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**OPERATING MANUALS – THE DEVIL IS IN THE DETAILS**

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Ms. Cheng's commercial transactional practice includes counseling clients on mergers and acquisitions, complex commercial relationships, and structuring and drafting contracts for business transactions. Ms. Cheng's general corporate practice includes corporate formation, strategic business alliances and joint ventures. Ms. Cheng combines her franchise and corporate experience to provide franchisors with comprehensive legal services to expand their franchise systems.

Ms. Cheng has spoken on panels and moderated roundtables for conferences and seminars sponsored by the American Bar Association's Forum on Franchising and the International Franchise Association ("IFA"). Additionally, Ms. Cheng frequently presents at other conferences and workshops on the topic of franchising. Ms. Cheng co-chairs the Chicago Chapter of the IFA's Women's Franchise Network and previously co-chaired the Chicago Chapter of the IFA's Franchise Business Network. For her work in this area, Ms. Cheng was named a "Legal Eagle" by the *Franchise Times*.

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## **I. INTRODUCTION<sup>1</sup>**

The operating manual is arguably one of the most critical documents in the franchisor/franchisee relationship. A well-constructed operating manual provides franchisees with clear directions in crucial aspects of franchisor-approved business operations. The operating manual should serve as a roadmap that guides the franchisee to maximum success, which in turn builds the franchise system.

Franchisors must decide the basic function of their operating manual for it to perform as intended. Does the operating manual exist to minimally comply with franchise regulations, or is it intended to be a comprehensive document with detailed instructions for franchise operations and procedures?

A useful operating manual is well-written, user friendly, and up-to-date. Lack of clarity invites costly operational and procedural errors and causes frustration. A poorly designed manual is difficult to navigate and, as a result, the information contained in it is oftentimes inaccessible. Outdated information causes errors, resulting in losses that cut into profits.

An operating manual should evolve as a franchise grows and changes. New methods and procedures must be documented, outdated information must be purged, and problem areas may be addressed with greater detail, allowing the document to mature to the level of the franchise. To remain competitive, franchisors should use their operating manual to efficiently implement system-wide changes.

Franchisees may improvise or invent their own operations and procedures because they lack clear directions for full compliance or do not understand the need to follow the system. A lack of direction jeopardizes brand integrity and rogue franchisees can tarnish the franchise. A properly constructed operating manual and a system for ensuring that all franchisees follow it, ensures that the customers' experience with the product and service is consistent.

This paper explores the purpose and contents of the operating manual, proposes alternative methods for distributing the operating manual, and discusses the advantages and disadvantages of each. It also identifies We identify critical provisions that must be included in the franchise agreement to preserve a franchisor's right to set system-wide standards through the operating manual; discusses various causes of action that may be advanced against the franchisor as a result of misuse of the operating manual; addresses protection of the confidentiality of the operating manual; and, offers practical suggestions for implementing changes to the operating manual.

## **II. PURPOSE OF THE OPERATING MANUAL**

The operating manual serves four main purposes:

1. It protects the brand by outlining approved systems, methods and procedures;
2. It is a tool for systematic and thorough training;

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<sup>1</sup> The authors acknowledge with appreciation Sabina Y. Chung, associate of Cheng Cohen LLC, and Steve Rickard and Steve Cruz, with Special Ops LLC, for their assistance with this paper.

3. It is a reference for required and suggested performance, standards, developments, and the source of all official updates; and

4. It is the tool the franchisor can use to attain, maintain and enforce system compliance.

#### **A. Brand Protection**

The operating manual protects the brand by providing franchisees with clear, detailed directions for building, operating, maintaining and growing their franchise. This results in brand uniformity and fulfillment of consumer expectations, which leads to customer satisfaction and loyalty, increased profits for individual units, operator success and confidence, and system-wide growth for the franchise.

A successful franchisor works rigorously to ensure that every aspect of its customers' experience is consistent because uniformity ensures customer loyalty to the franchise. If the meal at one franchise location is well presented, fresh, tasty and delivered promptly by a pleasant server, the customer is likely to return. If customers' experiences are consistently satisfying, they are likely to trust another franchise in the system. If, however, there is noticeable variation in the quality of meals or service, customers may lose trust in the franchise system and may be reluctant to try different franchise locations.

The operating manual fails to serve its purpose if franchisees are forced to improvise due to lack of clear operating instructions. If several franchisees fail to understand the same set of guidelines, the operating manual must be revised to clearly address the issue. If the operating manual clearly and succinctly describes a procedure, the franchisor will be able to use it to enforce system standards.

An operating manual must be rigid enough to require adherence to standard operating procedures, yet flexible enough to allow for improvements and system growth. When the proper balance is reached, the manual becomes a powerful tool: a useful and often-referenced core of standards and practices for franchisors and franchisees.

The franchisor is charged with protecting its brand, systems and approved procedures. This does not mean, however, that the franchisor only polices compliance. An effective franchisor continually works to improve the system, by anticipating trends and modifying its products and services. If procedures are maintained only because "it's always been done that way," the system becomes stagnant. Similarly improvisation and experimentation can weaken or damage the brand. Franchisors may test and streamline suggestions from innovative franchisees and then implement them through the operating manual.

#### **B. Using the Operating Manual as a Training Tool**

Training time, effectiveness, and expense are major concerns that are best addressed with a complete, up-to-date and clearly written operating manual. The operating manual details the processes and procedures of the franchise and is an essential component of the franchise training program. Franchisees benefit from thorough review and full understanding of the manual. In order to expedite franchisees' training, the franchisor may provide its franchisees with an operating manual prior to training, providing franchisees and opportunity to become familiar with the operating manual.

A franchisor may choose to raise the expectations it has for its franchisees by requiring them to pass a test before they are permitted to attend training. Pre-tests are strategically designed open-book tests, one for each chapter of the operating manual, designed to ensure franchisees are prepared to be trained. A simple 20-question exam requires franchisees to navigate the operating manual to find the answers. Franchisees must achieve a minimum score on the pre-test to qualify for training. Franchisees must satisfactorily complete the training course in order to open and operate a franchise. Training and testing ensure that franchisees begin their operations with a thorough knowledge of the information contained in the operating manual.

When franchisees leave training, they must understand what is expected of them. Thoroughly trained franchisees will need less supervision. Use of the operating manual as the basis for the training program establishes that information contained in the operating manual is complete, up-to-date, and must be followed to the letter. If franchisees request support on issues not contained in the operating manual, the franchisor is given an indication that an update is needed. Or, if franchisees ask for clarification about items in the manual, it is an indication that the manual is not as clear as it needs to be.

### **C. Reference**

The operating manual is the “bridge” between the franchisor and its franchisees; the primary method of communication and an authorized reference tool. Franchisees invest in a franchise because it is a successful brand that allows them to exercise their entrepreneurial drive in an established system. Similarly a franchisor selects franchisees that are willing and able to understand and execute the franchise’s proven business model.

The first line of franchisee support is the operating manual. Franchisees must have confidence that the operating manual is a useful tool to find accurate, current answers to their questions. If not, they will not use it. A franchisor should also establish an assistance team that uses the operating manual as its principal reference tool, thus creating a second line of franchisee support.

Because the operating manual is the primary reference tool, it must be regularly maintained. This includes both updating and purging — an up to date reference tool is most valuable and more likely to be used. A medical textbook written a century ago may have accurate and interesting information, but its obsolete passages render it practically useless, possibly harmful, to a current medical student and his patients. Likewise, an operating manual that has not been updated for two, three or ten years is not a reliable source of accurate information and will be disregarded by franchisees.

### **D. The Operating Manual in Compliance Enforcement**

Compliance with the operating manual ensures that a franchise operates consistently and in accordance with brand standards. A strong operating manual clearly defines standards and expectations to protect the franchise trademarks and identity. A McDonald’s® franchisee that changed the color of the arches from yellow to blue would be terminated. A Taco Bell® franchisee offering an unapproved menu item is out of compliance. Those are extreme examples in which franchisees diverge from basic system standards, but they illustrate the point that consumer expectations and experience are critical. If there is no consistency in the product

or service offered at each franchised location, the brand loses integrity and the brand's marks and goodwill are impaired.

The legalities of compliance enforcement are complex, but the process begins with clearly defining exact standards, processes and procedures in the operating manual. A well-written and regularly updated operating manual establishes the brand's standards, processes and procedures, leaving franchisees room for deviation yet maintaining common standards. As procedural improvements are discovered, the franchisor must document and test those new procedures before implementation. New ideas are integrated into the operating manual and rolled out system-wide. At that point, the revised processes become the new standard and can be enforced as such.

### **III. WRITING STYLE**

Clarity, brevity and simplicity are vital when drafting an operating manual. The most complicated processes must be broken into specific and easy-to-follow steps. Because of the volume of information being presented, the manual should be free from superfluous chatter. The author of the operating manual must also keep in mind the varying educational levels and language backgrounds of franchisees.

Due to liability concerns, which will be explored in Section X of this paper, certain sections of the operating manual should contain recommendations rather than mandatory requirements or, depending on the subject matter, should even be addressed in a separate manual. However, sections of the operating manual that concern system standards must use clear commands and not suggestive language. For example, if franchisees are required to use Brand X barbecue sauce, a suggestion that "franchisees should use Brand X barbecue sauce" does not adequately convey the compliance requirement.

A franchisor may want to personalize the operating manual with entertaining anecdotes. Alternatively, the manual may be written in wordy and confusing "legalese." Both styles increase the likelihood of misinterpretation, which interferes with communication between the franchisor and franchisee.

Anecdotes, insightful stories and amusing asides can be effective when used in classroom training and franchise newsletters, but they tend to clutter an operating manual. Storied or verbose operating manuals are much less readable and user-friendly because the instructions and procedures are unclear. Manuals that are not "user-friendly" are seldom used. The manual should be well-organized, well-maintained and it should not be cluttered with unnecessary or extraneous information.

The operating manual should not be used to "sell" the franchise. Oftentimes, a franchisee has already invested in the system by the time he or she receives the operating manual. Instead, it should be similar to an automobile manual that contains information on how to operate, maintain and problem solve.

### **IV. STRUCTURE AND LAYOUT**

The basic elements of each operating manual are the same, although the construction may differ between franchises. The operating manual provides a roadmap of approved standards and procedures so that franchisees can run their business in a fully compliant manner.

The first step toward creating a “user-friendly” operating manual is to draft a clear, detailed table of contents. Page and chapter numbering should be easy to understand. Numbering should resume at the beginning of each chapter; each new chapter begins with page one. This is important so that when one or two pages are updated in a chapter, only the pagination in that chapter is affected and only that chapter needs to be replaced in a physical manual. If an entire manual is numbered in a single sequence, every subsequent page must be renumbered when the volume gains or loses a page.

A comprehensive index is a useful addition to large operating manuals, but can be time consuming to create and update. The larger an operating manual, the more useful an index. It allows updates to be tracked for and provides a quick guide for users looking for a specific topic. If expense is an overriding issue, a detailed table of contents may serve as a substitute for a comprehensive index.

One of the most important features of any operating manual is its ability to facilitate regular updates. Updates must follow a planned strategy for writing, consistency check, proofing, approval, implementation and purging, as necessary. This underscores the need for operating manual content to be concise, up-to-date and orderly. If outdated or conflicting information is not purged from an operating manual, franchisees may inadvertently follow the outdated or conflicting information, which may result in inconsistencies between locations or, even worse, legal action.

Properly creating and maintaining an operating manual is an involved and ongoing task, but it is the core tool for training, operations, brand standards and compliance. The importance of the operating manual becomes increasingly evident as the business grows.

## **V. OPERATING MANUAL CONTENT**

The franchisor has developed a profitable and marketable system and the operating manual must detail every process that is critical for success: recipes, trade secrets, recruitment practices, bookkeeping requirements, building layout, site selection, trade dress, uniforms, even scripts for answering the phone and plan-o-grams for stockroom layout. The more detailed the manual, the more accurately franchisees can replicate the successful system developed by the franchisor. Although there is no “standard” operating manual, most address the following topics:

- An introduction to the franchise concept
- Mission statement/company values
- Organizational history
- Franchise start-up procedures
- Site selection and development
- Detailed business operations, including best practices
- Product sourcing, pricing and preparation
- Approved vendor information
- Marketing and sales practices
- Accounting processes
- Customer service procedures
- Personnel training and management
- Policies and procedures
- Emergency procedures
- Product handling

- Equipment acquisition, operation and maintenance
- Corporate and emergency contact information
- Forms used for business operations

A well-written operating manual breaks down the most complicated practices into specific and easy-to-follow steps. When appropriate, clear, carefully-labeled images can illustrate processes that are not easily described with text alone.

Every daily, weekly, monthly, quarterly and annual task should be outlined for each critical position and process. This is a time-consuming undertaking that may seem overwhelming, but like any other task, it becomes manageable when divided into basic steps, such as the ones identified below:

1. Determine which processes and procedures to include in the operating manual.
2. Develop the table of contents (TOC) listing major topics and subtopics.
3. Outline the content for each chapter listed in the TOC.
4. Adhere to the outline, write each chapter.
5. Review the material for gaps or redundancies, then fill in gaps and determine which redundancies are necessary.
6. Proof and edit the manual.
7. Test the content: someone unfamiliar with the content should understand the material.
8. Produce and distribute the manual.
9. Develop a process and timeline for regular updates.

A franchisor may decide to hire a staff training expert or retain a professional training and operations company to manage the process. Outsourcing the manual's development is done because the franchisor may lack the staff, skills or knowledge to write the manual in-house. Either way, the process remains consistent.

#### **A. Determine Which Processes and Procedures to Include**

The operating manual defines and clarifies the franchisor's business concept, describes the approved methods and brand standards, and provides a basis for training. A franchisor must answer some of the following questions to determine the content of its operating manual:

- "What are the procedures for each task within the company?"
- "Why is it done this way?"
- "How can someone else be trained to do it?"

These questions can be surprisingly difficult to answer, but provide necessary insight into what needs to be included in the operating manual.

Some systems and routines may be vital to the system and others should be optional. If a particular standard is vital to the system, it should be mandatory and thoroughly described in the manual. A preschool franchise, for example, may detail and require strict compliance with employee background checks and their proprietary lesson plans, but would allow franchisees to customize nearly every other aspect of the business. In contrast, a restaurant concept may detail site selection, build-out, trade dress, operating hours, staff uniforms, food handling and preparation techniques, customer service skills and marketing parameters, in order to accurately replicate the business.

Even if certain policies and procedures are not required by the franchisor, the franchisor may still choose to recommend that franchisees follow certain policies or procedures. However, because of the franchisor's liability concerns such as non-compliance actions, franchisee discipline or termination and third party claims — it is very important that the operating manual make a clear distinction between mandatory and recommended policies and procedures.

## **B. Develop the Table of Contents**

The Table of Contents is developed first and will serve as a roadmap for content of the operating manual. Content varies depending upon the franchise concept, but most manuals contain the following basic chapters:

### **1. Introduction**

This chapter opens with a welcome letter from the president of the company to new franchisees. It can address a variety of topics including confidentiality, legal requirements, system compliance, opening assistance, corporate expectations, logo and trademark usage, corporate history, mission statement, vision statement, ethical standards, and a brief introductory summary of each chapter in the operating manual. This chapter should also state that the operating manual contains guidance concerning legal matters, but that the franchisee is solely responsible for consulting its legal counsel and other advisors to ensure that it operates the franchise in compliance with all applicable laws, including laws pertaining to hiring/disciplinary/firing issues, tax requirements, and insurance requirements.

### **2. Start-Up**

This chapter outlines the steps necessary to open the franchise. It addresses the establishment of a business entity, business licenses and forms, setting up business bank and credit accounts, hiring financial experts, obtaining insurance, site selection, lease terms, building, franchisee training, timelines and guidelines for opening.

### **3. Daily Operations**

This chapter details the day-to-day operations of the franchise and varies considerably from business to business. The operations chapter can take a lot of time to develop and will probably undergo frequent updating. New franchisors may have miscellaneous checklists, notes, and memos that need to be gathered and converted into usable checklists, instructions and job aids.

### **4. Accounting**

This chapter describes the financial policies, practices and records required to run the business efficiently. It is important to prescribe recording and reporting requirements; poor financial records may contribute to business failure and prevent the franchisor from easily auditing its franchisees. This chapter also details royalty payments, advertising co-op fees and methods of payment required by the franchisor. Depending on the extent the franchisor chooses to exert control over its franchisees' financial duties, this chapter can be simple or extensive.

### **5. Customer Service**

This chapter details strategies for customer service issues. How will the telephone be answered? How will customers and clients be greeted? What is the procedure for handling customer complaints or disputes? What are the rewards for an employee who exhibits excellent customer service? What is the disciplinary action in the case of numerous customer complaints involving a particular employee? How is customer information captured and used? What is the

program for customer loyalty and rewards? These are a small sample of the customer service concerns that should be addressed in the operating manual.

## **6. Human Resources**

This chapter details the requirements of federal employment laws and hiring guidelines. Issues regarding fair hiring and equal opportunity practices should be addressed generally. Discipline and termination policies should be presented as recommendations. Guidelines for employment interviews should also be recommendations. A franchisor should describe the possible legal violations its franchisees will want to avoid. Suggested policies regarding prevention of sexual bias, harassment or violence should be included. Within this chapter, the franchisor should remind the franchisees that they are responsible for complying with all applicable laws and that legal requirements vary from state to state. Therefore, a franchisee must check with its attorney to ensure compliance with these laws.

## **7. Marketing**

This chapter details standard marketing practices designed to drive customer traffic and grow the business. It also covers franchise-specific marketing strategies and requirements. Without a marketing plan, many franchisees fail to market until their business is already failing. This chapter specifies the trademark, branding and imaging of the franchise. It may include a marketing calendar and schedule of activities to guide the franchisees' marketing efforts.

## **8. Safety & Security**

This chapter provides basic information on safety and security issues, accident and injury prevention and care, employee safety training, and suggestions to deal with various emergencies. A daycare center, for instance, needs information on protecting children during various types of emergencies, while a restaurant would need information on how to deal with cuts, burns and other kitchen-related hazards.

## **9. Management Forms**

A franchisor may recommend or require various forms to be used by franchisees. A copy of each form is kept in this chapter, along with instructions for use (if necessary), and how to access them if they reside online.

### **C. Creating the Outline**

Once the Table of Contents has been developed, an outline of each chapter should be drafted. The following is a sample outline for a Marketing chapter:

- I. Marketing philosophy
- II. Budget
  - a. Identifying outreach opportunities
  - b. Local marketing and advertising budget
- III. Brand identity
  - a. Franchise-approved templates
  - b. Graphic standards
  - c. Logo use and prohibitions
- IV. Marketing plans and strategies
  - a. Demographic information
  - b. Site-specific promotions
- V. Target market
  - a. Local store marketing

- i. Cross-promotions
    - ii. Marketing calendar
    - iii. Reaching the target market
    - iv. Sample marketing calendar
    - v. Talking with prospects
    - vi. Website
  - b. Event marketing
  - c. In-house event marketing
  - d. Marketing to the community
  - e. Marketing to the media
    - i. Press kit
    - ii. Press releases
  - f. Marketing to existing clients
- VI. Marketing tools
  - a. Leads generation material
    - i. Banners
    - ii. Business cards and stationary
    - iii. Coupons
    - iv. Customer information capture
    - v. Print advertising
  - b. Follow-up and presentation material
    - i. Brochures
    - ii. Collateral materials
    - iii. E-mail database
    - iv. Postcards
  - c. Internal marketing
    - i. Employee contests
    - ii. Employee newsletters
    - iii. Paycheck stuffers
- VII. Chapter conclusion

As evidenced by the above sample outline of the marketing section, each general task is divided into many smaller, specific tasks so that a franchisee can easily find the information that he or she needs and can easily follow the instructions.

#### **D. Writing the Content**

Once the outline has been completed and all existing materials are sorted into categories, the process of writing the first draft begins. Existing materials are edited, updated and formatted as necessary to fit into the new operating manual. Processes that are not clearly defined must be broken down into step-by-step instructions and may be illustrated with pictures when necessary.

It is common for manuals to go through several versions before being published. The manual will require a great deal of refinement, editing and fact checking. A franchisor may have several employees, or experts, review the materials and work with the author to identify, clarify or create the necessary content. There will likely be several versions of the operating manual before it is finalized.

## **E. Filling in the Gaps**

After existing data has been sorted into the outline and gaps are identified, the writer has three options to fill in informational gaps: interviewing a Subject Matter Expert (SME) on the steps involved in a process, asking the SME to write out a process, or shadowing the SME while he or she completes the process.

### **1. Interviewing the SME**

Before interviewing the SME, the writer must have a clearly defined objective. Does the writer need to clarify confusing sections or fill in gaps? Does the entire process need to be documented? How much detail is needed? The writer should review any existing material on the process before interviewing the SME, and should compile a list of questions in advance.

If possible, the author should interview the SME, asking open-ended questions beginning with the words “what,” “how,” and “why.” The writer should paraphrase the information and repeat it to the SME to be sure that he or she has an understanding of the information. Immediately after the interview is complete, the writer should review his or her notes and write out a rough draft while the information is still fresh.

### **2. Shadowing the SME**

Shadowing a SME is much like a face-to-face interview in that the author must take notes and ask open-ended questions. This time, however, the SME performs the task in question while the writer observes and asks questions to clarify any open issues.

### **3. SME Writes Documentation**

A third option is to have the SME write out, in as much detail as possible, the information needed. The author must clearly communicate to the SME exactly what is needed and should, if at all possible, develop a list of open-ended questions (what, how and why) for the SME to answer.

Once the SME has written out the information, the writer edits and formats it to fit into the manual, and asks the SME to review it for accuracy. The writer then makes any necessary changes and puts the final version into the appropriate chapter.

## **F. Proofing and Editing**

After the author fills in the gaps and completes the second draft, the document is handed to a proofreader and/or editor to ensure that the materials share the same voice, and to correct grammatical or typographical errors. The operating manual is a reflection of the franchise; make sure it is accurate, professional and intelligent.

## **VI. PUBLISHING THE OPERATING MANUAL**

In today’s world, the form in which a franchise operating manual is published varies. Manuals are most often printed or electronic. Both formats have benefits and challenges.

## **A. Printing**

Printed operating manuals fall mainly into two areas: word processing printouts and professionally designed publications. There are advantages and disadvantages to each. Word processing printouts are the most economical in terms of production because a franchisor can produce the manual. The pages are printed out, bound in a 3-ring binder, and presented to the franchisees. The advantages are both speed and cost. Word processing printouts can be updated quickly and efficiently with ease. This is an inexpensive way to produce franchise publications and for some businesses it serves its purpose

However, word processing programs are not professional design programs: formatting text, balancing pages, importing images and page numbering can be difficult and clumsy. Documents look like they came from a word processing program. This has the potential to impact the use of the operating manual and its effectiveness as a compliance tool.

Professionally designed publications tend to be impressive documents. Master page design can be created to complement existing franchise collateral. The operating manual is often bound in a 3-ring binder for ease of page insertion and removal. Customized covers reflect well on the detail and caliber of a franchise. A designer who is experienced with long format documents can turn the manual into a dazzling product. Professional page and publication design elevates the perception of the operating manual in the mind of the franchisees, which increases the likelihood of compliance.

## **B. Electronic**

Currently, the two most common electronic formats for placing operating manuals online are searchable PDF documents or web-based HTML. However, with the increased use of iPods® and other personal information devices, the format of the online operating manual is evolving. Advances in technology are changing the method in which the operating manual is delivered. As the costs associated with printing (paper, ink, labor, binding, and shipping) continue to rise, more franchisors turn to the Internet and companies that work to bring technology to all aspects of franchising.

Internet based compliance materials are in use today, and becoming increasingly sophisticated in their application and use. A franchisor can even manipulate a single piece of information to be used in multiple formats, and use the information contained in the operating manual for other purposes. For example, information about hand washing in the operating manual can be put onto a poster for use in training or in a checklist of compliance materials used by the field operations staff. Using this technology, the relevant portion of the operating manual is consistent every time it is referenced throughout the system.

The ease in which one updates an online manual depends on the software used to create site. If the manual is a linkable PDF, which is placed onto an existing website, the manual will need to be rewritten using the original document format, such as Microsoft Word. Manuals written using a content management system, that allows live, online changes, can make instantaneous modifications. Franchisors should maintain accurate records of all changes, including a record of the date on which a change was made. This protects franchisors if there is ever a debate regarding when a change was implemented. Regardless of whether changes are made electronically online, or by using traditional methods, it is important that one person within the organization is responsible for the manual.

## **VII. OPERATING MANUAL MAINTENANCE AND MODIFICATION**

Maintaining the operating manual must be a priority for every franchise system. Outdated manuals are ineffective and a liability. When an updated directive is not in the manual, franchisees can point to the outdated manual and claim ignorance. However, if the operating manual is properly constructed, franchisees can rely on the manual for the answers questions that may arise. Poorly maintained, muddled and difficult-to-navigate manuals become expensive doorstops.

A franchisor who creates a regular schedule for changes and places one person in charge of maintenance and updates, often finds itself in the enviable position of being ahead of the curve — it does not need to constantly monitor franchisees, or to rush to distribute new ideas and processes, or apologize for outdated material. Regularly scheduled updates can also open the door for franchisee participation. Franchise Advisory Councils are becoming increasingly common, and are often tasked with identifying “best practices” to be added to the operating manual. Franchisees are valuable resources for updates and system improvements. The franchisor should always run changes through the system’s experts and its legal counsel before implementing new processes and system standards.

Each new version should be marked on the footer with a copyright symbol, version and date of revision. This allows the franchisor to ensure franchisees are using the right content. Version control must be addressed as well. Many franchisors using paper based manuals send their franchisees a letter explaining how to change out sections of the manual and an envelope to send corporate the originals. Franchisors using electronic based manuals may want to create electronic receipts for the franchisees to acknowledge that they received the updated version. Field personnel can also add “Operations Manual Update” to their list of items to review while at the location. Implementing this systematic approach gives franchisors control over the flow of information and maintains system standards.

Which changes are ongoing and which are static? Franchises change and their systems grow with the introduction of new ideas, technologies and market strategies. The franchisor must determine which sections within each chapter of its manual should be monitored for regular updates and which sections contain relatively static content. An example of static content is the history of the franchise, mission statement, and chart of accounts and financial transaction details. The details of these topics rarely change. Regular updates often occur with marketing materials, uniform standards, product lines, recipes, and emergency contact information.

Frequent changes can cause stress for franchisees. If they frequently receive updates and changes, they may stop paying attention, choosing instead to ignore the changes and stick with outdated processes or improvise new ones. Limiting updates and changes to every six or twelve months allows the franchisor and its franchisees to ensure that changes are necessary, thorough, and implemented. It is important that franchisees know that changes happen on a regularly scheduled basis.

Franchisors should roll out new manuals or revisions to manuals using the same approach as rolling out new product or services. Rolling out a new, or revised, operations manual properly and with advance notice to franchisees, can have a positive impact on public relations. Many organizations use annual franchisee conferences to introduce the manual. Building workshops around the use and importance of the manual; how they will be used for

compliance and protecting the franchisee's investment. It is important that franchisees are enthusiastic about the tools that help make them successful.

After writing the initial manual, maintenance and updates are the keys to holding franchisees accountable. The manual becomes the basis for compliance. When writing and updating the operating manual, it is important for the legal team and the franchisor to understand the basic principles of the franchise, the way in which it operates and the expectations for the franchisor and franchisees.

## **VIII. DRAFTING FRANCHISE AGREEMENT PROVISIONS RELATING TO THE OPERATING MANUAL**

While the franchise agreement governs the relationship between the franchisor and the franchisee and identifies the obligations of the respective parties, the operating manual typically provides standards that the franchisees must maintain with respect to the day to day operations of the franchise. The operating manual is an essential part of any franchise system, and should be the glue that binds the franchise system together in order to achieve the uniformity and brand recognition essential for every franchise system. The provisions in the franchise agreement that introduce, define and otherwise incorporate the role of the operating manual should be carefully considered and drafted.

### **A. Definition of Operating Manual**

The operating manual should be defined in the franchise agreement as a compilation of materials pursuant to which the franchisor provides guidance with respect to operation of the franchise. Because such guidance is given frequently and in many different formats, it is important to define the operating manual as broadly as possible. Often, the operating manual does not come in one three-ring binder. Instead, it may come in various forms throughout the term of the franchise. It can include a memorandum addressing new procedures to follow when greeting customers. It can also include a memorandum requiring all franchisees change their hours of operation. The franchise agreement should clearly establish that the operating manual may include one or more separate manuals, memoranda, other written materials, as well as audiotapes, videotapes, compact discs and electronic media. This sample provision provides the broad definition of an operating manual to include all of the foregoing:

“We will furnish to you guidance in connection with the operation of your Restaurant. Such guidance will be furnished in the form of our operating manual for the operation of Restaurants (the “Operating Manual”), which may include one or more separate manuals as well as audiotapes, videotapes, compact discs, computer software, information available on an Internet site, other electronic media, and/or written materials that we may change from time to time.”

Technology has enabled franchisors to be more efficient when communicating new procedures, specifications and standards. Franchisors that provide the operating manual electronically communicate more efficiently and more economically than by use of a paper copy. Before the prevalence of Internet use, franchisors had to send changes to the operating manual to franchisees by mail or facsimile. The franchisees were required to physically replace those pages. This can be quite costly if the franchisor has thousands of franchisees. In order to take advantage of technology, the franchise agreement should include a provision reserving the right to provide the operating manual electronically. The franchise agreement should also contain language enabling the franchisor to upload any new information to the electronic operating

manual and shift the burden of learning the changes to the franchisees by including a provision that obligates franchisees to monitor and regularly access the operating manual for any updates. The following is sample language that could be used by a franchisor that desires to provide the operating manual in electronic format:

“At our option, we may post some or all of the Operating Manual and any changes on a restricted Website or extranet to which you will have access. (For purposes of this Agreement, “Website” means an interactive electronic document contained in a network of computers linked by communications software, including, without limitation, the Internet and World Wide Web home pages). Any passwords or other digital identifications necessary to access the Operating Manual on a Website or extranet will be deemed to be part of Confidential Information.”

## **B. Modifications to System Standards and Operating Manual**

Franchisors typically change system standards throughout the term of a franchise agreement through changes to the operating manual. The franchise agreement should clearly provide that the franchisor can promulgate system standards through the operating manual. The franchise agreement should also provide that the franchisor has a unilateral right to modify the system standards and the operating manual without restrictions. The following provision reserves these contractual rights:

“The Operating Manual contains mandatory and suggested specifications, standards, operating procedures and rules that we periodically prescribe for operating Restaurants (“System Standards”). We may modify the Operating Manual periodically to reflect changes in System Standards.”

Since the operating manual is subject to change, it is important to contractually require the franchisee to review and comply with all updates. However, if the franchisor provides only hard copies of the operating manual, it will inevitably be obligated to provide updates to the franchisees. If it fails to do so, the franchisor will not be able to enforce those new requirements. Therefore, franchisors that provide the operating manual electronically may want to include language in the franchise agreement which shifts the burden of learning about changes to the operating manual to the franchisees. For example:

“You agree that it is your obligation to monitor and access the Website or extranet for any updates to the Operating Manual or System Standards.”

However, even if the franchisor includes such language in the franchise agreement, it is still advisable to inform franchisees when changes are made to the operating manual. This can be accomplished by simply sending an email to franchisees to review additions of new sections or modifications to certain sections in the operating manual.

### **C. Incorporation of the Operating Manual into the Franchise Agreement**

In order to enforce the terms of the operating manual as if they are terms of the franchise agreement, the franchise agreement should contain an integration clause which includes the operating manual as part of the franchise agreement. The following clauses, which may appear separately in the franchise agreement, integrate the operating manual into the franchise agreement:

“You agree that System Standards we prescribe in the Operating Manual, or otherwise communicate to you in writing or another form, are part of this Franchise Agreement as if fully set forth within its text.”

“The preambles and exhibits are a part of this Franchise Agreement which, together with the System Standards contained in the Operating Manual (which may be periodically modified), constitutes our and your entire agreement, and there are no other oral or written understandings or agreements between us and you, or oral or written representations by us, relating to the subject matter of this Franchise Agreement, the franchise relationship, or your Restaurant (any understandings or agreements reached, or any representations made, before this Franchise Agreement are superseded by this Franchise Agreement).”<sup>2</sup>

These provisions are critical because courts are less likely to enforce the terms of the operating manual as part of the franchise agreement unless the franchise agreement clearly shows that the parties intended to incorporate the operating manual as part of the franchise agreement.

### **IX. IMPLEMENTING CHANGES THROUGH THE OPERATING MANUAL**

As discussed above, , a franchisor must be able to freely amend its operating manual from time to time in order for the document to remain effective. However, even if a franchisor contractually reserves the absolute right to implement system-wide changes through the operating manual, the franchisor must still carefully consider the types of changes that it seeks to implement. The operating manual is not meant to be a tool for the franchisor to change the fundamental terms of its relationship with its franchisees. The operating manual should not be used as a tool to create obligations that do not exist under the franchise agreement. For example, if the franchise agreement is silent as to whether franchisees are obligated to only purchase those products that meet the criteria determined by the franchisor, the franchisor may be unsuccessful in using the operating manual to introduce such a requirement. However, if the franchise agreement provides that the franchisee does have an obligation to purchase products that meet the franchisor’s criteria, the franchisor can certainly use the operating manual to identify those criteria and to change the criteria from time to time. If the franchise agreement contains a provision that simply requires the franchisees to comply with all system standards, the franchisor arguably has the right to require franchisees to purchase products that meet the franchisor’s criteria. However, if the franchisor’s prior system standards did not require the franchisees to purchase only required products, the franchisees may argue that such

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<sup>2</sup> In light of the Revised FTC Rule’s prohibition against requiring a franchisee to waive its right to rely on the franchise disclosure document, a franchisor may want to include the following disclaimer in its integration clause: “Nothing contained herein shall be deemed a waiver of any right the franchisee has to rely on the franchise disclosure document.”

modifications fundamentally changes the terms of the franchise agreement, particularly if the franchisor requires the franchisees to purchase products from the franchisor or its affiliates.

In addition to language that reserves the right to modify system standards through the operating manual, a franchisor may wish to justify its wide discretion in modifying system standards through the operating manual. The following passage provides an example of an attempt at such justification:

“Over the course of a long relationship, such as contemplated by this Franchise Agreement, it is expected that changes will occur in external conditions (such as demographics, general economic conditions, technological advances, and competition in our market) in our franchising plan and the franchise system. Some of these changes may affect, beneficially or adversely, the success or profitability of the concept for XYZ Stores or particular XYZ Stores, including your XYZ Store. As a franchisee, you will be bound to operate your franchised XYZ Store, in accordance with the System Standards as they change from time to time, even though you may not always agree with or benefit from those changes.”

Nevertheless, a franchisee that objects to a change implemented through the operating manual may claim that the franchisor’s decision to implement the change violates the covenant of good faith and fair dealing. Most states impose an “implied covenant of good faith and fair dealing” on franchisors in their dealings with franchisees.<sup>3</sup> The covenant can include an “implied undertaking on the part of every party that he will not intentionally and purposefully do anything to prevent the other party from carrying out the agreement on his part.”<sup>4</sup> However, the covenant can never be used to displace the express terms of a contract. It may only be used to augment or construe those terms.

If the franchise agreement specifically gives the franchisor discretion to make changes to the system standards through the operating manual, the franchisor’s reasonable exercise of its right should withstand scrutiny by the courts. In *King v. GNC Franchising Inc.*<sup>5</sup>, GNC franchisees sued GNC based on GNC’s implementation of policy changes relating to products purchased from outside vendor DP Products and placement of DP Products within the stores. GNC’s franchise agreement specifically reserved the right to revoke approval of DP Products and the GNC operating manual stated that GNC was not obligated to approve a DP Product, even if it satisfied GNC’s approval criteria. The GNC operating manual further notified franchisees that GNC will periodically require franchisees to “reset” and “refresh” the store’s appearance. Based on the language of the franchise agreement and the operating manual, the court dismissed the franchisees’ breach of contract claim for failure to present any evidence that GNC’s standard of performance or requirements under the franchise agreement were unreasonable. The court also granted summary judgment in GNC’s favor on franchisees’ claim of breach of the implied covenant of good faith and fair dealing. The court found that, where a contract affords one party discretion in its performance under the contract, a party may only be found to be in breach of the covenants of good faith and fair dealing if it “exercises its

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<sup>3</sup> See e.g. *Carvel Corporation v. Diversified Management Group, Inc.*, 930 F.2d 228, 230 (2<sup>nd</sup> Cir. 1991)

<sup>4</sup> *Id.*, citing *Grad v. Roberts*, 14 N.Y. 2d. 70, 75 (1964).

<sup>5</sup> 2006 U.S. Dist. LEXIS 76986 (Dist. NJ October 23, 2006)

discretionary authority arbitrarily, unreasonably, or capriciously, with the objective of preventing the other party from receiving its reasonably expected fruits under the contract.”<sup>6</sup>

The “implied covenant” is also used to measure the propriety of a franchisor’s use of “discretion.” Courts will analyze a franchisor’s exercise of its discretion under the implied covenant of good faith and fair dealing, compelling the franchisor to demonstrate that its exercise of contractual discretion was reasonable, proper and made in good faith. A franchisor’s pricing policy was challenged under the covenant of good faith and fair dealing in *Great Clips, Inc. v. Levine*<sup>7</sup> when a hair salon franchisee claimed that the franchisor’s amendment of its operating manual to impose new pricing restrictions on the franchisee violated the covenant of good faith and fair dealing. The court observed that the franchise agreement and operating manual reserved to the franchisor the right to set pricing policies. However, the franchisee argued that since there was no pricing policy in place at the time that he entered into the franchise agreement, the pricing policy introduced through the operating manual violated the implied covenant of good faith and fair dealing. In finding that, “the basis for [the franchisee’s] argument that the pricing policies is in breach of the covenant is unsustainable,”<sup>8</sup> the court further observed:

[T]here is no evidence that Great Clips has made [the franchisee’s] performance under the franchise agreement impossible to perform, or that Great Clips is acting in subjective bad faith. Equity might require the Court to act if the allegation were proven. However, since [the franchisee] can show no more than its conclusory allegation, there is no breach of the covenant of good faith and fair dealing.<sup>9</sup>

As illustrated in these cases, courts will generally enforce changes in system standards, even those requiring substantial change in the franchisee’s business and higher costs of operation, provided that they do not alter the fundamental rights and obligations of the parties and are reasonable under the circumstances. Further, proper drafting of the franchise agreement can dramatically reduce the ability of a court or arbitrator to substitute its notion of the “implied covenant” of fairness for what is contained in the franchise agreement.

As a practical matter, when implementing a change to the operating manual, a franchisor should not only consider the extent to which the franchise agreement permits the change in the manual, or any applicable franchise relationship laws or common law claims that could result from the change but it should also consider the sentiment of the franchisee population regarding the change. If the franchisees object to the change, rather than unilaterally implementing it and requiring the franchisees to abide by it, the franchisor should, wherever possible, work with the franchisees to communicate the rationale for the change and hopefully obtain the franchisees’ consent to the change.

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<sup>6</sup> *Id.* at p. 23.

<sup>7</sup> Bus. Franchise Guide (CCH) ¶9933 (N.D. Minn. 1991)

<sup>8</sup> *Id.* at p. 9.

<sup>9</sup> *Id.* (citations omitted).

## **X. LIABILITY ISSUES ARISING UNDER THE OPERATING MANUAL**

As discussed more fully above, the operating manual is a critical component of any franchise system. It provides franchisees with a roadmap for implementing the franchisor's proven system of operation, addresses issues relating to site selection and development, product sourcing and preparation, personnel hiring and training, security and other critical components of the franchised business. As a result, a franchisor's operations manual is oftentimes the subject of litigation initiated by franchisees or third parties against the franchisor.

### **A. Vicarious Liability – Liability to Third Parties**

Given the broad scope of the operating manual, it can be a franchisor's most valued asset because it is the roadmap of the franchisor's confidential system of operation. But it can also expose the franchisor to claims under a theory of vicarious liability.<sup>10</sup> Specifically, a plaintiff will argue that the franchisor is liable for injuries it sustained at a franchised location because the franchisor exercised control over the franchisee's operations as evidenced by the comprehensive operating manual, which the franchisee was contractually required to follow. In these cases, the degree of control that the franchisor exercises over the day-to-day operation of the franchise is a critical factor in determining whether the franchisor will be vicariously liable for injuries sustained at the franchised location. Franchisors and their counsel must possess a thorough understanding and appreciation of the law of vicarious liability as it relates to the franchise business model prior to drafting an operating manual or any modifications thereto.

The traditional rule of vicarious liability is set forth in the Restatement (Second) of Agency and it provides that the master is liable for the acts or omissions of its servants. The existence of a master-servant relationship (and the imposition of vicarious liability) turns on the "extent of control which, by the agreement, the master may exercise over the details of the work."<sup>11</sup>

This simplistic rule known as the "control test" is adequate in the context of determining whether a worker is an independent contractor or employee. However, application of this "control" test in the context of a franchise relationship is quite difficult given the nature of the franchise relationship. On the one hand, a franchisor must exercise control over a franchisee's operations in order to protect the franchisor's trademark and the integrity of the franchise system. But on the other hand, a franchisee is purchasing its own business which it will independently operate on a daily basis.

Courts nationwide have recognized the inherent problem in applying the traditional Restatement of Agency "control test" to the franchise relationship in order to establish whether a franchisee is an agent of its franchisor. Courts have instead moved toward a more sophisticated analysis of the franchisor-franchisee relationship. These courts have analyzed the unique nature of the franchise relationship and concluded that contractual provisions that might indicate control in an employment or other relationship do not justify imposition of vicarious liability, under an agency theory, in the franchise context. Under this analysis, a franchisor's general right to "control" its franchisees, by imposing systemwide standards of operation and

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<sup>10</sup> For a thorough discussion of the evolution of vicarious liability claims in the franchise context, see, Killion, William L., *Franchisor Vicarious Liability – The Proverbial Assault on the Citadel*, 24 *Franchise L.J.* 162 (2005).

<sup>11</sup> *Restatement (Second) of Agency* § 220, cmt.e (1958).

closely monitoring the franchisee's use of its trademarks, is insufficient to establish an agency relationship (and therefore, a claim for vicarious liability).

Recognizing that such generalized "control" through systemwide standards is, by definition, inherent in the franchise relationship, these courts have sustained the imposition of vicarious liability upon a franchisor only in instances in which the franchisor actually controlled, or had a right to control, the daily operation of the specific aspect, or "instrumentality," of the franchisee's business that is alleged to have caused the harm.

For example, the Texas Supreme Court analyzed vicarious liability in the franchise context and adopted this "control-of-the-instrumentality" rule in *Exxon Corp. v. Tidwell*.<sup>12</sup> Rejecting the application of the traditional "control test" in the context of a franchise relationship, the court explained:

Issues concerning control over operations, such as who held title to the gasoline or who set the sanitation standards for the restroom, obscure the true inquiry. The focus should be on whether Exxon had the right to control the alleged security defects that led to Tidwell's injury. If Exxon did not have any right to control the security of this station, it cannot have had any duty to provide the same. If Exxon had such a right of control, on the other hand, its conduct may be found to have contributed to Tidwell's injury. Applying the traditional test of right of control over general operation simply does not answer this question. It requires a factfinder to surmise a general right of control from factors unrelated to safety, and then to infer from that general control a right of control over the safety conditions that are the real issue in the case. We therefore reject this test in the context of an oil company's potential duty to provide a safe and secure workplace for its tenant service station's employees.<sup>13</sup>

Similarly, in 2004, the Wisconsin Supreme Court carefully considered and rejected the application of the traditional Restatement "control" test in the context of a plaintiff's attempt to assert vicarious liability upon a franchisor for the alleged negligence of its franchisee's employee (who hired and supervised another franchisee employee, who shot two individuals before killing himself). After reviewing the traditional Restatement "control" test and the nature of the franchise relationship, the Wisconsin Supreme Court concluded that the Restatement "control" test should not be applied in the franchise context:

The rationale for vicarious liability becomes somewhat attenuated when applied to the franchise relationship, and vicarious liability premised upon the existence of a master/servant relationship is conceptually difficult to adapt to the franchising context. If the operational standards included in the typical franchise agreement for the protection of the franchisor's trademark were broadly construed as capable of meeting the "control or right to control" test that is generally used to determine *respondeat superior* liability, then franchisors would almost always be exposed to vicarious liability for the torts of their franchisees. We see no justification for such a broad rule of franchisor vicarious liability. If vicarious

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<sup>12</sup> 867 S.W.2d 19 (Tex. 1993)

<sup>13</sup> Killion, William L., *Franchisor Vicarious Liability – The Proverbial Assault on the Citadel*, 24 Franchise L.J. at 166, quoting *Tidwell*, 867 S.W.2d at 23.

liability is to be imposed against franchisors, a more precisely focused test is required.

We conclude that the marketing, quality, and operational standards commonly found in franchise agreements are insufficient to establish the close supervisory control or right of control necessary to demonstrate the existence of a master/servant relationship for all purposes or as a general matter. We hold, therefore, that **a franchisor may be held vicariously liable for the tortious conduct of its franchisee only if the franchisor has control or a right of control over the daily operation of the specific aspect of the franchisee's business that is alleged to have caused the harm.**<sup>14</sup>

Since *Tidwell*, there has been a groundswell of federal and state court decisions recognizing the inherent incompatibility between the Restatement's "control" test and the franchise method of doing business to impose liability on a franchisor for the acts and omissions of its independent franchisees.<sup>15</sup> In each of these cases, the court declined to find, or permit a jury to find, a franchisor vicariously liable for the acts and omissions of its franchisee, unless the franchisor had control, or the right to control, the daily operation of the specific aspect of the

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<sup>14</sup> *Id.*, quoting *Kerl v. Dennis Rasmussen, Inc.*, 273 Wis.2d 106, 113,682 N.W.2d 328 (2004) (emphasis added).

<sup>15</sup> See, e.g., *Papa John's International, et al. v. McCoy*, 244 S.W.2d 44, 56 (KY 2008) (relying on *Kerl*, the Supreme Court of Kentucky held that because the franchisor did not have "control or right of control over the daily operation of the specific aspect of the franchisee's business that [was] alleged to have caused the harm," the franchisor could not be vicariously liable for its franchisee's employee's intentional, tortious conduct.) *Vandemark v. McDonald's Corp.*, 153 N.H. 753, 904 A.2d 627 (2006) (because franchisor did not control the franchisee's security operation, franchisor was not vicariously liable for the injuries sustained by an employee of one of its franchisees while working as an overnight custodian); *Allen v. Choice Hotels International*, 942 So.2d 817 (Miss. App. 2006) (hotel franchisor not vicariously liable, under a theory of actual agency, for the injuries sustained by a hotel guest and her husband who were harmed by criminal acts of an intruder; plaintiff did not establish that the franchisor had control over the security measures implemented by the franchisee); *Allen v. Greenville Hotel Partners, Inc.*, 409 F.Supp.2d 672 (D.S.C. 2006) (hotel franchisor could not be held vicariously liable under theory of actual or apparent agency as the franchisor did not control the hotel's daily operations, nor did it control the specific instrumentality which allegedly caused the harm, *to wit*, the hotel's security and life safety systems); *Hunter v. Ramada Worldwide, Inc.*, 2005 WL 1490053 (E.D. Mo. 2005) (granting summary judgment on plaintiff's claim for vicarious liability for franchisee's negligence in the maintenance of a hotel pool and pool deck, since franchisor lacked the authority to control the daily maintenance of the hotel and could not hire or fire hotel employees); *Hart v. Marriott International, Inc.*, 304 A.D.2d 1057, 758 N.Y.S.2d 435 (3d Dept. 2003) (hotel franchisor was not vicariously liable for injuries allegedly sustained when patron slipped and fell on wet floor of hotel owned by franchisee, since plaintiff offered no proof raising a question of fact as to the day-to-day control over maintenance and management by the franchisee); *Wu v. Dunkin' Donuts, Inc.*, 105 F.Supp.2d 83 (E.D.N.Y. 2000), *aff'd.*, 4 Fed. Appx. 82 (2d Cir. 2001) (franchisor cannot be held vicariously liable for injuries arising from franchisee's failure to prevent assault of its employee, since franchisor did not mandate specific security equipment or procedures or otherwise control the steps taken by its franchisees with respect to security to protect employees); *Kelley v. Wurzbach*, 1999 WL 33640 (Tex. App. 1999) (affirming directed verdict to restaurant franchisor in action brought by customer who was assaulted in a franchisee's parking lot, since franchisor did not control the security decisions made by its franchisee); *Folsom v. Burger King*, 135 Wash.2d 658, 958 P.2d 301 (1998) (en banc) (restaurant franchisor not vicariously liable for franchisee's negligence concerning security measures implemented by franchisee, resulting in murder of franchisee's employees during a robbery, since the franchisor did not retain control over the security of the franchised restaurant); *Helmchen v. White Hen Pantry, Inc.*, 685 N.E.2d 190 (Ind. Ct. App. 1997) (franchisor of convenience store not vicariously liable as a result of the abduction and murder of an employee of a franchisee, since the franchisor did not specifically mandate any security measures or otherwise control security at the franchised store); *Mobil Oil Corp. v. Bransford*, 648 So.2d 119 (Fla. 1995) (granting summary judgment on plaintiff's claim for vicarious liability against franchisor noting that "in today's world, it is well understood that the mere use of franchise logos and related advertisements does not necessarily indicate that the franchisor has actual or apparent control over any substantial aspect of the franchisee's business or employment decisions."); *Hoffnagle v. McDonald's Corp.*, 522 N.W.2d 808 (Iowa 1994) (restaurant franchisor not vicariously liable for injuries to franchisee's employees, since franchisor did not control security procedures at franchised restaurant).

franchisee's business that was alleged to have caused the harm. Thus, the rote application of the Restatement "control" test to hold franchisors vicariously liable for the tortious activity of their franchisees, based merely upon the franchisor's establishing systemwide standards of operation and monitoring its franchisees' use of its trademarks, has faded into the dustbin of judicial history.

Notwithstanding the fact that the vast majority of recent cases involving vicarious liability claims against a franchisor have been decided in the franchisor's favor, there are a number of cases which highlight the dilemma that a franchisor faces in attempting to balance the need to protect its brand through the franchise agreement and operating manual with the legitimate threat of liability that a franchisor may incur if it exerts too much control over the franchisees' daily operations.

In *Miller v. McDonald's Corp.*<sup>16</sup> a restaurant patron purchased a Big Mac and included in the "all beef patty, special sauce, lettuce, cheese pickles, onions and the sesame seed bun" was a sapphire. The plaintiff allegedly injured herself when she bit into the sapphire and as a result, she sued the franchisor, McDonald's corporation. McDonald's successfully moved for summary judgment at the trial court level based on its argument that as the franchisor it could not be liable for the negligence of its franchisee, But the appellate court reversed the trial court's decision finding that there was sufficient evidence for a jury to find that McDonald's was liable to Miller based on theories of apparent and actual agency.

The appellate court observed that if McDonald's had the right to control the franchisee's operation of the restaurant, the franchisee could be deemed to be the apparent agent and therefore, McDonald's could be vicariously liable for its franchisee's (or its employee's) negligence. Based on the record, the court held that a reasonable jury could find that the franchisor exercised sufficient control over the franchisee's daily operations to would support a finding of agency and vicarious liability.

Critically, the court looked to the franchisor's operating manual for support of its position. The court observed:

The manuals contain 'detailed information relating to operation of the Restaurant,' including food formulas and specifications, methods of inventory control, bookkeeping procedures, business practices, and other management, advertising, and personnel policies. 3K, as the licensee, agreed to adopt and exclusively use the formulas, methods, and policies contained in the manuals, including any subsequent modifications, and to use only advertising and promotional materials that defendant either provided or approved in advance in writing.<sup>17</sup>

In addition, the court found that further indicia of control were also present, including, the comprehensive franchise agreement that required the franchisee strictly adhere to McDonald's system of operation, which, as set forth in the operating manual, included controls over food preparation, which was the central issue in Miller's case against McDonald's. The court also

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<sup>16</sup> 945 P.2d 1107 ,150, Or. App. 274 (Or. Ct. App. 1997).

<sup>17</sup> 150 Or.App. 274 at 276-277.

noted that McDonald's routinely inspected the franchise location to determine whether the franchise in fact complied with the franchisor's standards.

While cases like *Miller* are certainly not the norm<sup>18</sup> and franchisors can typically impose and enforce strict systems standards through their franchise agreements and operating manuals without incurring liability to a third party based on principles of vicarious liability, franchisors and their counsel must be aware of the potential exposure and must draft the operating manuals carefully so that they will not be deemed to control the day-to-day operations of the franchised business.

It is imperative that a franchisor draft a comprehensive operating manual which outlines the system standards and performance criteria to which its franchisees must abide. But it is also critical that the operating manual is not overbroad. It must not include provisions which are so specific (other than those that are necessary to protect the trademark and goodwill of the brand) that the franchisor could be deemed to have control over the day-to-day operations of the franchise system.

Similarly, the operating manual must distinguish between mandatory and recommended operational standards and guidelines. In particular, chapters covering human resources and safety and security should contain recommendations and not mandatory standards since these are the two primary areas which form the basis of vicarious liability claims against a franchisor. If the operating manual contains specific, mandatory requirements, such as a requirement that the franchisee employ a specific number of security guards at a franchised location, a third party could claim that the mandatory requirement amounts to control over the day-to-day operation of the franchise.

Finally, under certain circumstances, it may be prudent for the franchisor to set forth minimum operational requirements that the franchisee must meet. For example, using the security personnel example from above, the franchisor may require a franchisee to have at least one security guard on duty at all times. If that is the case, the operating manual should provide that the franchisee must employ a sufficient number of security guards necessary to protect the customers but in no event shall the franchisee have less than one security guard on the premises at any time.

## **B. Liability to the Franchisee**

Franchisors also risk being sued by franchisees on a number of legal theories stemming from the franchisor's operating manual. These theories include the alleged failure to create, maintain and update the operating manual as required by the franchise agreement; the failure to make adequate disclosure of the contents of the operating manual in the franchisor's Franchise Disclosure Document; and, alleged violation of franchise relationship laws as a result of a change to the franchise system implemented through the operating manual.

### **1. Liability for failure to provide a current copy of the operating manual to the franchisee**

Franchisees have sued franchisors for failing to provide an updated and comprehensive operating manual. As discussed, in Section IX, above, a carefully drafted franchise agreement

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<sup>18</sup> See Note [11], *supra*.

will expressly permit the franchisor to implement system-wide change through the operating manual or provide guidance and set standards concerning the operations of the franchised business. As a result, some courts have concluded that franchisors have an affirmative contractual duty to provide an operating manual to a franchisee and to update it periodically.

In *Keshock v. Carousel Systems, Inc., et al.*,<sup>19</sup> a terminated franchisee sued its franchisor, Carousel, the franchisor of the Goddard Schools, for alleged breach of Carousel's contractual obligation to provide assistance with site selection, construction, advertising and training. The plaintiff claimed, *inter alia*, that while Carousel was required to provide its franchisee with a copy of the confidential operating manual to which the franchisee was required to adhere, Carousel provided an outdated or incomplete manual. Specifically, the franchisee claimed that manuals and forms relating to training were either missing from the manual altogether or were so incomplete that they were not helpful.

The court observed that under the franchise agreement, Carousel had a contractual obligation to provide a copy of the operating manual and any revisions to the franchisee. According to the court, the plaintiff raised a genuine issue of material fact as to whether Carousel satisfied its obligation to provide a complete copy of the operating manual and as a result, Carousel's motion for summary judgment was denied.

Likewise, in *Stevens v. Physicians Weight Loss*<sup>20</sup>, a franchisee sued its franchisor because the franchisor failed to provide a copy of the current operating manual to the franchisee as required under the franchise agreement. The court interpreted the franchise agreement to require the franchisor to not only provide an operating manual to the franchisee but also to periodically amend and supplement the operating manual. In other words, the franchisor had an affirmative duty to review and update the manual.

The lesson to be learned from *Carousel* and *Stevens* is twofold. First, in drafting the franchise agreement, the franchisor must clearly state that the franchisor may, **but is not obligated to**, update the operating manual from time to time. Second, and perhaps most important, a franchisor must continuously review its manual on an annual basis, at a minimum, to make sure that the information is current and franchisees will be unable to claim that the franchisor failed to provide a current version of the operating manual.

## 2. Liability for failure to properly disclose the table of contents of the operating manual prior to the sale of the franchise

In the recently amended Federal Trade Commission Franchise Rule,<sup>21</sup> the Federal Trade Commission (FTC) adopted the requirement, first introduced by the North American Securities Administrators Association (NASAA) in the now superseded UFOC Guidelines, that a franchisor provide the Table of Contents of its operating manual in Item 11 of the Franchise Disclosure Document (FDD).<sup>22</sup> In addition to the Table of Contents, the franchisor must also state the number of pages devoted to each subject and the total number of pages in the

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<sup>19</sup> 2005 WL 1198867 (E.D.PA. May 17, 2005) (Not reported in F. Supp.).

<sup>20</sup> Bus. Fran. Guide (CCH) ¶10,739 (N.D. Ohio August 21, 1995).

<sup>21</sup> 16 C.F.R. §436.1, *et seq.* (revised January 23, 2007)

<sup>22</sup> *Id.* at 436.5(k).

manual. States with franchise regulations also require the same Item 11, Table of Contents disclosure.

In the alternative, a franchisor can elect not to include the table of contents in its FDD if the franchisor offers the prospective franchisees the opportunity to review the operating manual before investing in the franchise. As a practical matter, many franchisors elect to include the manual's table of contents in the FDD rather than provide a copy of the operating manual in its entirety.<sup>23</sup>

If a franchisor fails to disclose the contents of the manual in Item 11 of the FDD or provide a copy of the operating manual for review by the prospective franchisee prior to entering into a franchise agreement, the franchisor will have violated the FTC Franchise Rule and, depending on the state in which the offer or sale of the franchise occurred, state franchise laws as well.

### **3. Franchise Relationship Laws**

Franchise relationship laws typically govern when, and under what circumstances, a franchisor may implement a change to the franchise system or terminate or refuse to renew a franchise. The following states and territories have franchise relationship laws: Alaska, Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Rhode Island, South Dakota, Utah, Virginia, Washington, Wisconsin, District of Columbia, Puerto Rico, and the U.S. Virgin Islands.<sup>24</sup> Some of these state franchise relationship statutes also address aspects of the franchise relationship such as fair dealing, discriminatory treatment, market protection, "encroachment," franchise transfers, the ability of franchisees to belong to franchisee associations and the minimum advance notice requirement of franchise termination or expiration.

While state franchise relationship laws deal primarily with termination and non-renewal by prescribing a minimum notice requirement for franchise termination, non-renewal or approval of a transfer, many of the laws also prohibit a franchisor from imposing unreasonable standards

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<sup>23</sup> See discussion in Section VIII, *infra*, concerning the confidentiality of the operations manual.

<sup>24</sup> *Alaska Statutes*, Title 45, Chapter 45, Article 9A, Distributorships; *Arkansas Franchise Practices Act*, Arkansas Code Ann., Title 4, Ch. 72, Section 4-72-201 *et seq.*; *California Franchise Relations Act*, California Business and Professions Code, Div. 8, Ch. 5.5, Section 20000 *et seq.*; Connecticut General Statutes, Title 42, Ch. 739 Section 42-133e *et seq.*; *Delaware Franchise Security Law*, Delaware Code Ann., Title 6, Ch. 25, Section *et seq.*; *Hawaii Franchise Rights and Prohibitions Act*, Hawaii Rev. Stat., Title 26, Ch. 482E, Section 482-E6; *Illinois Franchise Disclosure Act*, Illinois Compiled Statutes, Ch. 815, Sections 705/18-705/20; *Indiana Deceptive Franchise Practices Law*, Indiana Code, Title 23, Art. 2, Ch. 2.7, Section 1 *et seq.*; Iowa Code, Title XIII, Ch. 523H, Sections 523H.1 *et seq.* and Laws of Ch. 1093, Section 537.A.10; *Michigan Franchise Investment Law*, Michigan Compiled Laws, Ch. 445, Section 445.1527; *Minnesota Statutes*, Ch. 80C, Section 80C.14; *Mississippi Code Ann.*, Title 75, Ch. 24, Section 75-24-51 *et seq.*; Rev. Stat. of Missouri 1986, Ch. 407, Section 407.400 *et seq.* and 407.420; *Nebraska Franchise Practices Act*, Rev. Stat. of Nebraska, Ch. 87, Art. 4, Section 87-401 *et seq.*; *New Jersey Franchise Practices Act*, New Jersey Rev. Stat., Title 56, Ch. 10, Section 56-10-1 *et seq.*; *Rhode Island Fair Dealership Act*, Rhode Island Gen. L. Section 6-50-1, *et seq.*; *South Dakota Franchises for Brand-Name Goods and Services Law*, South Dakota Codified Laws, Title 37, Ch. 37-5A, Section 37-5A-51; Utah Consumer Sales Practices Act, Utah Administrative Code, Rule R152-11-11; *Virginia Retail Franchising Act*, Virginia Code, Title 13.1, Ch. 8, Section 13.1-564; *Washington Franchise Investment Protection Act*, Revised Code of Washington, Title 19, Ch. 19.100, Sections 19.100.180 and 19.100.190; *Wisconsin Fair Dealership Law*, Wisconsin Statutes, Ch. 135, Section 135.01 *et seq.*; *District of Columbia Franchising Act*, District of Columbia Code, Title 29, Ch. 12, Section 29-1201 *et seq.* *Puerto Rico Dealers' Contracts Act*, Laws of Puerto Rico Ann., Title 10, Chapter 14, Section 278 *et seq.*

of performance on its franchisees or changing the competitive circumstances of the franchise relationship without good cause.<sup>25</sup>

In *East Bay Running Store, Inc. v. Nike, Inc.*,<sup>26</sup> East Bay Running Store, Inc., an athletic apparel retailer, alleged that Nike's new policy, implemented through its manual, prohibiting the sale of certain items via telephone or mail order violated the Wisconsin Fair Dealership Law because it constituted a change in competitive circumstances of East Bay's license arrangement with Nike. The Seventh Circuit Court of Appeals, relying on its earlier decision in *Remus v. Amoco Oil, Co.*, 794 F2d 1238, 1240 (7<sup>th</sup> Cir. 1986), dismissed East Bay's claims holding:

Even though a new policy may hurt the profitability of some dealers, the prohibition on substantial changes in competitive circumstances was not meant to prohibit nondiscriminatory system-wide changes.<sup>27</sup>

As is the case with federal and state franchise registration/disclosure statutes, most state franchise relationship laws vest government officials with broad powers to investigate any violative conduct and, if the same is uncovered, to commence legal actions against the franchisor seeking damages, rescission, restitution, fines and penalties. A few state franchise relationship laws also impose criminal liability upon a franchisor that violates the regulations. Additionally, many state franchise relationship laws confer franchisees injured by violative conduct the right to commence legal proceedings against their franchisor seeking injunctions, damages, rescission, court costs and/or attorneys' fees.

Many state franchise relationship laws impose liability for misconduct not just upon the franchisor, but also upon all those who "control" the franchisor, such as its corporate parent, its officers and directors and management personnel that participated in the misconduct. The predicate to imposing any such liability is that the "control person" participated in the misconduct.

The Franchisor that imposes changes through its operating manual must ensure that its changes will not prove to be so onerous on a franchisee so as to constitute a violation of any applicable franchise relationship law.

## **XI. MAINTAINING CONFIDENTIALITY OF THE OPERATING MANUAL**

### **A. Critical Franchise Agreement Provisions**

The operating manual contains procedures, specifications, and methods of operation that make a franchise system unique. Protecting the information contained in the operating manual is essential to a franchisor. In order to protect its operating manual, a franchisor should never allow a third party, including prospective franchisees, to review the operating manual

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<sup>25</sup> See e.g., *Wisconsin Fair Dealership Law*, Wisconsin Statutes, Ch. 135, Section 135.03 ("No grantor ... may terminate, cancel, fail to renew or substantially change the competitive circumstances of a dealership agreement without good cause.").

<sup>26</sup> 890 F2d 996 (7<sup>th</sup> Cir. 1989).

<sup>27</sup> *Id.* at 1000.

without having signed a franchise agreement or a nondisclosure agreement. A franchisor should also include the following critical provisions in the franchise agreement:

1. Inclusion of the operating manual and all passwords and codes for accessing the operating manual in the definition of “Confidential Information.”
2. Covenant by the franchisee and all guarantors to maintain the confidentiality of “Confidential Information.”
3. Covenant by the franchisee to cause all employees and agents with access to the operating manual to execute a confidentiality agreement with the franchisee.
4. Covenant by the franchisee to refrain from making any copies of the operating manual, unless specifically authorized by the franchisor.
5. Covenant by the franchisee to return any copies of the operating manual upon termination and/or expiration of the franchise agreement.

Franchisors should control the form of the confidentiality agreement signed by employees of its franchisees. The confidentiality agreement should always include a provision that designates the franchisor as a third party beneficiary to the agreement so that the franchisor may, at its option, seek to enforce the terms of the agreement directly against the employee if the franchisee fails to do so. Since a franchisor does not typically have a contractual relationship with the employees of its franchisees, a franchisor would not be able to protect its confidential information by enforcing the terms of the agreement against the employee absent such third party beneficiary provision.

## **B. Copyright Protection**

Copyright protection for the operating manual automatically arises if the operating manual is an original work which is fixed into a tangible medium of expression.<sup>28</sup> The owner of a copyright, whether or not it is a registered copyright, has the exclusive right to reproduce and distribute the copyrighted work. A franchisor may not want to obtain a federal copyright registration for the operating manual because registered copyrights are available to the public and therefore available to competitors. Registration of the copyright may enable a franchisor to avail itself of rights to damages under federal law, but the risks inherent in making the content of the operating manual available to competitors is a sufficient deterrent to avoid registration. In the event a franchisor engages an employee or an independent contractor to write the operating manual, it should obtain a written statement from such person that the operating manual is “work made for hire” to ensure that the franchisor is deemed the author and owner of the operating manual.

## **C. Trade Secret Protection of the Operating Manual**

In addition to copyright protection, an operating manual may be entitled to protection as a trade secret. Classification as a trade secret provides additional statutory protection from disclosure of the contents of the operating manual. Under the Uniform Trade Secrets Act, a trade secret owner may seek injunctive relief for actual or threatened misappropriation of trade

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<sup>28</sup> 17 U.S.C. 101 et seq.

secrets and a court may also compel affirmative action to protect a trade secret under appropriate circumstances.<sup>29</sup> Further, a court may award exemplary damages in addition to actual damages in the event it finds willful misappropriation.<sup>30</sup>

The Uniform Trade Secrets Act §1(4) defines a trade secret as "information, including a formula pattern, compilation, program device, method, technique, or process, that: (i) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means, by, other persons who can obtain economic value from its disclosure or use, and (ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy." Each state may have their own definition of a trade secret and may illustrate specific examples. Colorado, for example, defines a trade secret as "any scientific or technical information, design, process, procedure, formula, improvement, confidential business or financial information, listing or names, addresses, or telephone numbers, or other information relating to any business or profession which is secret and of value."<sup>31</sup> Based on these definitions, it is very likely that certain content of an operating manual constitutes a trade secret.

Whether information in the operating manual qualifies as a trade secret is an issue of fact. In *Harvey Barnett, Inc. v. Shidler*, the court found that "to be a trade secret 'the owner thereof must have taken measures to prevent the secret from becoming available to persons other than those selected by the owner...'"<sup>32</sup> The following factors are considered in determining whether certain information is entitled to trade secret protection: (1) the extent to which the information is known outside the business; (2) the extent to which the information is known to those inside the business; (3) the precautions taken by the holder of the trade secret to guard the secrecy of the information; (4) the savings effected and the value to the holder in having the information as against competitors; (5) the amount of effort or money expended in obtaining and developing the information; and (6) the amount of time and expense it would take for others to acquire and duplicate the information.<sup>33</sup>

A franchisor must take precautions beyond normal business procedures to protect the operating manual as a trade secret. Such efforts may include advising employees of the existence of a trade secret, limiting access to a need-to-know basis and controlling access to locations where the information may be learned. Any agreements should state that "confidential information constitutes the 'trade secret'" of the franchise and that the confidentiality of this information will not be subject to contest."<sup>34</sup> Similarly, in *Kodekey Electronics, Inc. v. Mechanex Corp.*,<sup>35</sup> an agreement by defendants not to disclose information, not to compete, and not to use information detrimentally was an acknowledgement of fact that the information was a trade secret. If such a designation is not made, the Courts may be unwilling to recognize that a trade

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<sup>29</sup> Uniform Trade Secrets Act §2 and §3

<sup>30</sup> Uniform Trade Secrets Act §4

<sup>31</sup> Colo. Rev. Stat. §7-74-102(4) (2008)

<sup>32</sup> 143 F. Supp. 2d 1247, 1252 (D. Colo. 2001)

<sup>33</sup> *Id.*

<sup>34</sup> *Gold Messenger, Inc. v. McGuay*, 937 P.2d 907, 911 (Colo. App. 1997).

<sup>35</sup> 486 F.2d 449 (10<sup>th</sup> Cir. 1973).

secret actually exists, as was the case in *Harvey Barnett, Inc. v. Shidler*,<sup>36</sup> in that case, the lack of non-contest clause was indicative that no trade secret was involved. It is important to note that information designated a trade secret cannot be unreasonably broad, i.e. consist of in large part of information available in the public domain.

## **XII. CONCLUSION**

An operating manual serves four main purposes: it protects the brand, provides the basis for training, serves as a regularly updated point of reference, and gives the franchisor an expedient method with which to maintain and enforce franchisee compliance. Whether the operating manual is published in print or electronically, it must detail the day-to-day and step-by-step instructions that inform franchisees how to operate the business. The operating manual is the key to efficiency, customer satisfaction and care, and increased profit potential. In order to draft an operating manual that will serve these purposes, a franchisor must pay attention to every detail as it drafts and publishes the operating manual, maintain the operating manual, implement changes through the operating manual and protect the information contained in the operating manual. Failure to consider the applicable legal issues surrounding the operating manual will not only make the manual an ineffective tool for the franchisor, but may increase the franchisor's potential liability to third parties as well as to its franchisees.

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<sup>36</sup> 143 F. Supp. 2d 1247 (D. Colo. 2001).

## AMY CHENG

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Ms. Cheng has extensive experience in reviewing, structuring and drafting agreements for franchise, licensing and distribution relationships and in regulatory compliance. She has represented start-up franchisors as well as seasoned franchisors in all phases of their development. Ms. Cheng's experience includes representing franchisors in a myriad of industries to acquire and sell franchise companies of all sizes

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Ms. Cheng has spoken on panels and moderated roundtables for conferences and seminars sponsored by the American Bar Association's Forum on Franchising and the International Franchise Association ("IFA"). Additionally, Ms. Cheng frequently presents at other conferences and workshops on the topic of franchising. Ms. Cheng co-chairs the Chicago Chapter of the IFA's Women's Franchise Network and previously co-chaired the Chicago Chapter of the IFA's Franchise Business Network. For her work in this area, Ms. Cheng was named a "Legal Eagle" by the *Franchise Times*.

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Craig Dietz earned a Master's Degree in Curriculum and Instruction from the University of Colorado at Denver in 1996. While teaching in Denver Public Schools he learned to write effective instructional materials. Craig took those skills to a new level at Quiznos Sub where, in addition to developing all franchise owner, manager, and hourly employee training programs, he helped create Quiznos University, a centralized franchisee training center.

Craig founded Special Ops, LLC in 2003. Since then, the company has developed operations manuals, training materials and marketing collateral. Clientele includes franchisors in foodservice, personal care retail, luxury furniture retail, child care, home repair, nutritional supplementation, athletic training, family entertainment, and gas station convenience stores.

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