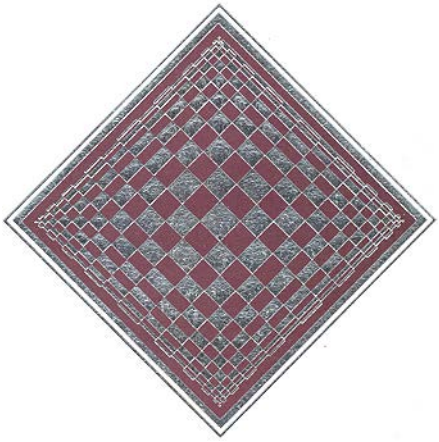

Guiding You Through the Legal Maze.℠

COLLECTIVE NEGOTIATION OF FRANCHISE AGREEMENTS

A Non-Legislative/Non-Litigious Solution to Franchise Disputes

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The Franchisee's Dilemma

The vast majority of today's franchise agreements (that is, "one-sided, franchisor-oriented") normally contain the following provision as one of the conditions to the franchisor agreeing to renew the franchise agreement at the end of the initial term:

> The Franchisee will sign the Franchisor's then-current form of Franchise Agreement, which agreement may contain terms materially different than the terms of this Agreement.

Rarely do the parties specifically negotiate this renewal provision, because it is included in the "standard" franchise agreement offered by the franchisor on a "take it or leave it" basis. The legal and business ramifications of this provision are not fully explained to, nor understood by, a prospective franchisee until, 5, 10 or 20 years later, a substantially different (and more onerous) franchise agreement is presented by the franchisor at the time of renewal.

An increasing number of franchise systems are now entering into a cycle of renewal. The dilemma currently faced by renewing franchisees is either to: (i) sign the new franchise agreement as presented, without negotiation; or (ii) "get out of the business," as most franchisees are subject to a 1-3 year covenant not to compete upon the expiration and nonrenewal of the franchise agreement. Neither of these alternatives is reasonable from the franchisee's perspective. Many franchise agreements provide that upon expiration and non-renewal, the franchisor can take over the franchisee's business by taking over the franchisee's lease, taking over the franchisee's telephone numbers, taking over the franchisee's customer list and perhaps giving the franchisor the right to purchase the business assets for an unfair price such as book value. The franchisee has not bought a business that creates equity for the future but the franchisee has merely entered into a 10-year "rent a business!"

What a Prospective Franchisee Should Do

A prospective franchisee needs to retain an experienced franchise attorney to review all of the terms of the franchise agreement including the renewal provisions. If the typical renewal provision is in the franchisor's standard form of franchise agreement, try to renegotiate this provision to make it fair. In my opinion, the following language makes the renewal provision fair:

> The Franchisee must sign and deliver to the Franchisor a renewal franchise agreement that will not vary the material business terms reflected in this Agreement. However, the Franchisee agrees to sign the Franchisor's renewal franchise agreement, even if materially different from this Agreement, if the new franchise agreement was collectively negotiated and approved by 50% of the franchisees in the system.

The franchisor community argues that it needs total flexibility in making changes to the franchise system and to the franchise agreement to reflect changes in technology, market conditions,

franchise and other laws, demographics, etc. These are all valid considerations. However, because a franchisor represents that the franchise is like a "partnership" rather than a master-servant relationship, certainly input by the franchisees is desirable, necessary and equitable. In reality, these changes are made unilaterally by the franchisor, not so much as a result to reactions to changes beyond the franchisor's control, but really as a result of the franchisor's desire to increase its income, to draft around adverse court decisions which favor franchisees or otherwise to improve its own self-interest, at the expense of its existing franchisees.

A prospective franchisee may assume and expect that the marketplace of the investment decisions of future prospective franchisees and their negotiations will be able to hold the franchisor in check on unilateral amendments to the franchise agreement favoring the franchisor. However, in today's world, since most franchisors continue to offer their franchises on a "take it or leave it" basis, no such negotiation occurs. Therefore, there is a compelling need for collective negotiation on a system-wide basis through an independent franchisee association to make the changes reasonable and necessary in reaction to changes beyond the franchisor's control and to continue to have the franchise relationship be a "win-win" for both the franchisor and its franchisees.

What an Existing Franchisee Should Do

If you are an existing franchisee, re-read the renewal terms of your franchise agreement. If this typical provision is in there, it is still not too late to do something. If there is no independent franchisee association operating within your system, the first thing to do is help organize an independent franchisee association. If your franchise system has an independent franchisee association in place and functioning (not a franchisor-controlled franchisee advisory council), you need to make sure one of the priority objectives of the association is to collectively negotiate the terms of any changes to the franchise agreement as well as try to "renegotiate" the existing franchise agreement where problem areas exist.

Change is inevitable. Change is necessary. However, in most contractual relationships, to make any change to a contract both parties to the contract must agree, usually in writing, to the change. The aberration reflected in franchising--that of unilateral modification by the franchisor--must be restricted. The franchisor and its franchisees, along with each of their experienced franchise counsel, need to sit down and discuss what changes are necessary to keep the franchise system viable in the marketplace, not just for the franchisor, but also for the existing franchisees.

What If the Franchisor Refuses to Negotiate?

Not all franchisors are enlightened to the fundamental truth that the long-term vitality of franchising depends on the mutual success of franchisors and all of their franchisees. Rather, most franchisors, particularly those who are large and mature, take the position: "It's my trademark - I can do what I want, when I want!"

Unfortunately, you signed the franchise agreement in which you agreed, 10 years ago, to sign the franchisor's then-current form of franchise agreement no matter what it said. Now you know what it says and you and your fellow franchisees do not like it. You tell the franchisor that you do not like it. The franchisor says, "sign it or get out of the business." At this point, there are still two alternatives:

(1) Mediation, and if that is not successful;

(2) Have a court find that the franchisor is acting in bad faith in refusing to negotiate the terms of a renewal franchise agreement.

Mediation

Mediation is similar negotiation except there is an extra, impartial person in the room, or going from room to room, to facilitate communication between the disputants and resolution of a dispute. Check to see if your franchise agreement provides for the mediation of any dispute. If so, ask for mediation of the terms of the renewal franchise agreement. If the franchise agreement is silent, ask your franchisor to mediate anyway. It is voluntary and nonbinding.

The International Franchise Association ("IFA"), along with the Center for Public Resources ("CPR") Institute for Dispute Resolution has created the National Franchise Mediation Program ("NFMP"). Franchisors who join the program must agree for at least 2 years to attempt to resolve any dispute with any of its franchisees through mediation. Many of the larger franchisors, that are members of the IFA, have volunteered to participate in the NFMP. To find out if your franchisor has joined the NFMP, contact CPR at (212) 949-6490. Even if your franchisor has not joined, ask it to use the NFMP to mediate the terms of the renewal franchise agreement. Unfortunately, the NFMP applies only to mediation between a single franchisee and the franchisor. Without the franchisor's consent, mediation on a group, class or collective basis cannot take place. If the franchisor does not consent, then NFMP is not available. The IFA should change its policy and allow collective mediation of similar disputes affecting more than one franchisee.

Litigation.

You are backed into a corner if your franchisor continues to "stonewall" you,. There is one other avenue left--litigation. While there is no decision, of which we are aware, specifically holding that the typical renewal provision is unenforceable, or that a franchisor that refuses to collectively negotiate the terms of a renewal franchise agreement violates the implied covenant of good faith and fair dealing, recent cases in favor of franchisees are heading in that direction. It is only a matter of time.

Numerous courts throughout the country have begun to take judicial notice of the fact that the typical franchise agreement is a "contract of adhesion" and contains many unconscionable terms. Parties having disproportionate bargaining power enter into the franchise agreement and its provisions are not subject to arms'-length negotiation between parties of comparable bargaining power, notwithstanding the party line of the franchisor community that the typical franchise agreement is negotiated by a knowledgeable franchisor and a knowledgeable franchisee. Franchisees are offered by a franchisor on a non-negotiable "take it or leave it" basis. Franchisees sign the franchise agreement that contains provisions, which are patently "commercially unreasonable." The courts have begun to recognize that the most egregious terms, in which franchisees relinquish valuable rights without getting anything in return, may not be enforceable.

Why would a prospective franchisee sign such an onerous agreement? There are a number of reasons besides the "take it or leave it" attitude of franchisors and their lawyers that franchisee's sign an unfair and overreaching franchise agreement including:

- the prospective franchisee's lack of sophistication
- failure to retain proper legal and accounting advice

- the fact that a competitor's franchise offering contains similar egregious terms

- the representations made by the franchisor's salespersons that the franchisor treats all of its franchisees as "partners"

- high pressure sales tactics

- their faith and trust in the franchisor that the franchisor, notwithstanding the terms of the franchise agreement, would not do something to hurt them

- the "franchise fraud" perpetuated nationwide that a person's chances for success are substantially greater being part of any franchise system than being an independent business.

In *Kubis & Persyzk Associates, Inc. v. Sun Microsystems Inc., CCH Bus. Fran. Guide* Para. 10,980 (N.J. Sup. Ct. 1996), a forum selection (venue) clause requiring a New Jersey franchisee to litigate a dispute with a California franchisor in California rather than in New Jersey was found by the New Jersey Supreme Court to be presumptively invalid because it fundamentally conflicted with New Jersey's public policy of swift and effective judicial relief. The New Jersey Supreme Court, quoting from its earlier decision in *Westfield Center Service, Inc., v. Cities Service Oil Co.,* 86 N.J. 453 (1981) stated:

> Though economic advantages to both parties exist in the franchise relationship, disparity in the bargaining power of the parties has led to some unconscionable provisions in the agreements. Franchisors have drafted contracts permitting them to terminate or to refuse renewal of franchises at will or for a wide variety of reasons including failure to comply with unreasonable conditions. Some franchisors have terminated or refused to renew viable franchises, leaving franchisees with nothing in return for their investment. Others have threatened franchisees with termination to coerce them to stay open at unreasonable hours, purchase supplies only from the franchisor and at excessive rates or unduly expand their facilities.
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> . . .[W]e hold that forum-selection clauses in franchise agreements are presumptively invalid, and should not be enforced unless the franchisor can satisfy the burden of proving that such a clause was not imposed on the franchisee unfairly on the basis of its superior bargaining position. **Evidence that the forum-selection clause was included as part of the standard franchise agreement, without more, is insufficient to overcome the presumption of invalidity. We anticipate that a franchisor could sustain its burden of proof by offering evidence of specific negotiations over the inclusion of the forum-selection clause and that it was included in exchange for specific concessions to the franchisee.** Absence such proof, or other similarly persuasive proof demonstrating that the forum-selection clause was not imposed on the franchisee against its will, a trial court should conclude that the presumption against the enforceability of forum-selection clauses in franchise agreements subject to the [New Jersey Franchise Practices] Act has not been overcome. [Emphasis Supplied.]

The impeccable logic of *Sun Microsystems* should apply with greater force to a renewal provision in a franchise agreement that requires a franchisee to sign the franchisor's then current form of franchise agreement containing material changes unilaterally made by the franchisor without specific negotiation with the franchisees, which changes are adverse to the economic and business interests of the franchisees. This is a far greater right a franchisee is relinquishing in giving the franchisor carte blanche to change the terms of the relationship from merely agreeing to litigate in the franchisor's home state. This type of renewal provision should be unenforceable as a matter of public policy if it was not subject to specific negotiation in exchange for specific concessions to the franchisee.

If the court refuses to recognize this argument, the alternative argument is that the franchisor is acting in bad faith in failing to negotiate with its franchisees concerning the material changes contained in the renewal franchise agreement. One of the franchisees' newest weapons in their growing arsenal is the franchisor's breach of the implied covenant of good faith and fair dealing. Courts in most states have recognized that the implied covenant of good faith and fair dealing applies to all parties to a contract including parties to a franchise agreement. Many states recognize an independent cause of action for breach of this implied covenant of good faith and fair dealing.

Under the rationale established by a number of encroachment cases, if the renewal provision in the existing franchise agreement is specific as to what the changed terms will be on renewal, then the court should uphold these changed terms. If these changed terms are not specified in the renewal provision of the existing franchise agreement, then any changes made unilaterally by the franchisor must be measured against the implied covenant of good faith and fair dealing to determine their reasonableness. For example, if an existing franchise agreement specifically provides that upon renewal the royalty will be increased from 5% of gross sales to 10% of gross sales, a court should deny a franchisee's claim of breach of the implied covenant of good faith and fair dealing and uphold the 10% royalty on renewal because that is what the contracting parties specifically agreed to. If the existing franchise agreement merely provides that the renewal franchise agreement may contain terms materially different than the existing franchise agreement, including an increase of the royalty, without specifying the exact change in the royalty, any increased royalty contained in the renewal franchise agreement, must be measured against the implied covenant of good faith and fair dealing.

For example, assume that the royalty rate in a current franchise agreement is 5% of Gross Revenues. What if the renewal franchise agreement provides that the royalty rate is 100% of the franchisee’s Gross Revenues? Of course, this would be ridiculous but it proves my point. At what point when the franchisor unilaterally makes increases in the royalty rate or other payments, or changes or eliminates another material term of the franchise agreement such as significantly reducing or eliminating a protected territory that the franchisor is acting in bad faith? Is it at 7%? 9%, 15%? Any rational person would conclude that a franchisor must act in good faith in materially changing the terms of a renewal franchise agreement. Yet, if you believe that the franchisor has unfettered, unilateral discretion because of the general language in the existing franchise agreement, you must say that it is permissible. Of course, the proper approach is the exercise of reasonable discretion held in check, preferably through negotiation with the franchisee, or through imposition of the implied covenant of good faith and fair dealing by a court or a jury.

Although the franchisor may have the contractual right to condition the renewal of the franchise relationship by the franchisee signing a new franchise agreement, any material changes in the terms of the new franchise agreement that are commercially unreasonable and adverse to the legitimate economic and business interests of the franchisees, should be subject to specific negotiation with its franchisees in good faith. For a franchisor to unilaterally make material adverse

changes to the terms of the franchise relationship and impose these changes on its franchisees on a nonnegotiable "take it or leave it" basis, it is an act of bad faith and is an actionable breach of the covenant of good faith and fair dealing. This is particularly true if this action is coupled with the threat of termination of the franchise agreement and the automatic and immediate imposition of a restrictive and penal covenant not to compete that would which place a significant number of franchisees and thousands of employees out of business. One day soon, a court will so hold.

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