreement against the other party. This is called the "material" or "first breach" rule. However, many contracts, including franchise agreements, now have a "severability" clause which states that an unenforceable term does not bar enforcement of the remaining terms of the agreement. Thus, a party – in this case the franchisor – may have its "cake and eat it too." It can load up the agreement with questionable terms, which if they prove to be unenforceable can just be severed and the rest of the agreement enforced. Allowing this "Heads I win, tails you lose" enforcement of franchise agreements is not good public policy.

10. In the event a franchisor allegedly breaches the franchise agreement and fails to cure the breach after receiving the franchisee's notice of same, the franchisee may declare breach and terminate the contract. However, in response to demand letters from, or a civil action filed by, a franchisee the franchisor will typically allege events of breach by the franchisee. Thus, the franchisee is forced to defend as well as prosecute the case.

11. In litigation the franchisee is often badly "outmatched" in terms of the time, experience, dollars, and attorneys it can use in the case. The franchisor has probably been "here before" and its attorneys almost certainly have. And, the franchisor can afford the cost of proceedings. Often a failing franchisee cannot.

12. Franchise agreements typically specify arbitration, not the court system, as the proper forum for action. As part of that the franchisee waives the right to jury trial. Arbitration keeps the matter private, not a matter of public record, thereby causing less harm to the franchisor's reputation. Arbitration and waiver of the right to a jury typically keep monetary awards down. (They also typically keep time and costs down, which can be good for the franchisee.)

All in all, given the one-sided nature of franchise agreements and the franchise relationship, a prospective franchisee should “look before leaping” and seek legal and perhaps other professional advice before signing the Agreement. At our firm we have a checklist of important terms in a franchise agreement and can advise the client how this franchise stacks up against the norm. Also, as a courtesy, we may also comment on the franchise business model.