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Mad About 'You': Drafting Agreements to Do No Harm

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Special to the Legal

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Franchisors, like landlords and other creditors of small businesses, want personal accountability by the individual owners of the business. Franchisors do not want their franchisees to escape liability for payment of ongoing royalties, advertising contributions, purchases and other obligations through the use of a corporation or limited liability company to shield the individual owners from the business debts.

Franchisors also want the owners to be personally bound by confidentiality, noncompetition, transfer, litigation or arbitration requirements, and other restrictions. Franchisors use a variety of drafting methods to ensure the individual owners of the business entity will be personally liable for payment and other obligations. A recent case provides a warning to franchisors and franchisees alike that the way the parties choose to provide for personal liability of the franchise owners to the franchisor could have serious unintended consequences for the franchisee.

Often the franchisor will allow the business entity to sign the franchise agreement as the franchisee, and will have the individual owners sign a separate guaranty. The confidentiality, noncompetition, transfer and dispute resolution provisions may be combined in the document with the guaranty or may be in a separate document.

Other franchisors feel more secure having the individuals sign the franchise agreement personally, eliminating concerns about defenses available to guarantors. The individuals might sign the franchise agreement as the original parties, and then by separate agreement assign the agreement to a business entity that assumes the obligations as franchisee. The individuals agree that they will remain liable for the obligations under the franchise agreement and will also guarantee the performance by the entity of its obligations under the franchise agreement.

Another drafting method is to have the individuals and the entity all sign as parties to the franchise agreement. Ordinarily, this should not pose any problems, but it may lead to ambiguity as noted in the cases discussed below. The agreement should make clear the respective capacities in which the business entity and the individuals are signing the agreement and their respective obligations. Sometimes the agreement will state above the signature lines for the individuals or in a paragraph in the agreement or in both places, that the owners are signing solely for the purpose of being bound by certain listed sections, corresponding to key provisions, such as confidentiality, noncompetition, transfer and dispute resolution.

The emphasis in recent years on drafting in plain language and streamlining the content of documents has lead to the individual owner of a franchise entity being exposed to otherwise avoidable substantial personal liability to third parties as a result of an agreement in which both the entity and the owner were named parties.

In *Allen v. Greenville Hotel Partners Inc., et al.*, decided in December 2005 in the U.S. District Court for the District of South Carolina, the court held that the individual owner who signed the hotel franchise agreement, together with the limited liability company he controlled, could be held jointly and severally liable with his business entity for alleged negligence in the operation of the hotel that lead to the deaths of six hotel guests and injuries to 12 others in a hotel fire. The court relied on the language of the franchise agreement to deny the individual's motion for summary judgment to dismiss the claims against him. The court focused on the meaning of "you" in the franchise agreement.

The court noted that the franchise agreement was between the franchisor, the limited liability company and the individual; the entity and the individual were jointly and severally liable; and for all operative terms of the agreement, the term "you" is defined as both the entity and the individual. The operator of the hotel, consisting of both the entity and the individual based solely on the language of the franchise agreement, was potentially liable to third parties for alleged negligence related to the fire.

The actual contract language is not provided in the case, but apparently for the purpose of simplifying the drafting, the entity franchisee and its principal were both defined as "you" and no differentiation between their respective roles was made in the agreement. A more traditional drafting format would be to separately define the entity as "you" or "franchisee" and the indi-

vidual as "principal." Throughout the agreement, the entity would undertake the obligations as franchisee, and only where the franchisor intended the individual owners to also be bound, for example in the confidentiality and noncompetition provisions, the language would include references to both "you" and "principals."

Even if the drafter of the agreement sought to simplify the reading of these provisions by eliminating the need to refer to the compound subject of "you and principal" and defined the entity and the individual owner both as "you," the joint definition should be qualified by language providing that both terms mean "you" only where the context allows, and either in the body of the agreement or above the signature lines, specifically stating which provisions are binding on the individual owners.

The court dismissed the argument that holding the individual owner of the business entity liable in this case would deprive the owner of the protection from personal liability that corporations and limited liability companies are designed to provide and would allow the plaintiffs to circumvent state law requirements for piercing the corporate or limited liability company veil. The key to the court was that the individual had signed the agreement personally and had assumed the obligations personally as franchisee jointly with the business entity. Certainly the franchisor had not intended to expose the individual owner personally to liability to third parties.

That is not to say that the franchisor would never expose the individual owners to liability for third party claims. Because typically a franchisor requires the franchisee to indemnify the franchisor against third-party claims, and the guaranty by the individual owners would include the indemnification obligation, the franchisor would indirectly impose liability on the individual owners for third party claims, but only to make the franchisor whole.

A case distinguished by the court, *Hair Associates Inc. v. National Hair Replacement Services Inc.*, decided in 1997 by the U.S. District Court for the Western District of Michigan, also points out the need for more careful attention to drafting. In this case, the business entity alone was identified in the franchise agreement as the franchisee. The entity, by its individual owner acting as officer, signed the franchise agreement. After the entity signature block, however, was a signature by the individual owner, "Individually." The court had to determine the parties' intention regarding the purpose of the unexplained signature.

Because the franchise agreement clearly referred to the entity as the franchisee throughout, but contained in one section a noncompetition obligation which applied to the entity but also its principals, the court held that the purpose of the individual's signature must have been solely to provide for the individual to agree to be bound by the noncompetition covenant. This interpretation by the court prevented the franchisor from collecting past due fees under the franchise agreement from the individual owner. The bare signature as "Individual" at the end of the agreement did not mean the owner was signing to become liable under all the provisions of the agreement or to guaranty the entity's obligations.

These two cases should serve as reminders to take care in drafting agreements. Taking shortcuts by referring to different parties with different rights and obligations, all under one defined term, or tacking on a signature line at the end of the agreement, in either case without taking the time somewhere in the agreement to describe the respective roles of the signers, may lead to serious adverse consequences for one or more of the parties. Using plain language and shortening agreements are legitimate goals, but clarity and precision should be maintained. •