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Basics Track:

Handling Franchise Defaults and Terminations

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I. Introduction[1]

This paper addresses the basics of franchise defaults and terminations.[2] The key term in that sentence is "basics." There are many nuances to the default and termination process. Any party seeking to issue, or defend against, default and termination notices should carefully consult the applicable franchise agreement and state relationship statute in addition to relevant case law and other more detailed secondary sources.

The paper begins by discussing common conduct that precedes franchisee defaults. This section also examines how franchisors might resolve potential defaults before they arise. The paper then identifies business and legal issues for franchisors to consider before deciding to issue a default or termination notice.

The next section discusses potentially applicable state relationship statutes.[3] Anyone new to this area of law must understand that if the protections given to franchisees under these relationship laws exceed those offered under the franchise agreement, then the relationship statute controls. Indeed, perhaps the most challenging aspect of issuing a default or termination notice is learning how to harmonize conflicting terms between the franchise agreement and state relationship laws.

Finally, the paper concludes with a discussion of what happens after the franchisor issues the default or termination notice. Franchisors must consider how these notices might impact other franchisees and the system. They should also prepare for what is required to enforce the default or termination or otherwise resolve the dispute.

II. Identifying Potential Problems Before They Arise

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[1] The authors would like to thank Tara N. Goodarzi, an attorney at Cheng Cohen LLC, for her significant contribution to this paper and its accompanying presentation.

[2] This paper borrows heavily from the many papers that have thoroughly addressed this same topic at the IFA Legal Symposium each of the previous five years. *See* Alyssa Barnes and Michael Einbinder, *Franchise Defaults and Terminations – Best Practices*, 51st Annual Legal Symposium, May 6-8, 2018; Judy Marsh, Eunice Nakamura, and Leslie Smith, *Basics Track: Handling Defaults and Terminations*, 50th Annual Legal Symposium, May 7-9, 2017; Christine E. Connelly, Aron Friedman and Mark Inzetta, *Franchise Default and Termination – Best Practices to Enforce the Contract and Protect the System*, 49th Annual Legal Symposium, May 15-17, 2016; Judy A. Rost, Dawn Newton, Glenn J. Plattner, and Meredith Flynn, *Basic Track: Best Practices For Handling Defaults and Terminations*, 48th Annual Legal Symposium, May 3-5, 2015; Harris J. Chernow, Stephen Hagedorn, and Leslie Smith, *Best Practices for Handling Defaults and Terminations*, 47th Annual Legal Symposium, May 4-6, 2014. The authors encourage readers to consult each of these resources and their helpful addenda.

[3] The focus is franchise relationship statutes. This paper does not address the many other similar statutes that govern, such as business opportunity investment statues, unfair trade practices acts, and statutes governing industry sectors like alcohol, automotive, farm equipment, and sales representatives, except to cite some case law interpreting those statutes, which may inform the interpretation of similar relationship act provisions.

Franchisors should aim to avoid potential problems with franchisees before they issue default or termination notices. By identifying potential problems early, the parties might find a business solution, which is generally cheaper and less disruptive to the franchise system. In addition, franchisees often respond better to informal, solution-focused discussions rather than formal defaults, which—even if cured by the franchisee—may weaken the parties' relationships.

A. Early Warning Signs of Problems in the Relationship

To identify potential problems before they require issuing default or termination notices, franchisors should monitor the system for conduct that often precedes franchisee defaults. Here are some examples of both financial and non-financial warning signs.

1. Financial Red Flags

Warning signs relating to possible financial issues are typically easier for franchisors to detect. They include the following:

- Failure to Report Sales. Many systems automate the reporting process or provide franchisors real-time access to franchisee sales data. For systems that require the submission of sales reports, however, a struggling franchisee may not timely produce such reports to avoid timely paying amounts owed under them.

- Underreporting. Underreporting sales may similarly signal an issue. This may be uncovered by the franchisor during a routine audit, or suspected by the franchisor and verified by an audit undertaken pursuant to the franchise agreement.

- Failure to Make Payments. Similarly, a struggling franchisee may repeatedly fail to timely make royalty, marketing, lease, or any other recurring payments required under the franchise agreement. Even if it ultimately pays all amounts owed, a franchisee that used to pay on time and begins paying late is a concern.

- Decreased Financial Performance. Particularly in systems where franchisors have real-time access to sales data, franchisors should be concerned by any significant decline in franchisee sales.

- Failure to Comply with Financial Reporting. A franchisee's failure to timely provide financial reports that it is required to under the franchise agreement is another good indicator of financial issues.

- Payment Defaults with Third Parties. A struggling franchisee might choose not to pay third parties before it stops paying its franchisor. Franchisors should be concerned if they discover late or unpaid payments to a franchisee's lenders, landlords, or third-party suppliers.[4]

- Canceled or Nonrenewed Insurance. Insurance premiums are another example of payments that a financially struggling franchisee will not pay before it stops paying its franchisor.

- Liens and Assessments. Unpaid third parties may obtain judgments and place liens on the franchisee's business, business assets, or personal assets. This is an obvious indicator that the franchisee will default on payments owed to its franchisor.

- Failure to Upgrade. A franchisee struggling financially may be unable or unwilling to participate in mandatory upgrades of software, décor, goods for sale, or to adhere to other system refresh directives of the franchisor.

- Unexplained Borrowing. A franchisee struggling to make any of the above-described payments or investments may borrow the funds needed to make those payments, which often leads to further trouble later.

2. Non-Financial Red Flags

Non-financial indicators of potential problems with franchisees are often more difficult for franchisors to detect. Nevertheless, franchisors should endeavor to identify and address any of the below warning signs.

- Disinterest in System. If a franchisee develops a reputation as a "loner" and does not participate in optional programs, attend conventions, or otherwise engage in the system, then its franchisor should beware of potential problems.

- Failure to Follow System Standards. Franchisors should note minor deviations from system standards—which for reasons discussed later may not warrant issuing a default—as precursors to potential problems.

- Decline in Operational Performance. Examples include failing to maintain a clean and updated premises, satisfy health code requirements, maintain business records, or train employees.

- Increase in Customer Complaints. If customer complaints at the business increase, then the franchisee is likely experiencing problems that may result in default notices later.

[4] Franchisors should note any changes to credit terms. Many vendors, for example, will require franchisees to pay for goods by cash on delivery if the franchisee missed too many prior payments.

- Increase in Employee Turnover. Some employee turnover is unavoidable. But if a franchisee is constantly losing employees—particularly at the manager level—then something is likely wrong.

- Attempts to Operate Outside Territory. In systems that assign franchisees exclusive territories, a franchisee's improper attempt to operate outside its territory may indicate larger underlying issues.

- Attempts to Violate Trademark, Confidentiality, or Other Restrictions. A franchisee's refusal to adhere to these key limitations on how it can use components of the franchise system is often a sign of a much larger problem, and could mean that the franchisee may plan to compete against the franchisor.

B. How to Respond to the Early Warning Signs

Franchisors should investigate significant warning signs further. The most important step is often overlooked: Communicate with the franchisee. Effective and well-trained field representatives are critical here. Field representatives should be trained to recognize the warning signs and other indicators that need follow up. Use communications with other franchisees sparingly and carefully. Be sure to maintain confidentiality. Franchisors should not discuss a franchisee's business issues, non-compliance, or other confidential matters with other franchisees. Franchisors must rely on their operations team to use their relationships with the franchisee of concern, as well as other franchisees who may have additional information, to understand the reasons behind the offending franchisee's conduct.

Although each situation is different, this step often involves creating an open dialogue with the offending franchisee to discuss all phases of the franchisee's operations. Simply addressing known issues may leave underlying ones unresolved. Here again, an educated and well-trained operations team is critical.

While an open dialogue is important, both the franchisor and franchisee should also endeavor to manage expectations. Franchisees cannot always resolve their issues immediately, or at all, without reasonable self-examination and support from the franchisor, nor can franchisors devote unlimited resources to a single franchisee. The point of the dialogue is to determine whether and how the parties can reach a realistic business solution.

III. Considerations in Deciding to Default/Terminate

If franchisees will not, or cannot, comply with their agreements, then franchisors must decide whether to issue a default or termination notice. Franchisors should avoid issuing default notices on which they do not intend to act. Indeed, consistently failing to follow through on uncured defaults may lead to other problems discussed later in this paper.

Even where the franchisee's conduct obviously constitutes a default (*e.g.*, if the franchisee has failed to pay a royalty or been convicted of a serious crime), deciding whether to issue a default notice may be difficult. This is particularly true in situations where the franchisor has invested considerable time and resources in assisting the franchisee or in developing the territory. Termination notices are explicit acknowledgements that the franchise relationship has failed. Such notices reflect on the franchisor as much as on the franchisee.

Franchisors must also consider the substantial risk associated with issuing default or termination notices. From a business standpoint, the notice might impact the relationship with the receiving franchisee as well as other franchisees in the system (that will likely hear about it). From a legal standpoint, there are additional risks. If, for example, there is an insufficient basis for sending the notice under the terms of the agreement or applicable state law, then the franchisor might expose itself to claims for wrongful termination, breach of contract, and violation of any applicable state relationship statute. Such notices must also comply with applicable statutory notice provisions.

Accordingly, franchisors should establish a clear process that identifies who has ultimate decision-making authority about whether to issue a default or termination notice. For franchisors that have in-house legal support, a good practice is to have all such notices go through legal review (even if the ultimate decision maker is not a legal professional). This review ensures, as much as possible, that there is a contractual and statutory basis for issuing the notice, thereby minimizing the risk of future litigation over the notice.

Before issuing any default or termination notice, franchisors should do each of the following:

A. Gather Facts and Information

The franchisor should first gather the relevant facts and information relating to the franchisee and its current issue. A good starting point is the franchisor's own files, including those from legal, franchise sales and operations, accounting, and any other department having relevant information about the franchisee. From there, the franchisor should talk to the franchisee. The goal is to understand the franchisee and its history of operations. Franchisors should avoid the urge to focus solely on the specific conduct at issue. The full history of the relationship informs possible counter-arguments the franchisee may raise.

The franchisor should next focus on the specific circumstances that gave rise to the possible default or termination by reviewing inspection or incident reports and related email correspondence. It should also consider interviewing relevant personnel who have specific knowledge of the situation. It is important to understand any additional circumstances or points that will be raised by the franchisee.[5] After doing this, the franchisor should consider whether the conduct is significant enough to proceed with the default process or better resolved another way.

B. Review the Franchise Agreement

If the conduct warrants further attention, the franchisor must then confirm that there is an actual basis under the franchise agreement to issue a default for that conduct. Here again, an obvious but critical step is often overlooked: Read the franchise agreement. Any failure to follow the franchise agreement's requirements may create substantial legal risk.

Franchisors often cite the following common franchise agreement provisions in default and termination notices:

- <u>Monetary Defaults</u>: Where a franchisee fails to meet monetary obligations to franchisor or its affiliates, such as royalties, advertising fees, payments to an affiliated supplier, or other payments.

- <u>Operational Defaults</u>: Where a franchisee fails to meet standards and comply with terms of the franchise agreement or operations manual. Typically, these should be material matters and not minor or common issues that every franchisee in the system experiences occasionally.

- <u>Competing with the Franchise System</u>: Where a franchisee obtains an interest in a competing franchise system or otherwise competes with its franchisor's system in violation of the franchise agreement's terms. This provision might also support issuing a default where a franchisee is selling unauthorized goods or services.

- <u>Unapproved Transfer</u>: Where a franchisee transfers its rights in the franchise or in the franchisee entity to another party without approval from the franchisor.

- <u>Performance and/or Quota Defaults</u>: Where a franchisee fails to meet sales or purchase quotas or performance standards.

- <u>Failure to Devote Best Efforts</u>: Where a franchisee fails to devote substantial full-time efforts to the franchise.

- <u>Violation of Law</u>: Where a franchisee violates local, state, or federal law, especially if related to health or public safety.

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[5] For example, if a franchisee has failed to upgrade her location by the due date, but her lease for the location expires in three years and the landlord has indicated it will not renew, default or termination may not be appropriate.

- Repeated Defaults: Where a franchisee has committed a prescribed number of defaults within a defined time period.

- Material Misrepresentation: Where a franchisee made a material misrepresentation or omitted material facts in the application process.

- Adverse Impact on Goodwill of the Brand: Where a franchisee's conduct casts the brand in an unfavorable light, often where the franchisee has had legal problems, such as criminal behavior or behavior that materially impacts the brand.

After identifying a contractual basis, the next step is to review the actual mechanics of the default or termination process in the franchise agreement. For instance, does the agreement require the franchisor to provide the franchisee notice and/or an opportunity to cure and how long is the cure period? How and to where should the franchisor deliver the notice? When is the notice effective? Do any applicable guarantees require the franchisor provide the guarantor notice? Franchisors might also review the franchisee's post-termination obligations to prepare for noncompliance.

In some cases, the franchisor might provide an interim notice of noncompliance before issuing a formal default. This might help in two ways. First, it provides the franchisee an opportunity to correct or add facts, allowing the franchisor to make a more informed decision about its next steps. Second, if the franchisee cannot rebut the allegations, then the franchisor has more confidence to enforce its rights under the agreement.

At this point in the process, in-house counsel should consider involving litigation counsel. Because default and termination notices may result in litigation, best practices include consulting with litigation counsel before issuing them. Litigation counsel, among other things, can ensure a proper record, confirm compliance with the franchise agreement and applicable state laws, and highlight the facts and arguments that comprise the key points of the franchisor's story in the event of litigation. A small investment in time and legal fees at this point could save the franchisor a great deal in the long run.

C. Review State Relationship Laws

Statutes in many states govern the franchise relationship, including the default and termination of franchisees. Before issuing a default or termination notice, franchisors must review any potentially applicable state relationship laws. Section IV discusses this issue in greater detail.

D. Review Potential Counterclaims and Defenses

Before deciding to issue a default or termination notice, evaluate the potential counterclaims and defenses available to the franchisee. If strong defenses or counterclaims exist, then consider other action. Some examples of franchisee arguments are discussed below.

1. Good Faith and Fair Dealing / Good Cause

One common franchisee argument is that the franchisor acted in bad faith. This allegation may be used to support a claim for breach of the implied covenant of good faith and fair dealing and to argue that the franchisor lacked good cause to terminate. The covenant of good faith and fair dealing states that one party to a contract cannot do anything to prevent the other party from receiving the benefits of the contract.[6] Good cause for termination is often required under applicable state relationship laws or by the terms of the franchise agreement.[7]

Courts generally uphold terminations where the franchisor complies with the terms of the franchise agreement. In *Pennington's, Inc. v. Brown-Forman Corp.*, the court held that a supplier did not violate the distributorship agreement by terminating it without cause because the agreement expressly provided for no-cause terminations.[8] The dealer therefore could not use the covenant of good faith and fair dealing to negate the express terms of the contract.[9] Similarly, in *Dayan v. McDonald's Corp.*, the franchisee argued that a franchisor's bad motives could violate the implied covenant of good faith and fair dealing even if the franchisor had good cause for termination.[10] The court disagreed; If good cause exists, then there can be no bad faith regardless of the franchisor's motives.[11]

In other instances, franchisees have been successful in challenging a termination. For example, in *Dunkin' Donuts of America, Inc. v. Minerva, Inc.*, franchisor attempted to terminate franchisee based on underreporting discovered after several financial audits.[12] The magistrate judge denied the franchisor's motion for judgment notwithstanding the verdict on the issue of its liability for breach of good faith and fair dealing.[13] The Eleventh Circuit affirmed because sufficient evidence existed for a reasonable jury to find that: (i) the audits were substantially motivated by franchisee's refusal to subscribe to a franchise renewal agreement, (ii) the method used by franchisor to audit the stores had not been disclosed in the franchise agreement, and

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[6] *See* Restatement (Second) of Contracts § 205 (1981).

[7] *See infra* Section IV. (explaining state relationship laws).

[8] 2 F.3d 1157, 1993 WL 306155 (9th Cir. 1993).

[9] *Id.*

[10] Bus. Franchise Guide (CCH) ¶ 8,223 (Ill. App. Ct. 1984).

[11] *Id.*

[12] 956 F.2d 1566, 1569 (11th Cir. 1992).

[13] *Id.* at 1570.

(iii) the termination was not based on good cause because there was no intentional underreporting. [14]

To avoid a similar outcome, franchisors should refrain from issuing a default or termination notice in response to some other unrelated conduct or position taken by the franchisee. Avoiding the appearance of retaliation can be difficult in franchise relationships that have long been contentious. In at least one case, the court harshly scrutinized a franchisor's termination notice where the franchisor's motive was simply to deter other franchisees from engaging in misbehavior.[15]

In *In re Globe Distribs., Inc.*, a bankruptcy court found that a brewer breached the duty of good faith and fair dealing owed to a distributor by terminating the distributor for allegedly being insolvent.[16] The court held that at the time of termination, the brewer did not know whether the distributor was, in fact, insolvent.[17] Instead, the brewer used the insolvency of the distributor as a pretext to terminate the distributor.[18] These actions, the court held, violated the spirit of the distributorship agreement.[19]

2. Discrimination and Inconsistent Treatment

Franchisees have also successfully asserted causes of action for breach of the implied covenant of good faith and fair dealing where franchisors discriminated between franchisees.[20] Moreover, five states specifically prohibit franchisors from treating similarly-situated franchisees in an inconsistent manner.[21] This prohibition applies to the inconsistent enforcement of contractual provisions, including the required royalty or the amount charged for goods, services, or advertisements. Claims alleging discrimination

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[14] *Id.*

[15] *See, e.g.*, *Dunkin' Donuts Franchising LLC v. C3WAIN Inc.*, No. 13CV6865PGSDEA, 2018 WL 4688335, at *12 (D.N.J. Sept. 28, 2018) (court denied franchisor's "unreasonable" request to enforce a cross-default provision and terminate two units, based on the franchisee's breach of the covenant not to compete related to a third unit).

[16] 129 B.R. 304, 317 (Bankr. D.N.H. 1991).

[17] *Id.*

[18] *Id.*

[19] *Id.*

[20] *See*, *e.g.*, *D&K Foods, Inc. v. Bruegger's Corp.*, Bus. Franchise Guide (CCH) ¶ 11, 506 (D. Md. 1998) (denying franchisor's motion to dismiss claim for breach of the implied covenant where bagel shop franchisor allegedly discriminated against franchisees in extending financial assistance); *Venta, Inc. v. Frontier Oil & Ref. Co.*, 827 F. Supp. 1526, 1530-31 (D. Colo. 1993) (supplier allegedly charging two distributors a higher price than its other customers could support implied covenant claim).

[21] Hawaii (Haw. Rev. Stat. § 482E-6(2)(C)); Illinois (815 Ill. Comp. Stat. 705/18); Indiana (Ind. Code § 23-2-2.7-2(5)); Minnesota (Minn. R. 2860.4400(B)); and Washington (Wash. Rev. Code § 19.100.180(2)(c)).

often turn on whether the terminated franchisee is similarly-situated to other franchisees that were not terminated.

For example, in *Canada Dry Corp. v. Nehi Beverage Co. of Indianapolis*, the Seventh Circuit held that a soft drink franchisee's discrimination claim failed as a matter of law because the franchisee did not produce any "evidence of more favorable treatment of similar bottlers under similar marketing conditions."[22] The franchisee argued that the franchisor unfairly discriminated against it by refusing to offer the franchisee an advertising program and by prematurely terminating its franchise agreement.[23] The court noted that the franchisee failed to demonstrate (i) that it was either as qualified to initiate the advertisement as those bottlers who were offered the program, or (ii) that it was more qualified than the bottlers who were also excluded from the program.[24] The court held similarly on the issue of termination, stating that there was insufficient evidence under the Indiana Deceptive Franchise Practice Act that the franchisor had never terminated any of its other bottlers, including those that shared some of plaintiff's own deficiencies.[25]

In *Implement Serv., Inc. v. Tecumseh Prod. Co.*, a franchisor required the plaintiff distributor to obtain products from a specific central warehouse but allowed other distributors to choose from two warehouses.[26] The franchisor argued that geographical considerations drove the distinction. Because, the court held, plaintiff distributor was not similarly-situated geographically to other distributors, plaintiff was unable to show that it was similarly-situated to those distributors and therefore could not claim discrimination.[27]

Federal discrimination statutes also protect franchisees in certain instances, although these claims are more difficult to prove. Title 42 U.S.C. § 1981, for example, prohibits discrimination on the basis of race in the formation, performance, modification and termination of a contract. To state a *prima facie* claim of discrimination under § 1981, a franchisee must show that he or she is (i) a member of a protected class, (ii) suffered an adverse decision in connection with a franchise agreement, and (iii) was treated differently than similarly-situated nonprotected franchisees.[28]

3. Waiver

[22] 723 F.2d 512, 521-22 (7th Cir. 1983).

[23] *Canada Dry*, 723 F.2d at 521.

[24] *Id.* at 522.

[25] *Id.*

[26] 726 F. Supp. 1171, 1174 (S.D. Ind. 1989).

[27] *Id.* at 1181.

[28] Carla Wong McMillan and Kelly J. Baker, *Discrimination Claims and Diversity Initiatives: What's a Franchisor to Do?*, 28 Franchise L.J. 71, 72 (Fall 2008).

If a franchisor has not previously enforced a provision of the franchise agreement against a franchisee, that franchisee may assert that the franchisor has waived the right to enforce the provision. In *CJ Rest. Enterprises, Inc. v. FMS Mgmt. Sys., Inc.*, a franchisor and franchisee entered into a stipulation relating to the franchisee's repeated failures to remit royalties to the franchisor.[29] Thereafter, the franchisee continued to pay late, which the franchisor accepted without sending a notice of default.[30] Eventually, the franchisor changed course and sought termination for untimely payments, but the court held that the franchisor had waived its right to terminate on that basis.[31] The court reasoned that the franchisee reasonably concluded that the late payments were not a default.[32]

To combat this outcome, most franchise agreements include an anti-waiver provision. But a terminated franchisee may still argue that the inconsistent enforcement of the agreement was improper. And that may be enough to survive a motion to dismiss and prolong litigation. Accordingly, franchisors must balance the risk of defaulting without enforcing—a concern discussed earlier—with not defaulting at all. There are drawbacks to both approaches. A prudent franchisor might want to consider a notice to an offending franchisee after discovering an alleged breach that reserves its rights to later terminate the franchisee for that or further breaches.

4. Tortious Interference

A terminated franchisee may also assert that the franchisor tortiously interfered with the franchisee's business relationships. In *Mach. Maint. & Equip. Co. v. Cooper Indus., Inc.*, a court upheld a jury verdict stating that a manufacturer tortiously interfered with one of its distributor's relationships.[33] The manufacturer had terminated the distributorship without providing the full notice period required under the agreement.[34] The manufacturer also attempted to poach the distributor's customers before the termination notice.[35] A jury awarded the distributor actual and punitive damages as a result.[36]

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[29] 699 So.2d 252, 253 (Fla. Dist. Ct. App. 1997).

[30] *Id.*

[31] *Id.*

[32] *Id.* at 255.

[33] 661 F. Supp. 1112 (E.D. Mo. 1987).

[34] *Id.* at 1116.

[35] *Id.*

[36] *Id.* at 112.

Tortious interference claims, however, are difficult to prove. In *Romacorp, Inc. v. TR Acquisition Corp.*, the court did not find tortious interference by the franchisor because the state law required a showing of malice.[37] Absent malice, the franchisor's legitimate business reason for terminating the franchise agreements could not support a claim for tortious interference.[38] In another case, a farm equipment dealer's tortious interference claim was unsuccessful where the manufacturer complied with the termination provisions of the contract.[39]

5. Compliance with State Relationship and Disclosure Laws

Most franchise agreements are governed by the law of the state where the franchisor is located. In some cases, the franchisor must also comply with other states' laws, often including states where its franchisees are located. If franchisors overlook applicable state laws, franchisees may have a basis to defend against default or termination.

For example, if the franchise agreement is governed by Illinois law, but the franchisee is located in Connecticut, the franchisor must comply with Connecticut's state relationship act, including giving proper notice under that law. Although providing 30 days' notice with opportunity to cure a default is sufficient to terminate under Illinois's relationship act, Connecticut law requires that the franchisor give the franchisee written notice of termination or intent not to renew at least 60 days in advance, with the cause stated on the notice.[40] The franchisor's failure to comply with Connecticut law may entitle the franchisee to damages, injunctive relief, and reasonable attorney's fees.[41]

Like state relationship laws, franchisors must also determine which state disclosure laws apply.[42] Failure to comply with applicable disclosure laws creates substantial legal exposure as those laws often grant rescission as a remedy.[43]

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[37] No. 93 CIV. 5394 (MEL), 1993 WL 497969, at *15 (S.D.N.Y. Dec. 1, 1993), *aff'd*, 29 F.3d 620 (2d Cir. 1994).

[38] *Id.*

[39] *Crosthwait Equip. Co., Inc. v. John Deere Co.*, 992 F.2d 525, 529 (5th Cir. 1993).

[40] 815 Ill. Comp. Stat. Ann. 705/19 (Illinois requires good cause for termination, but there are four situations where notice is not required); Gen. Stat. Ann. § 42-133(f)(a) (Connecticut also requires good cause for termination).

[41] Conn. Gen. Stat. Ann. § 42-133g(a).

[42] State disclosure laws regulate the offer and sale of franchises.

[43] *See Brader v. Minute Muffler,* 914 P.2d 1220, 1222 (Wash. Ct. App. 1996) (affirming trial court's order granting rescission and franchisee's summary judgment motion because the franchisor violated Washington's disclosure statute by failing to register and distribute required pre-sale information).

Moreover, if a franchisee's affirmative claims under a disclosure statute are barred by the statute of limitations, it can still use them to defend against franchisor's claims.[44]

Franchisors must also note that some states limit the enforceability of certain covenants in franchise agreements, such as noncompetition provisions. In California, for example, most noncompetition agreements are invalid.[45] Other states place different limitations on the parameters of such provisions.[46]

E. Evaluate Benefits to Avoiding Termination

Even where the franchisor has good cause for termination and fears no defenses or counterclaims, the analysis should not stop there. The franchisor should also assess the benefits that may result from not terminating a problematic franchisee.

One primary reason franchisors do not terminate is to maintain the flow of royalties, advertising fees, and other payments. While the failure to pay royalties and other dues may entitle termination, exercising that right generally ensures that the franchisor no longer receives any such payments.[47] Even if the franchisee had been paying such fees previously, it may stop after termination. By examining alternatives, the franchisor may continue receiving payments from the franchisee. In the case of franchisees that have fallen behind in payments, the threat of termination coupled with alternative solutions could increase the payments collected by the franchisor.

In addition to potentially cutting off royalties, franchisor could incur legal fees. Even terminations based on obvious violations can quickly become expensive. If a

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[44] *See Styne v. Stevens,* 26 P.3d 343, 350 (Cal. 2001) ("Under well-established authority, a defense may be raised at any time, even if the matter alleged would be barred by a statute of limitations if asserted as the basis for affirmative relief. The rule applies in particular to contract actions. One sued on a contract may urge defenses that render the contract unenforceable, even if the same matters, alleged as grounds for restitution after rescission, would be untimely.").

[45] Cal. Bus. & Prof. Code § 16600 (California law does prohibit non-competes to be enforced after the sale of a business or to protect trade secrets).

[46] *Window Gang Ventures, Corp., Plaintiff, v. Gabriel Salinas; the Gang Grp., Inc.; & Window Ninjas, LLC; Red Window, LLC; Blue Window, LLC; & Orange Window, LLC, Defendants.*, No. 18 CVS 107, 2019 WL 1471073, at *8 (N.C. Super. Apr. 2, 2019) (franchise agreement non-compete provision was found overbroad and unenforceable where prohibition extended to businesses that are "the same" or "similar to" franchisor, not simply to those that are "competitive").

[47] While the franchisor could seek lost future royalties, such claims can be difficult to obtain. *See*, *e.g.*, *Postal Instant Press, Inc. v. Sealy*, 51 Cal. Rptr. 2d 365, 369, 371 (1996) (court held that lost future royalties were not a proper element of contract damages because: (1) the franchisor's termination of the agreement, not the franchisee's non-payment, was the proximate cause of the lost future royalties; (2) regardless of proximate cause, it was "inappropriate to award lost future profits where it would result in damages which are unreasonable, unconscionable and oppressive"; and (3) the calculation of future royalties was too speculative to be allowed as contract damages). For further discussion *see infra* Section VII.B.1.

franchisee does not immediately cease operations under the franchise, injunctions and litigation will likely follow. By pursuing an alternative to termination, franchisors can avoid these costs.

F. Evaluate Impact on System and Other Franchisees

Franchisors should also consider the impact of termination on their systems. There is no guarantee that the customers of a terminated unit will return—even if the business is re-opened by a different franchisee. Nor will those customers necessarily seek out another franchised location. Additionally, customers may identify the now-closed unit with the franchisor's trademarks, which could reflect poorly on the entire franchise system.

Termination may also have a tangible effect on the franchise system and other franchisees. This is of particular concern in relatively small systems or systems that have endured a substantial number of recent terminations. In both cases, the impact of another termination on franchisee sentiment could be substantial. The franchisor should therefore carefully present news of terminations to other franchisees. By casting the termination as a benefit to the entire franchise system—for example, to protect the brand's goodwill—the franchisor can frame the issue positively. Other franchisees may even appreciate the termination of poor operators.

Terminations may also lead to increased costs of goods to the system and negative public scrutiny of the brand. They could impact nationwide accounts serviced by that franchisee, require notice to relevant lenders and landlords, and affect relationships with those parties.

Terminations could also affect prospective franchisees. Franchisors must disclose the number of franchisees who have left the system in Item 20 of its Franchise Disclosure Document ("FDD").[48] They must also disclose certain litigation—which may occur as a result of terminations—in Item 3.[49] In extreme cases, if the franchisor terminates a large number of franchisees, the FDD may need to be amended.[50] These disclosures could impact prospective franchisees.

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[48] FDDs are presented to prospective buyers of franchises in the pre-sale disclosure process and their contents are outlined by 16 C.F.R. § 436.5(t). The most recent North American Securities Administrators Association's commentary on financial performance representations ("FPRs") states that when franchisors make an FPR in Item 19 of its FDD, it may exclude data from franchise outlets that closed during the time period covered by the FPR but only if the franchisor also discloses (i) the number of franchise outlets that closed during the time period covered by the FPR, and (ii) the number of excluded outlets that closed during the same time period after being open less than 12 months. *NASAA Franchise Commentary Financial Performance Representations*, dated May 8, 2017. That data also, therefore, will be available to prospective franchisees.

[49] *Id.* at § 436.5(c).

[50] *See* Maryland Regulations § 02.02.08.01(9)(a)-(b) (termination, within a three month period, of either 10% of the franchisees in Maryland or 5% of all franchisees, is a material charge).

G. Assess Viable Alternatives to Termination

One common alternative to termination is a workout. A workout, or forbearance, is an agreement between the franchisee and franchisor, and any other relevant parties, where the franchisor provides some assistance to the franchisee or agrees to waive certain obligations or payments. A workout can be as simple as the franchisor deferring or forgiving certain franchise payments, or it can involve complex financing and leasing arrangements. A workout agreement typically includes the franchisee's reaffirmation of the franchise agreement and acknowledgement of: (i) its obligations under the franchise agreement, (ii) all defaults, (iii) the franchisor's remedies, (iv) agreed repayment terms or agreed terms for the cure of non-monetary defaults, (v) a release, (vi) any modification of terms of the franchise agreement, and (vii) a cross-default provision providing that a default under the workout agreement would be a default under the franchise agreement.

The goal of the workout is to provide the franchisee a path to staying in the system despite its admitted prior defaults.

IV. Navigating the Labyrinth of State Relationship Laws

As noted in Section III.C., a number of states have laws addressing the franchise relationship. These laws may extend the cure period for defaults or notice period for terminations, determine what qualifies as a default, or provide for certain remuneration in connection with defaults. It is critical that a franchisor determine which, if any, state laws apply. A failure to do so could result in substantial liability.

A. Which State Laws Apply – No Two Statutes Are Exactly the Same

Currently 18 states, plus Puerto Rico and the Virgin Islands, have enacted franchise statutes that govern termination of the franchise relationship by the franchisor. While there are some general trends, no two statutes are exactly alike. Under most statutes, a franchisor must have good cause to terminate. But the definition of good cause varies. Similarly, some statutes require notice and an opportunity to cure prior to termination. These parameters, and their exceptions, also vary.

B. Jurisdictional Application of State Relationship Laws

To determine which state relationship law applies, review the language of the statute. Each statute's scope falls into three general categories. The majority—including Arkansas, Connecticut, Illinois, Iowa, Missouri, Nebraska, New Jersey, Rhode Island, Virginia, Wisconsin, and Puerto Rico—are narrow. Their restrictions only apply if the franchised unit is located within the state.[51]

[51]Ark. Code Ann. § 4-72-203; Conn. Gen. Stat. Ann. § 42-133h; 815 Ill. Comp. Stat. Ann. 705/19; Iowa Code Ann. § 523H.2; Mo. Ann. Stat. § 407.400; Neb. Rev. Stat. Ann. § 87-403; N.J. Stat. Ann. § 56:10-3; 6 R.I. Gen. Laws Ann. § 6-50-2; Va. Code Ann. § 13.1-559; Wis. Stat. Ann. § 135.02; 10 L.P.R.A. § 278.

The next group—which includes California, Delaware, Hawaii, Indiana, Mississippi, and the Virgin Islands—is slightly broader. Their restrictions apply if the franchised unit is located within the state or if the franchisee lives in that state.[52]

The last group—which includes Michigan, Minnesota, and Washington—is the most comprehensive in terms of scope. The Michigan relationship law applies if (i) the franchised unit is in Michigan, (ii) the franchisee is domiciled in Michigan, or (iii) the offer to buy the franchise is accepted in Michigan.[53] The Minnesota relationship law applies if (i) the franchised unit is in Minnesota, (ii) a sale is made in Minnesota, or (iii) an offer to sell or purchase is made or accepted in Minnesota.[54] And the Washington law applies if (i) the offer is accepted or directed to a person in Washington, (ii) an offer originates from Washington and violates the laws of the state in which it is received, (iii) the offeree or purchaser is a resident of Washington, or (iv) the franchised business offered or sold is to be operated, at least partly, in Washington.[55]

Franchisors should also note that if the franchise agreement has a choice of law provision designating the law of one of the above states, a franchisee may attempt to argue that the relationship law of that state would apply even if the franchisee has no relationship to the state. To limit such claims, and assuming that the franchisee does not otherwise fall under the protections of the statute, the best practice is to exclude the application of the statute in the choice of law provision.

C. Conditions Required Prior to Termination

Most of the state relationship laws require good cause to terminate and also impose mandatory notice and cure periods. The definitions and parameters vary.

1. Good Cause

Out of the states that do have a good cause requirement, several provide a definition of good cause.[56] While these definitions vary slightly, they generally state that good cause is a failure to comply with the lawful and material provisions of the franchise

[52] Cal. Bus. & Prof. Code § 20015; Del. Code Ann. Title 6, § 2551; Haw. Rev. Stat. Ann. § 482E-4, 6; Ind. Code. Ann. § 23-2-2.5-2; Miss. Code. Ann. § 75-24-51 through 63; V.I.C. § 130-139.

[53] Mich. Comp. Laws § 445.1504.

[54] Minn. Stat. Ann. § 80C.19.

[55] Wash. Rev. Code § 19.100.020(2).

[56] These states include California, Connecticut, Hawaii, Illinois, Indiana, Michigan, Minnesota, Nebraska, New Jersey, Rhode Island and Washington. For franchise agreements entered into or renewed on or after January 1, 2016, California limits “good cause” for terminations to a franchisee’s failure to substantially comply with the lawful requirements imposed upon the franchisee by the franchise agreement.

agreement. Some states go further and outline specific situations that constitute "good cause" for termination.[57] These situations include a franchisee's bankruptcy, abandonment of the franchised unit, failure to pay amounts due, material impairment of the goodwill of the franchise system or the franchise trademarks, or repeated defaults of the franchise agreement. A list of such situations in a statute is not necessarily exhaustive.[58]

Iowa, in addition to good cause, requires that the termination not be arbitrary and capricious.[59] The Virgin Islands define good cause as the failure of the franchisee to substantially comply with essential and reasonable requirements of the franchise agreement.[60] Good cause also exists if either the franchisor or franchisee demonstrates the other's bad faith performance.

Puerto Rico has arguably the highest "good cause" standard.[61] The state relationship law requires "just cause" for termination, which occurs only when (i) the franchisee fails to perform under an essential provision of the franchise agreement or (ii) the acts or omissions of the franchisee "adversely and substantially" affects the interests of the franchisor in promoting the marketing or distribution of the merchandise or service. If the termination is based on a provision of the franchise agreement relating to certain changes in the operation of the franchise, the franchisor must demonstrate that the franchisee has affected or may affect the interests of the franchisor in an adverse or substantial manner.[62] If the termination is based on a provision in the franchise agreement outlining rules or conduct or distribution goals, the franchisor must show that the rule or conduct or distribution goal was reasonable in light of the "realities of the Puerto Rican market" at the time of the violation.[63]

Two states, Delaware and Virginia, impose a requirement of good cause for terminations but do not further define what constitutes good cause.[64] Franchisors should look to other states for guidance.

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[57] The states that outline specific examples of circumstances constituting good cause include Connecticut, Illinois, Minnesota and Rhode Island. Hawaii allows termination for either good cause or if done in accordance with the franchisor's current terms and conditions if such standards are applied equally across the franchise system. *See* Haw. Rev. Stat. § 482E-6(2)(H).

[58] *See*, *e.g.*, Conn. Gen. Stat. § 42-133f(a) ("good cause ....shall include, but not be limited to the franchisee's refusal or failure to comply substantially with any material and reasonable obligation of the franchise agreement or for the reasons stated in subsection (e) of this section.").

[59] Iowa Code § 523H.7.

[60] Wis. Stat. § 135.02(4); V.I. Code Ann. tit. 12A, § 132.

[61] P.R. Laws Ann. tit. 10, § 278a-1.

[62] *Id.* at § 278a-1(a).
[63] *Id.* at § 278a-1(c).

[64] Del. Code Ann. tit. 6, § 2552; Virginia actually requires "reasonable cause." *See* Va. Code Ann. § 13.1-564.

2. Cure and Termination Periods

In addition to good cause, many states require cure and notice periods. Mandatory cure periods vary, but three general trends exist. First, a number of states do not require a cure period but do require notice of termination (also known as a "wind down" period). Second, some states mandate a "reasonable" cure period but not a specific number of days to cure. Finally, some states require a specific number of days to cure certain types of defaults.

Connecticut, Delaware, Indiana, Mississippi, Missouri, Nebraska, New Jersey, and the Virgin Islands do not require any cure period but do require notice before termination becomes effective. In Connecticut, Nebraska, and New Jersey the wind down period is 60 days. In Delaware, Mississippi, and Missouri it is 90 days. Although Indiana's statute contains a 90 day-notice requirement, it rarely applies because any different notice period in the franchise agreement, including no notice period, overrides the statutory requirement.[65] The Virgin Islands requires 120 days' notice.

The second group of states—California[66], Hawaii, Illinois, Michigan, and Washington—require a cure period of unspecified duration. These states require a "reasonable" cure period, which generally means that the period need not be longer than 30 days.[67] These states also require that a franchisor provide a notice of termination but, unlike the prior group, do not require any notice period before termination becomes effective.

The final group of states—Arkansas, California, Iowa~~,~~ Minnesota, Rhode Island, and Wisconsin—specify a cure period for certain defaults. Arkansas and Rhode Island require a 30-day cure period. Minnesota and Wisconsin require a 60-day cure period. California requires a "reasonable" cure period of at least 60 days but not more than 75 days.[68] Iowa requires a "reasonable" cure period between 30 and 90 days long. These

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[65] *See* Ind. Code Ann. § 23-2-2.7-3 ("Unless otherwise provided in the agreement, any termination of a franchise . . . must be made on at least ninety (90) days' notice.")

[66] This requirement applies to franchise agreements entered into before January 1, 2016. For franchise agreements entered into or renewed after January 1, 2016, California requires a "reasonable" cure period of at least 60 days or more than 75 days. California Business and Professions Code, Division 8, Chapter 5.5, §20020.

[67] Washington provides that for defaults that cannot be cured within the statutorily mandated cure period, the franchisee may simply initiate "substantial and continuing action" to cure the default within the cure period. *See* Wash. Rev. Code § 19.100.180(2)(j).

[68] This requirement applies to franchise agreements entered into or renewed on or after January 1, 2016. For franchise agreements entered into or renewed prior to January 1, 2016, California requires a "reasonable" cure period which need not be longer than 30 days. California Business and Professions Code, Division 8, Chapter 5.5, §20020.

states also require franchisors to provide notice of termination to the franchisee. The termination notice period generally ranges from 60 to 90 days depending on the state. Certain states allow for the termination-notice period to run concurrently with the cure period.[69]

It is important to note that many of the above-referenced statutes exclude certain incurable defaults. Before issuing a default under any statute, franchisors must always review the statute and confirm that any default or termination complies with the cure and notice requirement or some applicable exception.[70]

D. Incurable Defaults

In some instances, franchisees cannot cure defaults, such as where the default is particularly damaging to the franchise system or trademarks. Additional examples of incurable defaults include the commission of a crime by the franchisee, a declaration of bankruptcy by the franchisee, or a violation of standards that affect health and safety.[71]

Many states that require cure periods recognize the reality of incurable defaults and exclude certain ones, allowing the franchisor to immediately terminate without providing a cure period for certain identified defaults. [72] Washington, for example, allows for termination without giving the required notice or cure period if the franchisee (i) is bankrupt or insolvent, (ii) assigns the assets of the franchised business to creditors, (iii) voluntarily abandons the franchised business, or (iv) is convicted of violating any law relating to the franchised business.[73]

Case law references other incurable defaults. As a general rule, if the default goes to the essence of the contract, the default is incurable. In *LJL Transportation, Inc. v. Pilot Air Freight Corp.*, a franchisee admitted that it had deliberately diverted business to a subsidiary to hide profits and avoid paying royalties to the franchisor.[74] No franchise relationship law applied but the franchise agreement required notice of termination and

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[69] These states include Arkansas, California, Minnesota, Rhode Island, and Wisconsin.

[70] For example, Arkansas does not require notice to be sent if the basis of termination is multiple defaults within a 12-month period. Ark. Code. Ann. § 4-72-204(d).

[71] *See generally* Jason J. Stover, *No Cure, No Problem: State Franchise Laws and Termination for Incurable Defaults*, 23 Franchise L.J. 217 (Spring 2004); *See, e.g., Pella Prod., Inc. v. Pella Corp.*, No. 3:18-CV-01030, 2018 WL 2734820, at *10 (M.D. Pa. June 7, 2018) (when evaluating distributor's motion for a preliminary injunction, the court concluded that supplier was likely within its contractual rights to issue a termination notice because distributor's sexually inappropriate comments to employees were inconsistent with his obligations to preserve supplier's good name and protect the goodwill of the brand).

[72] Arkansas, California, Illinois, Maryland, Minnesota, Rhode Island, Washington, and Wisconsin allow for immediate termination in certain circumstances.

[73] Wash. Rev. Code § 19.100.180(2)(j).

[74] Bus. Franchise Guide (CCH) ¶ 14,058 (Pa. 2009).

an opportunity to cure.[75] Despite these provisions in the franchise agreement, the court held that the franchisor could terminate without providing the required notice and cure periods because the franchisee's breach went to the essence of the contract and irreparably damaged the trust between the contracting parties.[76]

Not every court, however, has embraced the "essence of the contract" argument as a basis for termination. In *Manpower Inc. v. Mason*, an employment agency franchisee failed to require employers to complete and retain I-9 forms verifying each employee's eligibility for employment.[77] The franchisor contended that this was essential because the franchised business supplied temporary personnel to various employers and sought to terminate primarily on that incurable basis.[78] The court disagreed, defining an incurable breach as one that the contract provides no opportunity to cure or "one that cannot logically be cured, such as a franchisee's failure to meet a sales quota within a specified time."[79] The court, however, did hold that breaches that go to the "essence of a contract" allow for rescission—just not termination.[80]

In states with relationship laws, courts have also found that the franchisee's actions may excuse the franchisor from complying with the applicable statute. In *Harnischfeger Corp. v. Superior Crane Corp.*, a dealer misappropriated a manufacturer's designs and proprietary information to manufacture its own unauthorized replacement parts for the manufacturer's equipment.[81] The court held that the manufacturer was not required to provide the dealer an opportunity to cure, as required under Wisconsin's relationship law, because the dealer's "bad faith" acts were not subject to the cure provision.[82]

Similarly in *NOVUS du Quebec, Inc. v. NOVUS Franchising, Inc.*, a subfranchisor failed to require its franchisees to comply with the franchise system and also franchised units associated with another franchisor.[83] The court excused the franchisor from complying with the statute's cure period, which would have been "futile" given the widespread violations by the subfranchisor.[84]

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[75] *Id.*

[76] *Id.*

[77] 377 F. Supp. 2d 672, 674 (E.D. Wis. 2005).

[78] *Id.* at 679. Plaintiffs also presented other reasons for immediate termination, such as the inability to meet a minimum sales quota and insolvency. *Id.* at 674.

[79] *Id.* at 677.

[80] *Id.* at 679.

[81] Bus. Franchise Guide (CCH) ¶ 10,618 (E.D. Wis. 1995).
[82] *Id.*

[83] Bus. Franchise Guide (CCH) ¶ 10,823 (D. Minn. 1995).

[84] *Id.*

If a franchisor believes a default is incurable, state relationship laws and case law can provide guidance. If the default is not addressed in an applicable statute or case law, the franchisor must weigh the value of terminating the franchisee without a cure period against the risk of claims for unlawful termination.

E. Buyback Provisions

Some state relationship laws also require the franchisor to repurchase, or "buyback," certain items upon termination of the franchisee. The states with these provisions are Arkansas, California, Connecticut, Hawaii, Maryland, Rhode Island, Washington, and Wisconsin. As with good cause and notice/cure provisions, these buyback provisions vary.

Hawaii, Rhode Island, Washington, and Wisconsin have absolute buyback provisions that apply in all cases of termination. In contrast, Arkansas requires a franchisor to repurchase items if the franchisee was not terminated with good cause. In California, even upon a lawful termination, the franchisor must repurchase items from the franchisee except under certain defined scenarios.[85]

In Rhode Island and Wisconsin, the franchisor must repurchase the franchisee's inventory, regardless of whether the inventory was purchased from the franchisor. In Arkansas, Connecticut, Hawaii, and Washington, the franchisor has to buyback inventory, supplies, equipment, and furnishings that were purchased from the franchisor or its approved suppliers. In California, the franchisor must repurchase the franchisee's inventory, supplies, equipment, fixtures, and furnishings that were purchased from the franchisor or its approved suppliers and sources that are, at the time of the notice of termination, in possession of the franchisee or used by the franchisee in the franchised business.[86] Maryland limits this requirement to merchandise sold by the franchisor to the franchisee. Arkansas, California, Connecticut, Hawaii, and Washington do not require the repurchase of any personalized items of the franchisee while Rhode Island and Wisconsin only require the repurchase of items containing the identifying marks of the franchisor. In Washington, franchisors do not have to repurchase items that are not reasonably required in the operation of the franchise business. Further, if the franchisee maintains control of the premises, the franchisor must only buyback items purchased in accordance with the requirements of the franchisor.

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[85] This requirement applies to franchise agreements entered into or renewed on or after January 1, 2016. For franchise agreements entered into or renewed prior to January 1, 2016, California requires a franchisor to repurchase items if the franchisee was not terminated with good cause, as well as requires buybacks if the franchisor fails to meet any of the terms of the California Franchise Relations Act.

[86] This requirement applies to franchise agreements entered into or renewed on or after January 1, 2016. For franchise agreements entered into or renewed prior to January 1, 2016, California requires the franchisor to repurchase items if the franchisee was not terminated with good cause, as well as requires buybacks if the franchisor fails to comply with the California Franchise Relations Act.

State buyback provisions differ as to what price a franchisor has to pay to repurchase the required items. The fair market value or the fair wholesale market value is commonly used. Other states use a different valuation calculation. In Arkansas, the purchase price must equal the franchisee's net cost less a reasonable deduction for depreciation or obsolescence. In California, the price is the price paid minus depreciation.

It is important to note the exceptions to these repurchase requirements. For example, in California, franchisors may avoid the repurchase obligation by not preventing the franchisee from retaining control of the principal place of the franchised business.[87]

V. Steps in the Default/Termination Process

This section overviews the default and termination process. A franchisee's failure to comply with a franchise agreement typically falls into two categories: monetary defaults and non-monetary defaults. For each of these, the steps that begin the default/termination process vary.

A. Pre-Default Procedures

A franchisee's breach of its franchise agreement will not necessarily compel the franchisor to immediately place the franchisee in default. Instead, the franchisor may take various "pre-default" actions to encourage the franchisee to remedy its non-compliant behavior.

1. Monetary Defaults

The franchisor's accounting department is the first line of defense when a franchisee fails to timely fulfill its monetary obligations under the franchise agreement. When payment is deficient or delinquent, the accounting department should investigate and confirm the nature and extent of the delinquency. If it is confirmed that a payment was not timely received or could not be successfully debited from the franchisee's account, consider informally contacting the franchisee. An initial "friendly warning" by the accounting department can put the franchisee on notice without escalating the situation.

This warning may assume a variety of forms, depending on the nature of the default and the franchisee's history. For a first-time offender, a simple inquiry may be all that is necessary. If that does not work, the franchisor's legal department may need to step in.

Even then, however, the franchisor may not choose to default the franchisee. Instead, a more formal notice, or request for compliance, can be sent. This approach

[87] Cal. Bus. & Prof. Code § 20022(d).

may make the franchisor appear reasonable, which may encourage the franchisee to respond similarly. Such leniency may also build a positive record of communication, which will benefit the franchisor in the event of litigation.

2. Non-Monetary Defaults

Like accounting representatives for monetary defaults, franchise business consultants and field representatives are key for handling operational defaults. A franchisor's field representative is typically the one who will first observe such a default, in the course of either a routine visit or a formal inspection. The next step depends on the severity of the default.

For run-of-the-mill operational deficiencies, the field representative may provide the franchisee with a task list noting the deficiencies and required actions for addressing each. If the franchisee corrects them, and the field representative confirms, the situation ends there.

If the franchisee does not comply, the franchisor's administration and legal department should be notified. A formal default may be necessary to force compliance. For example, if the franchisee is jeopardizing the health or safety of customers, it may not be appropriate for the field representative to work informally with the franchisee. A formal notice of default may be appropriate to mirror the severity of the situation.

The franchisor and its staff should ensure that all issues are thoroughly and carefully documented in all cases. Establishing a complete record is good practice and will be useful should the franchisee's non-compliance persist or litigation occurs.

B. Notice of Default

Assuming the default is not so severe as to require immediate termination, the franchisors next step is to prepare a default notice. The notice serves three primary functions. First, it notifies the franchisee of a default of the franchise agreement, referencing specific provisions that have been breached and identifying the actions constituting such violations. Second, it identifies what corrective action the franchisee must take to cure the default within the cure period afforded to it. Finally, it previews the consequences if the franchisee fails to cure the default, including termination or other legal action. [88]

1. Franchise Agreement/State Statutes

The most critical aspect of issuing a default notice is confirming that the notice satisfies *both* the requirements under the franchise agreement *and* any applicable state relationship laws. For example, the franchisor must identify a basis in the franchise agreement for issuing a default for the franchisee's conduct. It must then also find a

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[88] Be sure to consult any applicable statutes and include any other required information.

basis under the applicable statute for issuing a default for that same conduct.[89] Franchise agreements and state statutes both often require franchisors to provide an opportunity to cure. If the cure periods conflict, then the franchisor must provide the one that is longer so as to satisfy both the franchise agreement and applicable statute.

The franchisor must also review the agreement to determine how to send the default notice. Franchise agreements inform the franchisor exactly how the notice of default must be delivered (*e.g.*, first-class mail, courier, email, etc.) and where to send the notice. These provisions may also indicate when to start the cure period, including from the day the notice is sent, received, or some other date. State statutes may prevent franchisors from beginning the clock before the notice is received by the franchisor.

2. Content

A notice of default should clearly state the facts constituting the default, the requirements to cure the default, the deadline for curing, and the consequences of failing to cure. If the franchisee operates multiple units, whether under one corporate entity or multiple entities, the franchisor should clearly identify each unit, franchise agreement, and party to which the relevant defaults apply.[90] The notice should state if the franchisor intends to exercise cross-default on other units based on the default of a single unit's franchise agreement.

The franchisor should ensure that the notice of default actually gets to the relevant parties. If there is any doubt as to the continuing validity of the notice address in the franchise agreement, a duplicate notice should be sent to wherever the franchisor deems necessary to effectuate actual notice. The franchisor should also forward the notice to any guarantors and consider forwarding it to other parties with an interest in the franchisee, such as a lender. In most cases, proof of delivery to the franchisee is necessary to calculate when the cure period beings.

C. Notice of Termination

Franchisors send notices of termination to formally end the franchise relationship. These notices usually follow a notice of default when the franchisee has failed to timely and properly cure such default. They can also be sent in situations where neither the franchise agreement nor applicable statute require a cure period and the franchisor wants to terminate without providing one.

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[89] For example, a state statute may indicate that conduct which constitutes a breach of the franchise agreement also constitutes good cause under the statute.

[90] If that makes the default notice too complicated, consider issuing separate notices for each agreement.

In other situations, a franchisor may send a hybrid notice of default and termination.[91] Such notices are often called “self-executing default notices” because they provide notice of the default and automatically terminate the franchise relationship if the default is not cured.[92] Termination notices require the same general considerations as default notices, absent any cure-period requirement. In addition, franchisors should consider the following issues.

1. Franchise Agreement/State Statutes

If a notice of default was previously sent (or not required), the franchisor should already be familiar with any relevant parameters under state relationship laws. Even so, the franchisor will want to revisit the relevant state statute and the franchise agreement to determine any information that specifically needs to be included in the termination notice. For instance, states that require a notice of termination typically include a requirement that the notice explain the reasons for it.[93] Other states may require a valid notice of termination “to be clear and unambiguous.”[94]

The franchisor should also review state relationship laws and the franchise agreement to determine any post-termination obligations. As previously noted, a handful of state relationship laws have buyback provisions that require the franchisor to repurchase certain goods from the franchisee in the event of termination.[95] Franchise agreements typically require the franchisee to honor many post-termination obligations, such as de-identification with the brand.

2. Content

Many state relationship laws require a notice of termination to include all bases for termination. Even if not required, it is generally good practice to include these reasons. The notice of termination should also specifically state the effective date of

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[91] The most common situation when hybrid notices are used is when a state relationship law requires both a cure period and notice of termination period and allows for them to run concurrently. *See*, *e.g.*, Minn. Stat. Ann. § 80C.14 (requiring the provision of 60-day cure period and 90-days-notice prior to termination).

[92] If a self-executing notice is used, the franchisor may want to send a “confirmation of termination” after the notice period expires.

[93] Arkansas, Connecticut, Delaware, Illinois, Iowa, Minnesota, Nebraska, New Jersey, Rhode Island and Wisconsin all require a notice of termination to describe the basis of the franchisee termination.

[94] *In re RMH Franchise Holdings, Inc.*, 590 B.R. 655, 662 (Bankr. D. Del. 2018) (discussing the validity of a notice of termination in view of a cure extension).

[95] *See supra* Section IV.E.

termination.[96] This date could be upon the franchisee's receipt of the termination notice, the expiration of any required cure period, or some other date.

Additionally, the termination notice should set forth the post-termination obligations of the franchisee and any post-termination covenants that apply. The franchisor may also request written confirmation or proof from the now-terminated franchisee that certain obligations have been met.

As with a notice of default, the franchisor should ensure that the notice of termination is sent to the franchisee's notice address and that duplicates are sent anywhere that is necessary to effect actual notice. Duplicates should be sent to any guarantors and other necessary parties.

D. Cease and Desist

In some cases, a terminated franchisee ignores a notice of termination and continues to operate as the franchised business. Before initiating legal action, franchisors may opt to send a "cease and desist" letter. A standard letter briefly recounts the events leading up to the default and termination, emphasizing that the continued operations and unauthorized use of the franchisor's marks constitutes a breach of the franchise agreement and violation of federal law, including the Lanham Act.[97] The franchisor should collect evidence of continued operation at this stage, such as continuing to utilize marks, selling unapproved product under franchisor's marks, keeping the unit open, etc. The letter should demand that the franchisee not only cease operations and comply with its post-termination obligations, but also certify its compliance with those obligations.

The effect of a cease and desist demand will depend on the specific franchisee. If the letter does not result in compliance, the franchisor might consider more formal ways to enforce termination.[98]

E. Workout Agreements

Workout agreements can be an effective alternative to termination.[99] Even if the franchisor and franchisee have already agreed to a workout, the franchisor may still want to send a notice of default to the franchisee. The notice can lay the groundwork for a later termination if the franchisee repeats its defaults. If the parties have not executed a workout agreement, a default notice can lay out the details of a proposed workout

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[96] California and Maryland both expressly require that the notice of termination include the effective date of the termination.

[97] 15 U.S.C. § 1051 *et. seq.*

[98] *See infra* Section VII.

[99] *See supra* Section III.G.

agreement and require the execution of the workout agreement in order to cure the default.

VI. Dealing With Other Franchisees

A. Selective Enforcement

Franchisors must consider not only how their decisions might affect the non-compliant franchisee, but also how other franchisees might view any responsive action. Specifically, when a franchisor decides to enforce a standard that is not widely observed in its system against a particular franchisee, that franchisee and other franchisees may view the franchisor's individualized treatment as discriminatory.

To preemptively address this, many franchise agreements include explicit acknowledgements by the franchisee that other franchisee agreements may include different terms, and that the franchisor's decisions regarding other franchisees do not constitute a waiver of any rights the franchisor may have. Despite these provisions, franchisees may still complain about a franchisor's selective treatment, particularly in situations where a franchisor decides to forgive one franchisee's breach of a certain contractual obligation but seeks to enforce the same obligation against another.[100]

Courts typically reject claims that selective enforcement by a franchisor is improper. For example, in *Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd.*, the Seventh Circuit rejected a franchisee's defense of selective enforcement, noting that "[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."[101] Other courts have reached similar conclusions.[102]

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[100] For a comprehensive discussion of issues relating to selective enforcement in the franchise context, see Mark J. Burzych and Emily L. Matthews, *Vive La Difference? Selective Enforcement of Franchise Agreement Terms and System Standards*, 23 Franchise L.J. 110 (Fall 2003).

[101] 970 F.2d 273 (7th Cir. 1992).

[102] *See also*, *Kilday v. Econo-Travel Motor Hotel Corp.*, 516 F.Supp. 162, 163 (E.D.N.Y. 1981) (a contract provision giving a franchisor the right to require conformance with standards "does not appear to obligate the [franchisor] to require all of its franchisees to conform with the standards required of the [plaintiff franchisee]."); *Staten Island Rustproofing Inc. v. Zeibart Rustproofing Co.*, Bus. Franchise Guide (CCH) ¶ 8, 492 (E.D.N.Y. 1985) (affirming franchisor's termination of franchisee over franchisee's argument regarding selective enforcement because the agreement did not provide that the franchisor "promised to enforce its standards against other franchisees," and thus the franchisor was free to terminate the subject franchise without having to take action against other franchisees); *Chick-Fil-A, Inc. v. CFT Dev., LLC*, 652 F. Supp. 2d 1252, 1262 (M.D. Fla. 2009), *aff'd*, 370 F. App'x 55 (11th Cir. 2010) (any inaction by franchisor or non-enforcement of other contracts was insufficient to estop the enforcement of a covenant not to compete against another franchisee); *Creel Enters., Ltd. v. Mr. Gatti's, Inc.*, Bus. Franchise Guide (CCH) ¶ 9,825 (N.D. Ala. 1990) (alleged non-enforcement of quality standards against some franchisees did not breach contract with another franchisee); *Quality Inns Int'l, Inc. v Dollar Inns of Am., Inc.*, Bus. Franchise Guide (CCH) ¶ 10,007 (D. Md. 1989) (implied covenant of good faith and fair dealing not violated by selective enforcement of franchise agreement because the covenant does not require

Complaints of selective enforcement have also been unsuccessful where the franchisor demonstrates a legitimate reason for not taking similar actions against other franchisees that may have committed similar violations. For example, in *Bonanza Int'l, Inc. v. Rest. Mgmt. Consultants, Inc.*, the court reasoned that a franchisor's disparate treatment of other franchisees was justified because the franchisor either had a long-standing relationship with such franchisees or their defaults had been timely cured.[103]

Two common franchisee arguments related to selective enforcement include waiver and discrimination. Franchisees may sometimes contend that the franchisor excused or waived the franchisee's non-compliance by failing to strictly enforce the franchise agreement. This argument is generally unsuccessful when the franchise agreement contains standard anti-waiver language.[104]

Discrimination claims are closely related to complaints of selective enforcement. Franchisees may assert that the franchisor's selective enforcement of its franchise agreements constitutes a violation of state or federal anti-discrimination statutes. The statutes in this area and the case law interpreting these statutes give a franchisor a great deal of leeway in dealing with its franchisees, provided the franchisor treats "similarly-situated" franchisees in approximately the same manner and it has rational, non-arbitrary reasons for engaging in the alleged discrimination between franchisees.[105]

B. Communication With Other Franchisees

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franchisors to deal with other franchisees in a particular manner). In certain contexts, however, selective enforcement can inhibit a franchisor's ability to exercise its rights. *See*, *e.g.*, *Surgidev Corp. v. Eye Tech., Inc.*, 648 F. Supp. 661 (D. Minn. 1986) (accepting selective enforcement evidence as a defense to enforcement of a non-compete because "[u]nder the circumstances, it would be inequitable to permit plaintiff to now rely on a non-compete agreement which it has so blithely ignored in the past.").

[103] 625 F. Supp. 1431 (E.D. La. 1986); *See also Baskin Robbins v. D&L Ice Cream Co., Inc.*, 576 F. Supp. 1055, 1059 (E.D.N.Y. 1983) (allowing selective enforcement when other franchisee who sold unauthorized products removed the products within 24 hours); *NOVUS du Quebec, Inc.*, Bus. Franchise Guide (CCH) ¶ 10,823 (D. Minn. 1995) (failure to enforce quality standards with respect to some franchisees did not prevent termination of another franchisee for standard violations since the violations of terminated franchisee were more serious, and the franchisor had warned the offending franchisee); *Petland, Inc. v. Hendrix*, No. 204CV224, 2004 WL 3406089, at *7 (S.D. Ohio Sept. 14, 2004) (franchisor's selective enforcement of non-competition clause was grounded in credible business reasons, *e.g.*, other markets were not meant for re-franchising, and did not serve to render non-competes invalid against franchisee defendants).

[104] *See, e.g.*, *In re Keelboat Concepts, Inc. v. C.O.W., Inc.*, Bus. Franchise Guide (CCH) ¶ 13,216 (Ala. 2005) (where the franchise agreement has an anti-waiver provision, the franchisor's failure to strictly enforce some terms of the contract against the franchisee cannot amount to a waiver of other requirements); *Subaru Distribs. Corp. v. Subaru of Am., Inc.*, Bus. Franchise Guide (CCH) ¶ 12, 264 (S.D.N.Y. 2002) ("no waiver" clause protected importers right to demand exact compliance with contractual provisions).

[105] *See supra* Section III.D.2.

Franchisors should also aim to be reasonable and fair and to demonstrate this before other franchisees. Communications with other franchisees regarding system defaults and terminations can take various forms. In some instances, there may be a very public issue regarding a particular franchisee's breach of its agreement – *e.g.*, a health and safety issue, or some other aspect of the franchisee's conduct that garners press attention. Particularly in situations where there is negative publicity surrounding a franchisee's defaults, it is important that a franchisor reassure its franchisees and the public that it is responding to the offensive conduct and acting to protect the system.

Most franchise defaults do not draw outside attention. In these routine circumstances, franchisors may elect to be the primary source of information to franchisees regarding system defaults and terminations. Franchisors may present enforcement efforts at annual franchisee conventions or update the franchisee advisory council. Such communication serves two purposes: (i) it reassures franchisees that the franchisor is actively working to protect the system and goodwill of all franchisees by enforcing franchise agreements and system standards, and (ii) it warns franchisees that the franchisor takes defaults seriously.

Franchisors should not bully their franchisees and should avoid any perception that they are doing so. This is especially necessary in a climate where social media allows individuals to quickly and publicly spread their side of any story, while others weigh-in with comments and criticisms. Accordingly, franchisors should strategically craft their message to other franchisees regarding defaults and be careful to manage the perception they give other franchisees and their customers. At the same time, any messaging to franchisees about a specific default or termination should be carefully controlled by the franchisor. It is important to protect franchisee confidentiality. Franchisor employees should not feel automatically authorized to share information about particular franchisees with others.

VII. Enforcing Termination

A. Non-Judicial Enforcement

1. Self-Help Remedies for Franchisors

Most franchise agreements impose various post-termination obligations on the franchisee, such as the obligation to cease operations, to discontinue use of the franchisor's confidential information and proprietary marks, to cancel phone listings, and to de-identify the franchised premises (meaning remove signs, symbols, logos, devices, forms, and other items associated with the franchised system). Many franchise agreements also allow the franchisor to take certain of these actions on the franchisee's behalf. For example, agreements often give franchisors the right to de-identify the former franchised premise, at the franchisee's expense, without committing trespass or some other tort. Franchisors, however, may decide not to invoke such self-help rights, like when the former franchised location is not geographically convenient for any of the franchisor's personnel. Moreover, absent permission from the property owner, self-help is fraught with legal risk.[106] And the franchisor may never collect its expenses—especially if the former franchisee already owed the franchisor money.

Where self-help is unavailable or impractical, the franchisor may turn to other avenues for enforcing the termination of the franchise agreement.

2. Mediation

Before or instead of resolving a dispute before the courts, parties may engage in in one or more forms of alternate dispute resolution ("ADR"). Mediation is one type of ADR where an impartial third party helps parties negotiate a mutually-agreeable solution. It can be an efficient and cost-effective way of reaching resolution. Other benefits include control of the process, confidentiality, and speed to resolution.

Some franchise agreements require mediation as a first step to resolving any dispute. The clauses typically mandate the parties submit certain (or all) disputes to nonbinding mediation upon the request of either party. Nonbinding means that the parties must merely engage in the mediation—often expressly in good faith—before proceeding to litigation.

Although mediation is controlled by the parties, the proceedings generally assume a similar format. After being selected by the parties, the mediator solicits input from both parties regarding legal and factual issues in the dispute—usually via written submission and follow-up joint or *ex parte* phone calls with the parties' counsel. Next, the actual mediation session occurs, during which the mediator may begin by joining the parties together and requesting opening statements from counsel. If the mediator thinks that opening statements would not be productive—perhaps because both parties are highly sophisticated or too emotionally involved—the mediator may start with each party in its own room. The mediator then shuttles between rooms, discussing strengths and weaknesses of each party's claims and defenses and pushing each party to agree to some sort of compromise that makes business sense for both. Various organizations offer mediation services, such as the National Conflict Resolution Center, American Arbitration Association, CPR Institute, and state and local ADR organizations.

If one party refuses to engage in contractually-mandated mediation, courts usually compel that party to participate. Since most jurisdictions do not have mediation-specific acts, courts extend the scope of arbitration laws to include mediation clauses—grouping arbitration and mediation under the general rubric of ADR.[107] The rationale for

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[106] If the franchisor holds the site of the franchisee's business through a lease or sublease, self-help might be easier, as the franchisor has the right of access. But even in these circumstances the franchisor will incur expenses in removing the vestiges of the terminated franchisee.

[107] The Federal Arbitration Act, 9 U.S.C. §§ 1-15 governs the enforcement of arbitration agreements. *See infra* Section VII.A.3; The Federal Arbitration Act, 9 U.S.C. §§ 1-15 governs the enforcement of arbitration agreements. *See*, *e.g.*, *Wolsey, Ltd. v. Foodmaker, Inc.*, 144 F.3d 1205 (9th Cir. 1998) (finding a mediation provision enforceable, and that the lower court should have granted the motion to compel arbitration under the FAA).

this extension is that both arbitration and mediation evidence the parties' desire to pursue an alternative to litigation.[108]

A handful of courts, however, have distinguished mediation from arbitration and refused to compel the former. In *Lynn v. Gen. Elec. Co.*, the court applied a two-step test to address this very issue.[109] The first step examined how closely the proposed mediation process resembled classic arbitration, and the second step analyzed whether treating the procedures the same furthered Congressional intent.[110] In refusing to compel arbitration, the court's decision hinged on the fact that arbitration is binding while mediation is not, and that there was no evidence suggesting Congress intended to include mediation in the Federal Arbitration Act.[111]

3. Arbitration

Arbitration is another common form of ADR. It involves submitting a dispute to a third-party administrator that appoints an arbitrator through certain procedures. The arbitrator then hears the parties' dispute and issues an award that the parties often agree in advance to be bound by.

One of the reasons arbitration is so prevalent is that the parties' agreement to arbitrate is heavily protected by state and federal laws. The Federal Arbitration Act ("FAA") strongly favors enforcement of arbitration clauses in commercial contracts.[112] This law allows a party subject to a contract with an arbitration clause to petition a federal court to stay any litigation and to compel arbitration.[113]

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[108] *See CB Richard Ellis, Inc. v. Am. Envtl. Waste Mgmt.*, No. 98-CV-4183(JG), 1998 WL 903495, at *2 (E.D.N.Y. 1998) (noting that "[b]ecause the mediation clause in the case at bar manifests the parties' intent to provide an alternative method to 'settle' controversies arising under the parties' agreement, this mediation clause fits within the Act's definition of arbitration.") (citing 9 U.S.C. § 2).

[109] No. 03-2662-GTV-DJW, 2005 WL 701270, at *5 (D. Kan. Jan. 20, 2005).

[110] *Id.*

[111] *Id.* at *6.

[112] The FAA specifically provides that "[a] written provision in…a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction…shall by valid, irrevocable, and enforceable, save upon grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2; *See also, Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983).

[113] *See, e.g.*, *High Country Dealerships, Inc. v. Polaris Sales, Inc.*, No. 1:18-CV-00078-MR-DLH, 2018 WL 3620494, at *2-3 (W.D.N.C. July 30, 2018) (court compelled arbitration under the FAA after dealer agreement was terminated where there was: (i) a dispute between the parties, (ii) a written agreement that contained an arbitration provision purportedly covering the dispute, (iii) a transaction related to interstate or foreign commerce, and (iv) failure, neglect or refusal of one party to arbitrate the dispute).

Arbitration can offer various advantages over litigation. Like mediation, arbitration may provide for a more rapid resolution of disputes and the ability to select decision makers with relevant experience. Arbitration proceedings also tend to be more procedurally relaxed than litigation.[114]

There are some disadvantages. Due to the limited scope of judicial review, arbitration awards are generally unappealable. Critics also complain about the perceived tendency by some arbitrators to issue compromise awards and never rule fully in favor of either party.

Despite these concerns, many franchise agreements require arbitration for some or all disputes arising under them or relating to the franchise relationships.[115] Even the most broadly-worded arbitration provision usually excludes claims relating to the franchisor's intellectual property or right to enforce restrictive covenants.

Frequently designated arbitration administrators include the American Arbitration Association ("AAA") and JAMS (formerly Judicial Arbitration and Mediation Services). To initiate a proceeding, either party must file a "Demand for Arbitration," which is similar to filing a complaint in court.[116] The responding party has a period to file an answer or counterclaims. Under most administrator rules, the failure to file an answer is deemed a denial of all claims by that party—which is a significant difference from most court rules. Next, the administrator leads the arbitration selection process, which is either governed by the parties' express agreement or the administrator's rules. The arbitrator then sets the duration and scope of discovery, any other pre-hearing deadlines, and the final hearing deadline. After the final hearing occurs, the arbitrator issues an award.

An award is merely a piece of paper until a court turns it into a judgment. The FAA provides that if a party applies to the proper court for an order confirming an arbitration award, the court "must grant such an order unless the award is vacated, modified, or corrected as prescribed in Sections 10 and 11 of the [FAA]."[117] These sections set forth certain technical grounds for modifying or correcting an award as well as egregious grounds for vacating an award, such as when the award is procured by corruption, fraud, or undue means.[118]

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[114] *See*, *e.g.*, American Arbitration Association Commercial Arbitration Rules, R-31(a) ("Conformity to legal rules of evidence shall not be necessary.").

[115] A detailed discussion of arbitration proceedings is beyond the scope of this paper. For more on this topic, see Bethany L. Appleby, Richard L. Rosen and David L. Steinberg, *Inside a Franchise Arbitration*, ABA 31st Annual Forum on Franchising (October 2008).

[116] *See*, *e.g.*, www.adr.org.

[117] 9 U.S.C. § 9.

[118] 9 U.S.C. §§ 10-11.

In 2008 the Supreme Court held in *Hall Street Associates, LLC v. Mattel, Inc.*, that Section 10 and 11 of the FAA are the exclusive grounds for vacating, modifying, or correcting an arbitration award, and cannot be supplemented by contract.[119] This ruling created uncertainty regarding the viability of a judicially-created standard for vacating arbitration awards that involved a "manifest disregard of the law."[120] Federal circuit courts remain split regarding whether manifest disregard of the law is still a viable ground on which to overturn an arbitration award.[121] Although the precise standard for overturning an arbitration award may vary, courts routinely confirm arbitration awards absent unusual events during the arbitration process.

B. Judicial Enforcement

1. Damages

The franchise agreement often defines the types of damages that may be available to the franchisor following breach or termination of the franchise agreement. For example, many franchise agreements contain liquidated damages provisions. These provisions entitle a franchisor to recover a certain amount from the franchisee following termination of the franchise agreement based on a formula – *e.g.*, 100% of the royalty fees paid during a specific period. Courts scrutinize these provisions to assess their reasonableness before enforcing them.[122]

Even absent a liquidated damages provision, a franchisor may recover lost future royalties.[123] Recovery of such damages is not certain and varies by jurisdiction. In *Postal Instant Press, Inc. v. Sealy*, the court held that a franchisor that terminated its franchisee for failure to pay royalties was not entitled to recover lost future profits.[124]

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[119] 552 U.S. 576, 584 (2008).

[120] In dicta in the 1953 case of *Wilko v. Swan*, the Supreme Court mentioned "manifest disregard" while discussing the power to vacate arbitration awards, spawning a significant body of case law that treated manifest disregard as a separate judicially-created basis to vacate arbitration awards. 346 U.S. 427 (1953); *See, e.g., Daesang Corp. v. NutraSweet Co.*, 85 N.Y.S.3d 6, 16 (N.Y. App. Div. 2018) (discussing *Wilko* and how the limited doctrine of "manifest disregard" gives extreme deference to arbitrators).

[121] *See Abbott v. Mulligan*, 440 F. App'x 612 (10th Cir. 2011) (noting Circuit split in continued application of manifest disregard of law standard).

[122] *See*, *e.g.*, Dennis R. LaFiura and David S. Sager, *Liquidated Damages Provisions and the Case for Routine Enforcement*, 20(4) Franchise L.J. 175 (Spring 2001); Restatement of Contracts (Second) 356(1) (1981) ("Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss. A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty.").

[123] A full discussion of the recoverability of lost future royalties is beyond the scope of this paper. For additional discussion, see Joseph Schumacher and Kimberly Toomey, *Recovering Lost Future Royalties in a Franchise Termination Case*, 20(3) Franchise L.J. 116 (Winter 2001).

[124] 51 Cal. Rptr. 2d 365 (Ct. App. 1996).

The court reasoned that the franchisor's decision to terminate—not the franchisee's breach—was the proximate cause of the franchisor's loss of the future royalty stream.[125] The court further reasoned that recovery of such amounts would be unconscionable.[126]

Not all courts follow the reasoning in *Sealy*. In 2011, the Fourth Circuit weighed in on this issue in *Meineke Car Care Centers, Inc. v. RLB Holdings, LLC*, which involved a franchisee that had closed its four units prior to the end of the franchise term.[127] Following the unauthorized closure, the franchisor terminated the franchisee and filed suit for prospective royalties and advertising fund contributions.[128] The court ultimately determined that the franchisee's abandonment, rather than the subsequent termination by the franchisor, was the proximate cause of the franchisor's lost profits such that the franchisor was not barred from recovering future damages.[129]

Franchisors may also be entitled to statutory damages in connection with terminations. In the case of a "holdover franchisee," or a franchisee that continues to operate using the franchised system following termination of the franchise agreement, the Lanham Act—which governs federal trademark infringement and counterfeiting claims—authorizes recovery of any actual damages proximately caused by infringement of a registered trademark.[130] Critically, the Lanham Act allows for treble damages if the infringement was willful.[131]

A franchisor may also recover damages against holdover franchisees under the counterfeiting provisions of the Lanham Act. The counterfeiting provisions state that in cases of willful counterfeiting, the court shall enter judgment for treble profits or damages, whichever amount is greater, together with reasonable attorneys' fees, unless there are some extenuating circumstances.[132] Counterfeiting remedies are of significant

[125] *Id.*

[126] *Id.*

[127] 423 F. App'x 274, 2011 WL1422900 (4th Cir. 2011).

[128] *Id.* at 278.

[129] *Id.* at 289; *See also Medicine Shoppe Int'l, Inc. v. TLC Pharmacy, Inc., et al.*, Bus. Franchise Guide (CCH) ¶ 14,416 (E.D. Mo. 2010) (no recovery of future license fees following termination of a license agreement where the license agreement did not expressly provide that the licensee's obligation to pay license fees survives termination).

[130] 15 U.S.C. § 1114; Unregistered trademarks can be protected under Section 43(a) of the Trademark Act, 15 § U.S.C. 1125.

[131] *See*, *e.g.*, *U.S. Structures, Inc. v. J.P. Structures, Inc.*, 130 F.3d 1185 (6th Cir. 1997) (awarding franchisor past profits and trebled profits).

[132] 15 U.S.C. § 1117(b). In the alternative to these damages, § 35(c) of the Act, 15 U.S.C. § 1117(c), offers an option of statutory damages ranging between $500 and $100,000 per counterfeit mark per type of goods/services sold, or if the court finds that the use of the counterfeit mark was willful, up to $1,000,000 per counterfeit mark per type of good/services sold.

economic value to franchisors, particularly because these judgments may not be dischargeable in bankruptcy.

2. Injunctive Relief

To enforce termination and compliance with the franchise agreement, franchisors often seek preliminary and permanent injunctive relief from the courts. Although routine in the franchising context, injunctions are generally considered an extraordinary and drastic remedy that are closely scrutinized by the courts.[133]

To obtain an injunction, the moving party must demonstrate (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.[134] Courts vary in how these factors are applied and weighed, such as whether each must clearly favor the moving party or if a sliding scale approach is more appropriate.

Often the two most important factors of the test are the franchisor's likelihood of success and ability to demonstrate irreparable harm. If franchisors cannot show, for example, that the agreement was properly terminated and that the franchisee is continuing to operate without authorization, then the inquiry ends there. If, however, termination is proper and the former franchisee continues to use the franchisor's marks, then the franchisor has likely met its burden. As one leading commentator explained: "[I]f, as a matter of contract law, a service mark or a trademark license has ended, the licensee has no right to continue use of the licensed mark. Any such use is without the trademark owner's consent and constitutes infringement."[135]

The second important requirement is demonstrating irreparable harm. Irreparable harm is a harm that cannot be remedied by a subsequent award of monetary damages.[136] Courts historically have been willing to presume that trademark infringement constitutes irreparable harm as a matter of law.[137] In recent years,

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[133] *Mazurek v. Armstrong*, 520 U.S. 968, 972 (1997).

[134] *See*, *e.g.*, *Winter v. Natural Res. Def. Council*, 555 U.S. 7 (2008).

[135] J. Thomas McCarthy, TRADEMARKS AND UNFAIR COMPETITION § 25:31 (4th ed. 2011).

[136] *GNC Franchising, LLC v. Masson*, No. CIV.A. 05-1613, 2005 WL 3434076, at *3 (W.D. Pa. Dec. 13, 2005) (denying franchisor's request for preliminary injunction, finding that any harm suffered could be remediated by monetary damages and therefore was not irreparable.)

[137] *See*, *e.g.*, *Pappan Enterprises, Inc. v. Hardee's Food Sys., Inc.*, 143 F.3d 800, 805 (3d Cir. 1998) ("once the likelihood of confusion caused by trademark infringement has been established, the inescapable conclusion is that there was also irreparable injury."); *S&R Corp. v. Jiffy Lube Int'l, Inc.*, 968 F.2d 371, 378 (3d Cir. 1992) ("[b]ecause we have concluded that [the franchisor] is likely to prove at trial

however, some Courts have questioned the continued viability of this presumption.[138] Even if irreparable harm is not presumed, franchisors might establish it by showing that the franchisee's unauthorized use of trademarks causes a loss of control over the franchisor's reputation.[139]

In challenging the franchisor's request for injunctive relief relating to a termination or seeking its own injunctive relief to prevent the termination, the franchisee may emphasize the irreparable harm that it will suffer from enforcement of the termination of the franchise agreement. Courts will balance these harms as contemplated in the third prong of the test. With holdover franchisees, courts generally find the harms are self-inflicted and not cognizable, such that a franchisor would not be precluded from enforcing its rights.[140]

The final factor considers the public interest. A franchisor might argue that the public has an interest in the enforcement of valid contracts to avoid confusion about a formerly-authorized unit.[141]

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that [the franchisee] is infringing its trademark, we find that [the franchisor] has *a fortiori* alleged irreparable injury.").

[138] *Century 21 Real Estate LLC v. All Prof'l Realty, Inc.*, No. CIV. 2:10-2751, 2011 WL 221651, at *13 (E.D. Cal. Jan. 24, 2011) (granting preliminary injunction despite questioning viability of presumption because of risk of damages to Century 21's marks, goodwill and reputation).

[139] *See* J. Thomas McCarthy, TRADEMARKS AND UNFAIR COMPETITION § 30:47 (4th ed. 2011) (there is irreparable harm because the owner "will probably lose control of its reputation because this reputation rests upon the quality of defendant's activities as a result of a likelihood of confusion of purchasers. Such a likelihood of damage to reputation is by its nature 'irreparable.'"). Courts also have recognized that a franchisee's continued unauthorized operations constitutes irreparable harm because it inhibits the franchisor's ability to secure a legitimate franchisee in the same territory.

[140] *See Pappan*, 143 F.3d at 805 (awarding preliminary injunction to franchisor where any difficulties faced by the franchisee "were brought on by its own conduct in continuing to use the [] marks despite the termination of the franchise agreements"); *Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd.*, 970 F.2d 273, 277 (7th Cir. 1992) (awarding preliminary injunction to franchisor where franchisees "have only themselves to blame" and franchisees' "dubious showing" is balanced against "the real though unquantified harm to the [franchisor] of being forced to continue doing business with [such] a franchisee"); *S&R Corp.*, 968 F.2d at 379 (affirming preliminary injunction where former franchisee "brought much of the difficulties of which he complains upon himself"); *Huang v. Holiday Inns, Inc.*, 594 F.Supp. 352, 356 (C.D. Cal. 1984) ("a franchisor is not precluded from exercising its right to terminate a franchise in a reasonable, good faith manner merely because the franchisee will suffer great hardship as a result of the termination.").

[141] In the trademark context, public interest "is most often a synonym for the right of the public not to be deceived or confused." *Pappan*, 143 F.3d at 807; *Opticians Ass'n of Am. v. Indep. Opticians of Am.*, 920 F.2d 187, 198 (3d Cir. 1990) ("Having already established that there is a likelihood of consumer confusion created by the concurrent use of the ... marks, it follows that if such use continues, the public interest would be damaged. Conversely, a prohibition upon [defendants'] use of the marks would eliminate that confusion.").

The same factors must be met to obtain injunctions to enforce other common provisions in connection with franchisee termination, such as noncompetition covenants. The law in this area, however, varies widely compared to claims related to trademark infringement.[142]

[142] *See generally*, *Covenants Against Competition in Franchise Agreements* (Michael R. Gray & Natalma M. McKnew, 3d ed. 2012).