

FRANCHISE LAW INSIDER™

A Newsletter Reviewing Recent Franchise and Related Business Developments 3rd Quarter 2006

"The highest reward for a person's toil is not what they get for it, but what they become by it."

-John Ruskin-



HOLMES & LOFSTROM, LLP
Franchise and Business Counsel

IFA QUARTERLY EVENTS
Hosted by
Holmes & Lofstrom, LLP.

January 2007

Topic: to be determined

LOCATIONS:

Orange County Breakfast
Scott's Seafood Grill & Bar
3300 Bristol Street
Costa Mesa, CA 92626
7:30 AM

San Diego Lunch
Franchise.com
135 Saxony Road,
Second Floor
Encinitas, CA 92024
11:30 AM

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7 STEPS BEFORE YOU FRANCHISE YOUR BUSINESS

By: Lori M. Lofstrom, Partner

1. "Prepare To Franchise!"
It is so important to *take your time* and do this correctly. Errors are expensive.
2. "Franchise-ability."
There are many different businesses that are franchise-able. It's really a case by case assessment of what you're doing with your business or your unique "angle" that is important. Talk to a franchise consultant or franchise counsel.
3. The Psychological "Shift."
Once you begin to franchise, you will be operating a different type of business than the underlying business. This step can be difficult as it involves a new identity and takes you out of your "core" business.

Continued on page 5

7 QUALITIES OF SUCCESSFUL FRANCHISORS -FOR NEWLY ESTABLISHED FRANCHISORS

By: Lori M. Lofstrom, Partner

1. Keep It Simple.
Complicated concepts including multi-unit franchising, area development programs or those dramatically outside the norm can come later. Avoid significant revisions to your documents and making "special deals" that are difficult to track and compromise uniformity.
2. Find a Mentor.
Try to meet up with "seasoned" franchisors willing to share. This can help you avoid costly mistakes and learn proven methods to accomplish your goals successfully. Join trade organizations like the IFA.

Continued on page 4

IN THIS ISSUE

7 Steps Before You Franchise Your Business.....	1
7 Qualities Of Successful Franchisors	1
Lessons Learned	3
Franchise Legal Updates	3
Franchise Growth Continues into 2006	5

FRANCHISE LAW INSIDER™

FRANCHISE LAW INSIDER™ is published to provide our clients and friends with information on legal developments affecting the franchising world. The articles and/or opinions presented are necessarily of a general nature and should not be construed as legal advice or opinions on specific facts.

We're happy to provide additional information regarding any of the articles contained herein, or to discuss how they may apply to your situation. We invite your comments, questions, or any short articles of a pertinent nature for possible inclusion in a future newsletter. Please contact our offices if you're interested.



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Firm News!

Lori Lofstrom speaks on a panel at a recent Long Beach Chamber Town Hall event



L-R: Lori Lofstrom, Partner at Holmes & Lofstrom; Kathay Feng, Executive Director for Common Cause; Steve Ochoa of the William C. Velasquez Institute; Senator Alan Lowenthal of the 27th District of the State of California; and Doug Johnson of the Rose Institute of State and Local Government. Ms. Lofstrom represented the Long Beach Chamber in support of the Senator's bill to resolve political gerrymandering through redistricting.

David Holmes named Editor of the new CEB treatise on Franchising in California

David Holmes has recently been appointed as the Executive Editor of a new book on franchising. Continuing Education of the Bar (CEB), a joint venture between the University of California and the State Bar, will be publishing a treatise on California Franchise and Distribution Law, the first of its kind in the U.S., and David will be responsible for the content of the book.

The book will serve as a resource for the new California program for attorneys wishing to become Certified Franchise and Distribution Law Specialists, for which David is Co-Chair of the Commission which brings that program into effect.

California Governor Arnold Schwarzenegger gets re-election support from Long Beach Chamber



L-R: Chamber Chairman Byron Schweigert, Vice Chair of Public Policy Lori Lofstrom of Holmes & Lofstrom, Governor Schwarzenegger, Chair-elect Matt Kinley and Chamber President and CEO Randy Gordon.

H & L July Franchise Business Network (FBN) meeting



Stuart Mathis, President of Mail Boxes, Etc. and UPS Store speaks to **Franchise Business Network** meeting held July 12th. Other presenters included franchise consultants Dan Martin, President and CEO of IFX International, Inc. and Mary Ann O'Connell, President of O'Connell and Company.

LESSONS LEARNED

By: David Holmes

A continuing column drawing lessons for franchise systems from franchise litigation and other sources.

California Law Applied to Protect California Franchisees, In Spite of Florida Choice of Law Clause

In any dispute between a Franchisor and a Franchisee, the question of which state's laws apply can be critical. If the law of a state such as California (which has highly pro-Franchisee laws) controls, then the Franchisee may be in an advantageous position in any dispute.

For that reason, Franchise Agreements regularly specify the applicable law, often choosing the law of a state that may not have such pro-Franchisee legislation and court rulings. But will that clause in the Franchise Agreement actually control, if the Franchisees are residents of a state with pro-Franchisee laws?

A recent case decided by a Federal trial court in California (Burgo v. Lady of America Franchise Corp.), not surprisingly, held that it did not and that California's fundamental public policies, as embodied in the California Franchise Investment Law, mandated that California law be applied, even though the franchise agreements at issue contained clauses selecting Florida law as controlling. Critical in this case was that all of the plaintiff Franchisees were California residents and that each of the franchised businesses were located in California.

The case is a reminder that even the best drafted Franchise Agreements may sometimes be trumped by the laws and policies of the states where Franchisees are located.

Non-Competition Clause Enforced Against Wife Who Did Not Sign Franchise Agreement

California-based Franchisors (and even some in other states) sometimes assume that post-term non-competition clauses in franchise agreements may not be enforceable, either because of states' laws with which they're familiar, or due to experience with similar laws in the employment context, where enforcement is, in fact, often difficult.

Continued on page 5

FRANCHISE LEGAL UPDATES

INTERNATIONAL LEGAL UPDATE

A continuing series designed to keep our U.S. clients informed regarding international franchise legal developments.

For further information on the items reported, and before taking any steps relating to the information presented, please contact any of the international franchise attorneys at Holmes & Lofstrom, LLP.

Belgium – New Franchise Law

Effective February 1, 2006, and reported in August of this year, Belgium became one of the most recent countries to introduce a franchise disclosure law. In broad outline, the law requires Franchisors, at least one month before the signing of an agreement, to provide various disclosures to the prospective purchaser.

As is typical with most countries franchise disclosure laws, failure to comply with the disclosure requirement will have the effect of allowing the purchaser to cancel the agreement, in this case within two years of the date the agreement is signed.

Vietnam – New Franchise Law

Unknown to many Americans, Vietnam is currently the third fastest growing economy in Asia, after China and India. As one in a continuing series of steps to prepare Vietnam for World Trade Organization membership (expected in 2007) the country published, in July, a Decree Making Detailed Provisions for Implementation of the Commercial Law with Respect to Franchising Activities, bringing into practical effect laws enacted earlier this year.

Continued on page 4

3. **Compliance Program Set-up.**
Work with a consultant or counsel to draft a compliance checklist for you. This will help ensure that you are following the franchise sales rules and maintaining good recordkeeping.
4. **Sales Process Checklist.**
Successful franchisors have a pre-determined, step-by-step sales process through which they carefully and methodically lead each of their prospective franchisees. If a franchisee cannot follow a sales process, they will probably not be able to follow your system either.
5. **Controlled Growth.**
Don't let your prospects control your growth, set a growth plan of those states that you will expand to and stick with it. Establish a response system for prospects in states where you are not yet legal to offer or sell.
6. **Franchisee Communication.**
Facilitate periodic communication with your franchisees to get their input and feedback. Set up a Franchise Advisory Council once you have some interested franchisees that are not in "start up" mode.
7. **Enforce Your Agreements.**
When a franchisee is not following the system, it is your responsibility to the System and the other franchisees to notify and mandate that the franchisee comply. Follow the steps in the franchise agreement, but be firm so that you send the right message to all.

**IFA Convention in Las Vegas is
fast approaching and
Holmes & Lofstrom, LLP will be there!
Will you?**

The 47th Annual International Franchise Association Convention will be held February 24-27, 2007 at Caesar's Palace. Details at: www.franchise.org under the news and events section.

Vietnam—continued

The new law applies both to foreign systems entering the Vietnamese market and domestic Vietnamese companies awarding franchises, including acting as Master Franchisees for foreign-based concepts. Apparently, the law would also cover the award of a master franchise by a non-Vietnamese system.

Under the law, both registration and disclosure are required, although the intensity of review of the "Franchise Description Document" (serving a similar function to our UFOC) is not known at this time. Application for registration must be made in Vietnamese.

Similar to Chinese regulations (and probably influenced by them), the Franchisor must have operated the business to be franchised for at least one year, and a Master Franchisee wishing to sub-franchise must have operated the business to be franchised for at least one year in Vietnam.

The Franchise Description Document must be delivered to a prospective franchisee at least 15 business days prior to signing the agreement, and includes disclosure categories similar to those used in the U.S. and other countries.

One curious provision is a requirement that the Franchisor notify all Franchisees of any important changes to the franchise system that affect the Franchisees' business, even after they have begun operations. The extent of this requirement is unknown and it will be interesting to see how it evolves, both in practice and enforcement.

Continued on page 6

However, the result in many states can very well be that non-competition agreements will be enforced, including against persons who may not have even signed the franchise agreement, according to a recent federal court case (Merry Maids v. WWJD Enterprises) arising in Nebraska and applying Tennessee law.

The facts, as found by the court, were basically these: The Franchisee had signed a franchise agreement prohibiting competition for one year and within 75 miles of the franchised location. His wife did not sign the franchise agreement. After the franchise agreement expired, the husband funded his wife's opening of a competing cleaning business and transferred the assets of the franchised business to her new business.

The court held that the transfer was essentially a sham and was designed to "park" the husband's business with his wife while he continued to manage it. In effect, the court found that there was a conspiracy between the husband and wife to evade the non-competition clause in the franchise agreement and issued an injunction against the wife.

An interesting wrinkle in the case is that the injunction continued for one year after its date of issuance, not merely one year after expiration of the franchise agreement, since the court concluded that the Franchisor was entitled to one year's benefit of the non-competition clause.

Franchise growth continuing into 2006

In California, the number of 2005 initial and renewal franchise filings represent an increase over 2004's figures and the growth projection continues into the first half of 2006.

In 2005, there were 885 renewals, which is a 16.9% increase over the 757 renewals in 2004. By June 30, 2006 the renewals have already climbed to 840.

For initial filings (which include the 31111 filings) there was a 14.1% increase, from 490 filings in 2004 to 559 in 2005. By June 30, 2006 the renewal filings have already reached 318.

Overall, this may be an indication and hint of confidence in the economy as well as profitability of the franchise systems themselves.

4. Establish A Successful Business Model and Infrastructure.
 - one or more operating units with a track record (1 or more years) of success.
 - manuals or operating guidelines.
 - training program for franchisees and staff.
 - support personnel to help when franchisees stumble.
 - successful operations when you're gone.
5. Adequately Capitalize.

You will need enough cash to sustain some legal, accounting and consulting expenses in setting up your infrastructure as well as for additional sales and support personnel. You will need sufficient finances to fund the venture *PRIOR TO* ever selling a franchise.
6. Protect Your Intellectual Property.

At the heart of any franchise system is a license of its trademarks and other proprietary information. It's imperative that you take care of this step early since it can take some time to assess and register your marks.
7. Get Educated.

Attend franchise conventions and meetings to fully appreciate the effort needed to become a successful franchisor. Take a "professional" view of franchising, you may well find that franchising is not the right vehicle for your growth.

Resources:

Franchisors:

"What No One Ever Tells You About Franchising"
by: Jan Norman. (Contribution from Lori M. Lofstrom to "Experts" section.)

www.holmeslofstrom.com under "Resources" section of site.

www.franchise.org – resources and contact information about Franchise Consultants and various suppliers such as brokers, technical writers, intranet, website development, etc.

www.franchise.com – marketing resource and online UFOC delivery services.

Relationship elements are also included under the Decree, including limitations on the situations in which a Franchisor can deny approval of an assignment by a Franchisee. One unusual provision is an obligation for the Franchisor to provide equal treatment to all franchisees in the system.

Also, other than contracts involving a franchise from Vietnam to overseas, the franchise agreement itself must be in Vietnamese and it is possible that this requirement may be applicable to master franchise agreements, as the decree generally applies to foreign and domestic franchise systems equally.

[Austria, Germany and Switzerland - Compensation to Franchisee on Expiration of Franchise Agreement](#)

Many U.S. Franchisors engaged in international franchising are aware that, if they wrongfully terminate a Franchisee, they may be required to pay compensation. What is far less known is that the courts in some countries, including Austria, Germany and Switzerland have indicated that compensation may be payable merely as a result of expiration of the Franchise Agreement, on the basis of loss of goodwill and customer base as "created" by the Franchisee.

UK counsel suggests the following steps to reduce exposure in this area:

Do not agree that the laws of Austria, Germany and Switzerland will govern the agreement, the relationship or otherwise.

If counsel is not confident that the above step will have the desired effect, consider removing provisions transferring customer lists, etc. to the Franchisor on expiration (noting, of course, issues related to the business practicality of such an approach).

Incorporate in the agreement a formula for appropriate compensation, remembering that an excessively pro-Franchisor formula may still be open to challenge.

Note that even in these countries, the compensation required will often be capped at one year's income to the Franchisee, and may be reduced if the Franchisor can show that customers will continue to do business with the former Franchisee.

(Our thanks to Mark Abell at Field Fisher Waterhouse in London for information relating to this column.)

[Australia](#)

Australia (after Canada) is one of the most popular destinations for U.S. franchise systems seeking to expand internationally, in part due to a similar culture and style of doing business, a common language and entrepreneurial

spirit and (to no small degree) a generally friendly legal environment, including a rational franchise disclosure scheme.

Therefore, recent news that Australia is considering making changes to its franchise disclosure rules was greeted with some concern, based on a "if it's not broken, don't fix it" philosophy.

In part, the review of current disclosure requirements is a result of some recent disputes and insolvencies. Steps being considered include mandatory requirements for legal advice for prospective Franchisees (perhaps limited to those systems requiring more than a AUS \$20,000 investment), required disclosures (perhaps by Franchisees) on re-sales and required disclosures with respect to international transactions.

A further area of exploration may include mandatory earnings claims, perhaps with a "safe harbor" protection for Franchisors in the event that a Franchisee's actual results do not meet reported averages.

(We wish to thank Baybridge Lawyers, in Sydney, co-founding member with Holmes & Lofstrom in the UniFran Alliance of international franchise law firms).

Continued on page 7

Canada – Prince Edward Island and New Brunswick

As forecast in earlier bulletins from Holmes & Lofstrom, the Prince Edward Island Franchises Act became effective on July 1, 2006, making it the third Canadian province (after Alberta and Ontario), and the smallest, to pass franchise-specific laws. Enabling regulations have also been adopted. In general, the law and regulations mandate pre-sale disclosure, similar to regulations in Alberta and Ontario, but also regulate some aspects of the franchise relationship, including a “fair dealing” obligation on each party.

The new Prince Edward Island (PEI) law requires a franchisor to provide a prospective Franchisee with a disclosure document at least 14 days before the Franchisee enters into an agreement related to the franchise or makes any payment to the Franchisor, with rescission as a remedy for failure to make proper disclosure. Unlike the Ontario law, the PEI franchise law excludes confidentiality and site selection agreements from the definition of a franchise agreement, apparently allowing a Franchisor and a prospective Franchisee to enter into those arrangements before a dis-

closure document is prepared or delivered, an approach which seems to make practical sense given that no funds have exchanged hands at that point.

New Brunswick, another relatively small Canadian province, is seriously considering adoption of a similar law, but the relevant government committee will probably not start consideration of the Bill until this Fall, eventually holding public hearings on the Bill. Therefore, it’s difficult to estimate when the proposed law might come into effect, even assuming that it is adopted by the provincial legislature.

It remains an open question as to whether or not more populous Canadian provinces, such as British Columbia and Quebec, will follow this lead and adopt similar laws, resulting in something like the patchwork quilt of regulations present in the U.S. Clearly, the trend in many countries has been to passing franchise regulations, but with a single set of laws covering the entire country. The U.S. is the notable exception to this approach and Canada may be following the U.S. model, unfortunately.

Spain

Although Spain is not the largest potential market in Europe, it is a sizeable economy and a legitimate potential venue for franchising, with a GDP in excess of One Trillion US Dollars and a 2005 growth rate of 3.4%. Therefore, recent changes to the Spanish franchise law, and a potential trap for unwary franchisors, are of interest.

Revisions to the law effective in May now require, among other things, each franchisor to disclose how long it has been running the franchise business, for Master Franchisees to attach to their disclosure document a copy of their Master Franchise Agreement (thereby making public their economic relationship with the Franchisor!) and foreign companies to translate all documents into Spanish and register them in that form.

Also, the law requires an annual filing, disclosing (among other items) closing or openings of franchised establishments. Failure to make this annual filing can result in loss of registration, and the annual filing should therefore be appropriately calendared.

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