

2023 LEGAL SYMPOSIUM


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BASICS TRACK: HANDLING DEFAULTS AND TERMINATIONS



Speakers

- 
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There's nothing basic about defaults and terminations.



Steps for Issuing Default/Termination Notice



Due Diligence – Gathering Facts and Information



Review Franchise Agreement



Review Potential
Counterclaims/Defenses



Review Applicable State Relationship
Laws



Identifying Potential Problems Before They Arise

Franchisors can monitor their systems for warning signs and potentially resolve problems before sending default or termination notices.

Some warning signs are more overt than others.



Identifying Potential Problems Before They Arise



- Typical Financial Red Flags:
 - Failing to Report Sales
 - Underreporting Sales
 - Failing to make payments to the franchisor
 - Decreased financial performance
 - Failing to comply with required financial reporting
 - Defaulting on payments to third-parties
 - Cancelling or failing to renew insurance policies
 - Liens and assessments

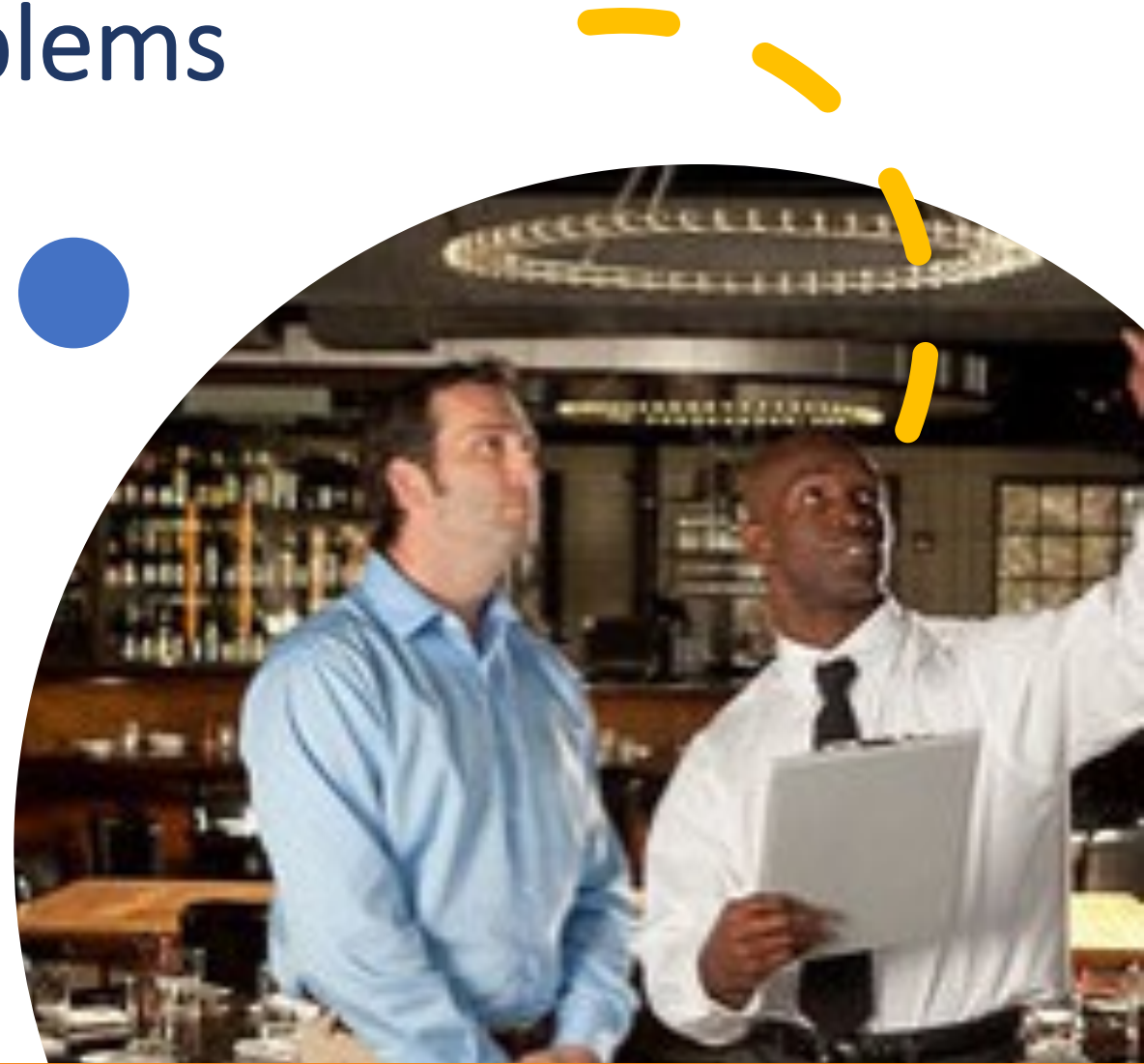
Identifying Potential Problems Before They Arise

- Typical Non-Monetary Red Flags:
 - Disinterest or disengagement in the system
 - Failing to follow system standards
 - Decline in operational performance
 - Increases in consumer complaints
 - Increases in employee turnover
 - Attempts to operate outside territory
 - Attempts to violate trademark, confidentiality, or other restrictions



Identifying Potential Problems Before They Arise

- Respond to Early Warning Signs
 - Communicate and visit with franchisees
 - Send Pre-Default Warnings
 - Negotiate Workout/Forbearance Agreements





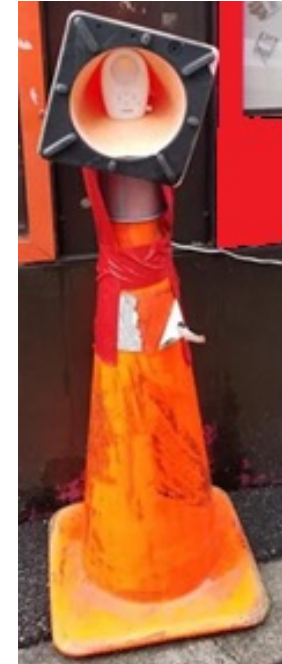
KEY TAKEAWAY:

Learning how to recognize and address early warning signs can help franchisors minimize legal costs & disruptions to their systems while better preserving relationships with their franchisees.



Due Diligence

- Gather Facts and Information – Accounting, Operations, etc.
 - Relevant documentation,
 - Franchisee history
 - Prior resolution attempts
- Evaluate the Severity of the Conduct at Issue
- Consider Respective Costs of Issuing a Default/Termination versus Inaction (or taking a more interim measure)



Baby monitor in use as a drive-thru speaker

Review Franchise Agreement

- Identify Contractual Basis for Default
 - Monetary? Operational? Selling Unauthorized Goods or Services?
- Identify Cure Requirements
 - Cure Period
 - Curative Actions



Review Franchise Agreement

- Consider Materiality – *Peterbrooke Franchising of America LLC v. Miami Chocolates LLC*, No. 21-10242, 2022 WL 6635136 (11th Cir., Oct. 11, 2022)
 - Reversing trial court’s grant of summary judgment to franchisor on franchisee’s claim of wrongful termination and finding that there were material issues of fact as to whether franchisee’s breach by not implementing a required POS system was a **material** breach warranting termination



Potential Franchisee Defenses & Counterclaims

- Good Faith and Fair Dealing/Good Cause
- Waiver
- Tortious Interference
- Compliance with State Laws
- Late Cure
- Discrimination
- Force majeure



Potential Franchisee Defenses & Counterclaims



Good Faith and Fair Dealing/Good Cause



generally: a party cannot prevent the other party from receiving the benefits of the contract, particularly in the exercise of discretion afforded that party



generally: cannot be used to circumvent the clear terms of a contract



Potential Franchisee Defenses & Counterclaims

Good Faith and Fair Dealing/Good Cause

- Does motivation matter?
 - *Dayan v. McDonald's Corp* Bus. Franchise Guide (CCH) ¶ 8,223 (Ill. App. Ct. 1984);
 - *Dunkin' Donuts of America, Inc. v. Minerva, Inc*, 956 F.2d 1566, 1569 (11th Cir. 1992); *Khorchid v. 7 Eleven, Inc.*, 08-14-2019, 2019 WL 3812472 (D.C.N.J. Aug. 14, 2019)



Potential Franchisee Defenses & Counterclaims

Waiver

- *CJ Rest. Enterprises, Inc. v. FMS Mgmt. Sys., Inc.*, 699 So.2d 252, 253 (Fla. Dist. Ct. App. 1997).
- *E2W, LLC v. Kidzania Operations, S.a.r.l.*, No. 1:20CV02866 (S.D.N.Y., April 9, 2020).

Potential Franchisee Defenses & Counterclaims

- Late Cure
- Franchisor's Fault
- Force majeure



Compliance with State Laws



RELATIONSHIP LAWS



DISCLOSURE LAWS AND
“LITTLE FTC ACTS”



COMMON LAW
MISREPRESENTATION

Review Franchise Agreement

- Notice Requirements
 - Delivery Methods – Overnight Courier, Email, etc.
 - Timing and Effective Date of Notice
 - Recipients – Guarantors, Co-Owners, Counsel



Impact of State Relationship Laws on Default and Termination



What?

- Govern material aspects of the franchise relationship, including default, termination, transfer, and non-renewal
- **Today's focus is default and termination.**

Why?

- To protect the franchisee's significant investment in entering into a franchise relationship
- Counterbalance perceived greater franchisor power and potential abuses



18 States and 2 U.S. Territories with Relationship Laws Governing Franchise Default/Termination

Arkansas	Iowa	Rhode Island
California	Michigan	Virginia
Connecticut	Minnesota	Washington
Delaware	Mississippi	Wisconsin
Hawaii	Missouri	Puerto Rico
Illinois	Nebraska	Virgin Islands
Indiana	New Jersey	

BUT no two state relationship laws are identical.



Impact of State Relationship Laws

- CRITICAL to assess the applicability and impact of state relationship laws **before** sending the franchisee a notice of default or termination.
 - If the protections under an applicable state relationship law (*e.g.*, good cause required and mandatory minimum notice and cure periods) are greater than those in franchise agreement, relationship law generally controls.
- Failure to consider these laws may give rise to a wrongful termination claim and entitle the franchisee to damages, punitive damages, injunctive relief, and costs and attorneys' fees.



Applicability of State Relationship Laws

GENERALLY, there are 3 jurisdictional touchstones:

- Franchised outlet located in the state
- Franchisee is domiciled in the state
- Sales activity in the state



Franchised Outlet Located in the State

For example, Arkansas -

This subchapter applies only to a franchise entered into, renewed, or transferred after March 4, 1977, the performance of which contemplates or requires the franchise to establish or maintain a place of business within the State of Arkansas.



Franchisee Is Domiciled in the State

For example, California -

The provisions of this chapter apply to any franchise when either the franchisee is domiciled in this state or the franchised business is or has been operated in this state.

Sales Activity in the State

For example, Minnesota -

The provisions of sections 80C.01 to 80C.22 concerning sales and offers to sell shall apply when a sale or offer to sell is made in this state; when an offer to purchase is made and accepted in this state; or when the franchise is to be located in this state.



Drafting Point – Governing Law

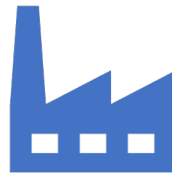
If franchise agreement is governed by laws of a state having a relationship law (and even if it's not), best practice is to exclude application of the state relationship law in choice of law provision if state relationship law's jurisdictional elements are not independently met.

Any law regulating the sale of franchises, licenses, or business opportunities, governing the relationship of a franchisor and its franchisee or the relationship of a licensor and its licensee, or involving unfair or deceptive acts or practices will not apply unless its jurisdictional requirements are met independently without reference to this Section.

Good Cause for Termination



Most state relationship laws prohibit franchisor from terminating franchise agreement without “good cause.”



Goes to materiality



A number of states provide specific guidance as to what constitutes good cause.

Generally – failure to comply with lawful and material provisions of the franchise agreement.



Statutory Examples of Good Cause

Franchisee's bankruptcy

Voluntary abandonment of franchise

Failure to pay amounts due

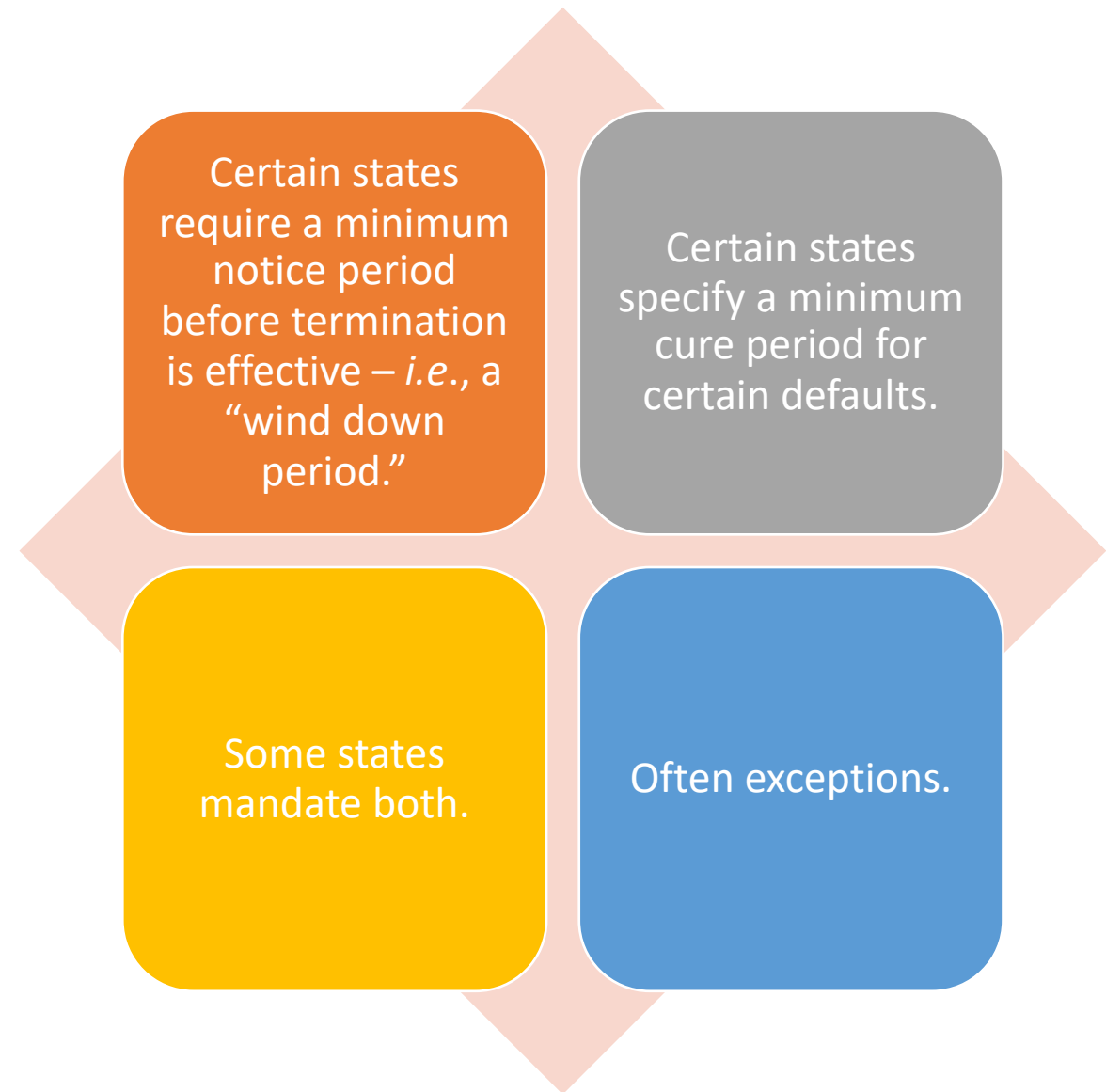
Conviction of felony offense related to business

Material impairment of system goodwill or trademarks

Unauthorized transfer

Repeated defaults

Statutory Wind Down and Cure Periods



Mandatory Wind Down Period

- Generally, 60-120 days' notice
- For example, Missouri –

No person who has granted a franchise to another person shall cancel or otherwise terminate any such franchise agreement without notifying such person of the cancellation, termination or failure to renew in writing at least ninety days in advance of the cancellation, termination or failure to renew, except that when criminal misconduct, fraud, abandonment, bankruptcy or insolvency of the franchisee, or the giving of a no account or insufficient funds check is the basis or grounds for cancellation or termination, the ninety days' notice shall not be required.

- Note the exceptions

Required Minimum Cure Period

Certain states
require a
“reasonable”
cure period.

Generally means no longer than 30 days

For example, Michigan – The following is void and unenforceable in any franchise document

[a] provision that permits a franchisor to terminate a franchise prior to the expiration of its term except for good cause. Good cause shall include the failure of the franchisee to comply with any lawful provision of the franchise agreement and to cure such failure after being given written notice thereof and a reasonable opportunity, which in no event need be more than 30 days, to cure such failure.

Some states
specify a cure
period
ranging from
30-90 days,
depending
on the
default.

For example, Iowa –

Prior to termination of a franchise for good cause, a franchisor shall provide a franchisee with written notice stating the basis for the proposed termination. After service of written notice, the franchisee shall have a reasonable period of time to cure the default, which in no event shall be less than thirty days or more than ninety days. In the event of nonpayment of moneys due under the franchise agreement, the period to cure need not exceed thirty days.

Certain States Require Both



For example, Wisconsin -

Except as provided in this section, a grantor shall provide a dealer at least 90 days' prior written notice of termination, cancellation, nonrenewal or substantial change in competitive circumstances. The notice shall state all the reasons for termination, cancellation, nonrenewal or substantial change in competitive circumstances and shall provide that the dealer has 60 days in which to rectify any claimed deficiency. If the deficiency is rectified within 60 days the notice shall be void....



Incurable Defaults

- **Certain defaults cannot be cured.**
 - For example, franchisee is insolvent or bankrupt, has committed fraud or is convicted of a felony, or abandoned the franchised business.
- **Many state relationship laws provide for exceptions to their mandatory notice and cure periods in such cases.**
- **Case law may also provide guidance regarding circumstances under which the franchisor need not comply with required notice and cure periods.**
 - Where a franchisee's breach goes to "the essence of the contract" and irreparably damages the trust between the parties
 - Franchisee's bad faith acts
 - Franchisee's widespread contractual violations



Franchisor's Repurchase Obligations Upon Termination

- Upon termination, certain states require franchisor to repurchase particular items from franchisee.
- Conditions under which franchisor's repurchase obligations arise and the items subject to repurchase vary by state, including -
 - All cases of termination, but, generally, only at franchisee's election
 - Only if franchisee was not terminated for good cause
 - Only inventory items sold by franchisor to franchisee that bear franchisor's mark
 - Inventory, supplies, equipment, and furnishings purchased from franchisor or its approved suppliers/sources in possession of franchisee or used in franchised business



Valuation

Methodologies vary

- Fair market value or fair wholesale market value
- Franchisee's net cost less a reasonable deduction for depreciation or obsolescence
- Price paid less depreciation
 - California amended its relationship law effective January 1, 2023 to provide that franchisor may only offset amounts owed by franchisee to franchisor if franchisee agrees to the amount owed OR franchisor has received a final adjudication of such amounts.

Possible exclusions

- Franchisor does not prevent franchisee from retaining control of the principal place of franchised business or termination due to franchisor's publicly announced and nondiscriminatory decision to withdraw from franchising in market in which franchisee is located. See, for example, California and Washington



KEY TAKEAWAY:

Comply with franchise
agreement and applicable
statutes



Additional Considerations Before And After Issuing Defaults And Terminations



Dealing with Other Franchisees

Selective Enforcement

Impact of Termination on Other
Franchisees

Information Provided to Other
Franchisees About a Termination

Impact of Termination on Potential
Franchisees



Dealing with Other Franchisees

Selective Enforcement



“[t]he fact that the [franchisor] may have treated other franchisees more leniently is no more a defense to breach of contract than laxity in enforcing the speed limit is a defense to a speeding ticket.”

Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd, 970 F.2d 273 (7th Cir. 1992)



Enforcement



Protecting the Brand,
Trademark, and System



Prepare for Unit Closure
and Possible Brand
Image Issues

Enforcement

01

Self Help

02

Mediation

03

Court/Arbitration

- What Court to File in (venue)?
- What Action to Take?
 - Injunctive Relief/TRO?





Enforcement

Injunctive Relief/TRO Elements:

(i) a likelihood of success on the merits, (ii) that it will be irreparably harmed if the injunction is denied, (iii) that the harm to it if the injunction is denied is greater than the harm to the non-moving party if the injunction is granted, and (iv) that the public interest favors issuance of the injunction

Winter v. Natural Res. Def. Council, 555 U.S. 7
(2008)



Enforcement

Injunctive Relief/TRO

- Focus is often on Likelihood of success on the merits and ability to demonstrate irreparable harm
- Still using Trademarks/Trade Dress/Trade Secrets?
- Challenges to termination
- Presumption of irreparable harm

Questions?



Thank you!

