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Basics Track:

Franchise Defaults and Terminations – Best Practices

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I. Introduction¹

This paper addresses the basics of franchise defaults and terminations, but beware that there is nothing “basic” about a franchise default and termination. Defaults and terminations are based upon subjective and objective criteria, along with the interplay of the terms of the Franchise Agreement, and various state franchise relationship laws.² In addition, there are system-wide, economic and franchisee ramification issues that should be considered with any default and termination. What does the termination of a particular franchisee mean to the system, how will that termination be received, will it be challenged, and will it be upheld in court should the termination be challenged by the franchisee? Also, there are the economic consequences to termination – not only losing an operating unit in the franchise system and the potentially diminished revenue (assuming the franchisee was not in default for failure to pay royalties or other monetary obligations) – but the perception ramifications of a closed unit to the general public and brand harm, and the costs of enforcing termination.

These and many other factors should be evaluated before triggering the termination. Given that there can be negative implications to the franchisor with a termination, even if it is valid and justified, a franchisor would not want to regret a termination simply because the default and termination process was perfunctory.

We will take you through some of the various aspects of the default and termination process and will primarily be from the franchisor perspective in terms of the engagement of the default and termination process, to enforcement. It will also address certain franchisee perspectives. Note that the paper focuses on the franchisor initiating the default and termination process, even though there are, at times, opportunities for a franchisee to place a franchisor in default.

¹ This paper serves primarily as an update to the sterling work of last year’s authors Judy Marsh, Eunice Nakamura and Leslie Smith, *Franchise Defaults and Terminations – Best Practices*, 50th Annual Legal Symposium, May 7-9, 2017. We would like to acknowledge both them and the fine work of previous authors, including Harris J. Chernow, Stephen Hagedorn, and Leslie Smith, *Best Practices for Handling Defaults and Terminations*, 47th Annual Legal Symposium, May 4-6, 2014; and 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; and their exceptional papers (and each of the iterations of this topic before them by other fine authors.) As this topic has been so well presented in the past there is no reason not to make the best use of all these authors’ prior good work.

² This paper does not address myriad distributorship and sales representative termination laws enacted in many states.

The authors recommend this document be utilized as a basic guide with the understanding that there are numerous nuances to the default and termination process, which modulates the use of a good due diligence default and termination policy and a review of the written agreements between the parties along with the potentially relevant state laws before one begins the default and termination process. Keep in mind that a franchisor by virtue of the termination process is “taking” a business away from a franchisee. If a franchisor must resort to the courts (or arbitration) to enforce a termination, it may be highly scrutinized and a marginal or very subjective default and termination determination by a franchisor will not be well received by the court or arbitrator.

We will begin with the process that a franchisor should engage in when drafting the default and termination provisions of its franchise agreement and, from there, identify the issues and problems that may give rise to a default and termination, review the state relationship laws, the steps necessary to initiate the default and termination, and how to work through the eventual enforcement of the termination (or resolution of the default).

II. Drafting Default and Termination Provisions in the Franchise Agreement

As with almost any point of contention that may arise during the franchise relationship, the parties’ starting point will be the language of the franchise agreement. As such, the franchisor should invest considerable time carefully considering how to draft the default and termination provisions on which it will inevitably need to rely in the future. The franchisor must balance its desire to draft language that affords it the broadest ability to protect the franchise system by issuing notices of default or termination against the franchisee’s desire to feel confident that its good standing under the agreement is not subject purely to the whims of the franchisor. For example, although a franchisor may wish to retain the ability to issue a default notice at any time in its sole discretion, such a one-sided right will likely prove untenable during the negotiation of the agreement and may even be considered unconscionable by some courts. Striking an appropriate and reasonable balance is key.

In addition, the drafter must also juggle the use of broad, catch-all language to describe what gives rise to an event of default or basis for termination while also identifying specific acts or inactions that may be easy to anticipate and are deserving of particular attention. Some of the most common bases for defaults and terminations are discussed in Section IV.B. and the franchisor should consider making specific reference to some, if not all, of those instances in the franchise agreement.

Once the initial drafting process is complete, the franchisor should also give thought to which, if any, of the default and termination provisions it has included are open to negotiation during the sales process. While certain rights reserved to the franchisor should properly be considered off limits, others may be subject to compromise. Making those decisions in advance of the franchise sales process can help a franchisor remain consistent from one agreement to another, thereby helping to maintain a degree of consistency across the franchise system.

III. Identifying Potential Problems Before They Arise

The best way to avoid a franchisee default and/or termination is to identify potential problems while they are in their infancy. Early identification of potential problems allows the franchisor to work with the franchisee to develop acceptable solutions, which are often cheaper and less disruptive to a franchise system than defaulting or terminating a franchisee. The early identification and resolution of potential problems also serve to strengthen the franchise relationship, which can increase the chances that a franchisee will be successful and/or at least overcome the default and potential termination.

A. Early Warning Signs of Problems in the Relationship

Certain signs can indicate that problems are looming for the franchisee. These signs can act as an early warning system for the franchisor and should prompt the franchisor to further investigate the franchisee.³ These early warning signs are both financial and non-financial.

1. Financially-Related Red Flags

Financially-related red flags are often easier for a franchisor to identify because many of them can be found in the ordinary course of a franchisor's accounting. Below are some common financial issues that may indicate a serious problem.

- Failing to Make Payments. A franchisee fails to timely make royalty, lease, marketing or other recurring payments. While a single late payment may be innocuous, if the franchisee is repeatedly failing to timely make payments or fails to make several different types of payments, this can be a sign that the franchisee is unwilling or unable to make those payments.
- Failing to Provide Financial Reporting. A franchisee fails to timely provide required financial reports, such as profit and loss statements and balance sheets. Failure to provide such financial reports can be a sign that the franchisee is trying to conceal an unstable financial situation.
- Decreased Financial Performance. As a result of technological connectivity between the systems of the franchisor and franchisee, franchisors may be able to identify any dramatic drop in a franchisee's financial performance before the franchisee's periodic reporting occurs. Such an isolated, precipitous decline may be an indicator of problems requiring immediate attention.

³ Once red flags start to appear, the franchisor should review the applicable franchise agreement's default and termination provisions to determine if the franchisee's behavior is addressed in those provisions and to determine the potential remedies and required procedures for those events.

- Inability to Use Credit with Vendors. A franchisee's vendors refuse to extend credit to the franchisee and are requiring the franchisee to pay for goods with cash on delivery (C.O.D.). When vendors put a franchisee on C.O.D., that franchisee likely has already been late with several payments and may have a significant payable outstanding to the vendor. This lack of extension of credit terms can indicate that the franchisee may soon be unable to make other payments, such as royalty or lease payments.
- Canceling or Failing to Renew Insurance. A franchisee cancels or fails to renew its required insurance. Failure to maintain or renew required insurance is often a signal that the franchisee has insufficient funds on hand.
- Unexplained Borrowing. A franchisee who borrows funds for reasons not immediately clear to the franchisor. Excessive borrowing could eventually result in the franchisee missing payments owed to the franchisor.
- Other Default Notices. A franchisor may receive notices from a lender that the franchisee is in default under its loans. Such defaults could, in turn, portend that the franchisee may also be unable to make its payments to franchisor.
- Liens and Assessments. The imposition of any tax or mechanics liens or other assessments upon the franchisee or the premises on which the franchise is operated is a warning sign of problems with the franchisee. If the government or a contractor has problems collecting money from the franchisee, it indicates a problem with the franchisee's cash flow.

2. Non-Financial Red Flags

Non-financial red flags may not be as obvious as financial red flags, but they can similarly indicate that a franchisee may soon develop serious problems. Maintaining a strong relationship with franchisees is often the best way to detect these non-financial red flags before these problems become too damaging and uncorrectable.

- Failing to Follow System Standards. A franchisee who fails to comply with the franchise system's standards. Some specific failures the franchisor should watch for include a franchisee offering products or services that are outside the system or a franchisee failing to secure vendor and other contracts required by the franchisor.
- Operational Issues. A franchisee has numerous or repeated operational issues. Issues such as failing to maintain clean and updated premises, follow health code requirements, keep required records, or properly train franchisee personnel are all red flags. If a franchisee exhibits a pattern of such operational issues, the franchise relationship may already be in trouble.

- Acting as a “Loner”. A franchisee begins acting as a “loner,” declining to interact with the franchisor or participate in promotions or other marketing activities. The franchisee may refuse to respond to direct requests from the franchisor. While such actions may not be too disruptive in the beginning, they may indicate that the franchisee is distancing him/herself from the system and may decide in the future not to comply with the franchise system standards or other requirements.
- Extra-Territorial Operations. A franchisee operates or sells outside of a designated territory. Even if there are only a few instances of extra-territorial operations, these should be addressed promptly as such operations can impact not only the franchisee’s relationship with the franchisor, but also the franchisor’s relationship with other franchisees and create confusion with customers.
- Failing to Comply with Trademark, Confidentiality and Other Restrictions. A franchisee fails to comply with restrictions outlined in the franchise agreement. Failure to comply with restrictions that relate to the franchisor’s confidential materials and trade secrets, as well as the misuse of the franchisor’s trademarks, should be particularly worrisome to the franchisor because repeated or excessive violations of these restrictions could have severe consequences on the franchise system, such as the loss of customer goodwill.
- Increased Incidence of Complaints or Claims. A franchisee has experienced an uptick in the number of customer complaints or in the number of claims, including employment claims. Worse yet, if the franchisee has litigation filed against it. An increase in complaints, claims or litigation could indicate more serious underlying problems.
- Persistent Turnover. A franchisee has persistent employee turnover. This is especially worrisome if the turnover is in the franchisee’s managers. In addition to turnover in the franchisee’s employees, turnover in outside professionals, such as accountants and lawyers, could also suggest problems.

B. How to Respond to the Early Warning Signs

When warning signs appear, the franchisor should reach out to the franchisee to further investigate the situation and try to determine why the signs are appearing. As with most relationships, open and early communication is essential to ensuring any problems are revealed and addressed. Robust discussions about all phases of the franchisee’s operations should be had because simply addressing the identified issues may leave underlying issues unresolved. While robust discussions are necessary, a franchisor should be mindful that it will be accountable for what is said by its representatives so the franchisor’s field personnel should be aware of what they can say and should not say.

While an open dialogue will be very important in responding to any early warning signs, both the franchisor and franchisee should also endeavor to manage expectations. A franchisor will not be able to immediately resolve a franchisee's issues, nor will a franchisor be able to devote unlimited resources to addressing the franchisee's problems. A franchisor should not suggest or imply to the franchisee that the franchisor will be able to provide such assistance or achieve immediate results.

Similarly, a franchisee that evinces one or more of the issues described above may not be able to correct these problems overnight and may have real difficulties in complying with some of the franchisor's remedial requests. Accordingly, the franchisor should not expect immediate and unquestioned compliance. Instead, the franchisor and franchisee should discuss realistic solutions and come to an understanding regarding what is expected from each party.

IV. Considerations in Deciding to Default/Terminate

If the franchisee will not comply with the terms of the franchise agreement, then the franchisor must decide whether to default (and possibly terminate) the franchisee. While not all defaults result in termination, a franchisor should avoid sending default notices unless the franchisor is ready, willing and able to follow through with a termination should the need arise. Although at times a default or termination is the clear answer (e.g., if the franchisee has failed to pay a royalty or been convicted of a serious crime), reaching that decision is often very difficult because it is an explicit acknowledgement that the franchise relationship has failed in that particular circumstance. Such decisions can be made even more difficult if the franchisor has invested considerable time and resources in assisting the franchisee. Additionally, defaulting or terminating a franchisee can have negative consequences if done improperly. For instance, defaulting a franchisee will negatively impact the franchise relationship, while an improper termination will often be very expensive and potentially embarrassing. Thus, prior to deciding whether to default or terminate a franchisee, the franchisor should analyze the facts and the law surrounding the proposed default or termination to decide whether the action makes sense in that particular circumstance. Additionally, a franchisor should consider the impact of the proposed termination on the franchise system and other franchises. This analysis is critical since once the default process commences, a franchisor must be prepared to follow through with termination if the franchisee does not cure. Failure to do so signals to the franchisee in question, and the larger franchise community, that the franchisor will not follow through in enforcing the system and franchise agreement.

A franchisor should also 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. Such review ensures, as much as possible, that there is a contractual or statutory basis for issuing the default or termination notice and minimizes the risk that the default or termination notice may be the basis of litigation in the future.

Below is a list of considerations a franchisor should review prior to making a determination regarding default or termination.

A. Gather Facts and Information

The franchisor should first gather the relevant facts and information relating to the franchisee. A good starting point to begin such a review is with the franchisor's own files that pertain to the franchisee. The franchisor should review files from legal, franchise sales and operations, accounting and any other department having relevant information about the franchisee. The goal of reviewing one's own files is to obtain a comprehensive understanding of the franchisee and its history of operations. Avoid the urge to focus only on the specific circumstances that gave rise to the possible default or termination. It is beneficial to have an understanding of the history of the relationship between the franchisor and franchisee and mitigating factors a franchisee might raise.

After reviewing information regarding the franchise relationship generally, the franchisor should focus on the specific circumstances that gave rise to the possible default or termination. This information can be obtained by reviewing inspection or incident reports, and by interviewing relevant personnel who have specific knowledge of the situation.

At this stage, the franchisor should consider the type of failure at issue and determine whether the failure warrants proceeding with the default process. Not all technical defaults warrant a notice of default. The franchisor must determine if the default is material and whether it is significant enough to proceed with the default process or might be better handled through other means.

B. Review the Franchise Agreement

After the franchisor has a sufficient understanding of the franchisee and the facts surrounding the situation, the franchisor should review the franchise agreement. This is a critical step to ensure that a default or termination is proper. If the requirements in the franchise agreement are not followed, a default or termination may not be effective and could expose the franchisor to breach of contract and other claims.

When reviewing the contract, the franchisor should first determine the possible contractual bases for the proposed default or termination of the franchisee. The franchisor must identify one or more provisions of the franchise agreement that the franchisee has actually breached. Such breaches may include the following:

- Monetary Defaults – 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.
- Operational Defaults – 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.

- Competing with the Franchise System – where a franchisee obtains an interest in a competing franchise system or otherwise competes with a franchisor's franchise system in violation of the franchise agreement's terms. This might also be a situation where a franchisee is selling non-approved goods or services.
- Unapproved Transfer– where a franchisee transfers its rights in the franchise or in the franchisee entity to another party without approval from the franchisor.
- Performance and/or Quota Defaults – where a franchisee fails to meet sales or purchase quotas or performance standards.
- Failure to Devote Best Efforts – where a franchisee fails to devote substantial full-time efforts to the franchise as required by the franchise agreement.
- Violation of Law – where a franchisee violates local, state or federal law, especially if related to health or public safety.
- 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 a material fact in the information furnished to the franchisor in connection with its decision to enter into an agreement with the franchisee.
- Adverse Impact on Goodwill of the Brand – where the franchisee's conduct casts the brand in an unfavorable light, often where the franchisee has had legal problems, such as criminal behavior.

Once a contractual basis for default or termination has been identified, the franchisor must review the actual mechanics of the default or termination process in the franchise agreement. For instance, does the franchise agreement require the franchisor to provide the franchisee notice and/or an opportunity to cure and how long does the franchise agreement state the cure period must be? Should notice be provided to others? For example, do any applicable guarantees require the franchisor to provide the guarantor notice or do any applicable comfort letters require notice to the lender? A franchisor may also find it prudent to review the franchisee's post-termination obligations at this time to identify where non-compliance may arise.

Another avenue to explore is one that actually stops short of declaring a default. Having gathered the necessary facts and assessed their relationship to the provisions of the franchise agreement, a franchisor should consider obtaining a formal response from the franchisee before issuing a notice of default. Whether couched as an allegations letter or a notice of potential non-conformance, such interim steps can be helpful for two main reasons. First, it provides the franchisee an opportunity to correct or add to the

facts that the franchisor has already gathered so that the franchisor can make a more informed decision as to whether to resort to a notice of default or termination. And, second, in the event that the franchisee cannot rebut the allegations made by the franchisor, it provides the franchisor with more confidence that it is well-positioned to proceed with its remedies under the franchise agreement.

For in-house counsel, this is also a good time to consider getting litigation counsel involved. Because many defaults and terminations result in litigation, it makes sense to discuss the who, what, when, where and why with your litigation counsel before taking any affirmative steps. Further, litigation counsel will help you to be certain that you are creating a record that will be ultimately successful. Litigators are who will ultimately tell your story in court. There is real value in having them involved in writing the story and not simply acting it out after the script is complete. A small investment in time and legal fees at this point truly could save a great deal in the long run (not to mention helping you to avoid any unforced errors).

C. Review State Relationship Laws

A number of states have laws addressing the franchise relationship, including the default and termination of franchisees and certain unfair practices and obligations arising post-termination. Prior to proceeding with a default or termination, the franchisor should investigate if any state relationship laws would be applicable and, if so, what is the potential impact of those laws. For more information, refer to Section V., where state relationship laws are discussed in detail.⁴

D. Review Potential Counterclaims and Defenses

Prior to proceeding with a default or termination, the franchisor should evaluate the potential counterclaims and defenses available to the franchisee. If the circumstances surrounding the situation provide the franchisee with a particularly strong counterclaim or defense, the franchisor may decide that another course of action is preferable. Even if the franchisor decides to move forward with a default or termination, recognizing the defenses and counterclaims available to the franchisee will help the franchisor prepare accordingly. Some of the more common franchisee claims and defenses are discussed below.

1. Good Faith and Fair Dealing / Good Cause

A common claim asserted by defaulted or terminated franchisees is that the franchisor acted in bad faith. These claims are generally couched as either a breach of the implied covenant of good faith and fair dealing or a lack of good cause to terminate. The covenant of good faith and fair dealing generally states that one party to a contract will not do anything that will impair the right of the other party to the contract from

⁴ Consideration also should be given to whether any post-termination non-competition provision is enforceable which could factor into the decision to terminate. See, e.g., Cal. Bus. & Prof. Code § 16600.

receiving the benefits of the contract.⁵ The good cause requirement is enshrined in various state franchise laws and generally prohibits franchisee termination without adequate justification.⁶

Generally a termination completed according to the terms of the franchise agreement will be upheld. In *Pennington's, Inc. v. Brown-Forman Corp.*, the court found that a supplier did not violate the distributorship agreement even though the supplier had no reason for termination.⁷ The court held that the distributorship agreement allowed for termination and noted that the express terms of a contract overrode the implied covenant of good faith and fair dealing. In *Dayan v. McDonald's Corp.*, a franchisee attempted to argue 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.⁸ The court held that if good cause exists for termination then there is no bad faith on the part of the franchisor, regardless of its motives.

In some instances franchisees have been successful in challenging a termination. For example, in *Dunkin' Donuts of America, Inc. v. Minerva, Inc.*, the franchisor attempted to terminate a franchisee based upon the results of a series of audits.⁹ A magistrate judge dismissed the franchisor's motion for judgment n.o.v. and stated that a reasonable jury could find that the franchisor breached its implied duty of good faith and fair dealing. The judge specifically noted that the audits on which the termination was based appeared retaliatory and relied upon previously undisclosed and inaccurate methods. The judge went on to state that the franchisor lacked good cause for termination because the franchisor failed to demonstrate any intentional underreporting. The Eleventh Circuit upheld the findings of the magistrate judge.

Retaliation is never a proper motive for a default or termination. Setting moral and equitable arguments aside, the franchisor will not be the sympathetic party in litigation, and thus care should be taken to make certain that franchisor's default or termination does not have the appearance of having a retaliatory motive. However, this is often easier said than done in franchise relationships that have been contentious over a long time and where there is ill will on both sides.

Similarly, the court found that a brewer breached the duty of good faith and fair dealing owed to a distributor even though the distributor was insolvent.¹⁰ A bankruptcy

⁵ See Restatement (Second) of Contracts § 205 (1981).

⁶ See *infra* Section V. (explaining state relationship laws).

⁷ Bus. Franchise Guide (CCH) ¶ 10,260 (9th Cir. 1993).

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

⁹ Bus. Franchise Guide (CCH) ¶ 9,988 (11th Cir. 1992).

¹⁰ *In re Globe Distributions, Inc.*, Bus. Franchise Guide (CCH) ¶ 9,821 (Bankr. D.N.H. 1991).

court held that the brewer actually did not know at the time of termination whether the distributor was insolvent and could not repay its obligations. Instead, the brewer used the insolvency of the distributor as a pretext for terminating the distributor. The court found that while the brewer had legitimate reasons to be concerned regarding the distributor's ongoing viability, the brewer's actions in plotting the termination of the distributor violated the spirit of the distributorship agreement.¹¹

In one case, a bankruptcy court refused to recognize the purported termination by the franchisor even when the franchisor followed the termination procedures in the franchise agreement because the franchisor acted in bad faith.¹² The court reviewed the circumstances that led up to the termination and found that the termination of the franchisee was in bad faith as retaliation for the franchisee refusing to sell the franchised units back to the franchisor.¹³

2. Discrimination

Related to a claim that a termination was made without good cause is a claim that the franchisor discriminated among its franchisees.¹⁴ Five states specifically prohibit discrimination between franchisees.¹⁵ Generally, these laws and regulations prohibit the franchisor from treating similarly situated franchisees in an inconsistent manner. This prohibition would apply to inconsistencies in a number of areas, including the amount of royalties required or the amount charged for goods, services, or advertising services. Claims alleging discrimination often turn on whether the terminated franchisee is similarly situated to other franchisees that were not terminated.

For instance, in *Canada Dry Corp. v. Nehi Beverage Co.*, the Seventh Circuit held that a soft drink franchisee's discrimination claim failed as a matter of law because

¹¹ *Id.*

¹² *In re Paris Health Sys. Mgmt., Inc.*, Bus. Franchise Guide (CCH) ¶ 9,608 (Bankr. N.D. Ill. 1990).

¹³ *Id.*

¹⁴ Indeed, some claims of discrimination have been brought as claims for breach of the implied covenant of good faith and fair dealing. 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 of breach of the implied covenant where bagel shop franchisor allegedly discriminated between franchisees in extending financial assistance); *Venta, Inc. v. Frontier Oil and Ref. Co.*, Bus. Franchise Guide (CCH) ¶ 10,286 (D. Colo. 1993) (recognizing common law claim of breach of the implied covenant arising from fuel supplier's alleged charging two distributors a higher price than its other customers).

¹⁵ 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)).

the franchisee did not produce any “evidence of more favorable treatment of *similar* bottlers under *similar* marketing conditions.”¹⁶ In that case, the franchisee argued that the franchisor unfairly discriminated against it by refusing to offer the franchisee an advertising program for ginger ale and by prematurely terminating its franchise agreement. The court noted that the franchisee failed to demonstrate that it was either as qualified to initiate the soft drink program as those bottlers who were offered the program or that it was more qualified than the bottlers who also were excluded from the program. In addition, as to termination, the court determined that the plaintiff’s evidence that the defendant/franchisor had never terminated any of its bottlers, including those that shared some of plaintiff’s own deficiencies, was inadequate to establish a *prima facie* case of discrimination under the Indiana Deceptive Franchise Practices Act.

In *Implement Services, Inc. v. Tecumseh Products Co.*, a franchisor’s decision to require its distributor to obtain products from one particular central warehouse was driven by geographical considerations.¹⁷ The court found the complaining distributor was not similarly situated to distributors near the Ohio border that had a choice of purchasing from an Illinois or Ohio warehouse because the complaining distributor’s location was not adjacent to the Ohio border. Thus, because the distributor failed to show that it was similarly situated to distributors receiving more favorable treatment, it could not recover for unfair discrimination.¹⁸

Finally, federal discrimination statutes may be available to a franchisee. For instance, 42 U.S.C. § 1981 prohibits discrimination on the basis of race in the making, performance, modification and termination of contracts. To state a *prima facie* claim of discrimination under § 1981, a franchise owner would have to show that he or she (1) is a member of a protected class; (2) suffered an adverse decision in connection with a franchise agreement; and (3) was treated differently than similarly situated nonprotected franchisees.¹⁹

3. Waiver

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 that provision. For instance in *CJ Restaurant Enterprises Inc. v. FMS*

¹⁶ Bus. Franchise Guide (CCH) ¶ 8,090 (7th Cir. 1983).

¹⁷ Bus. Franchise Guide (CCH) ¶ 9,649 (S.D. Ind. 1989).

¹⁸ See also *Wright-Moore Corp. v. Ricoh Corp.*, Bus. Franchise Guide (CCH) ¶ 9,665 (7th Cir. 1990) (finding that a terminated national distributor that was not offered a regional distributorship was not similarly situated to another terminated “national” distributor who was offered the dealership when the other “national” distributor operated in smaller region of the country).

¹⁹ 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).

Management Systems, Inc., a franchisor and franchisee entered into a stipulation and agreed order relating to the franchisee's repeated failures to stay current on payments owed to the franchisor.²⁰ Even after the stipulation, the franchisee continued to be late in its payments. The franchisor accepted these late payments and did not default the franchisee for its delinquency. Eventually, the franchisor attempted to declare that the franchisee breached the stipulation due to the late payments. The court held that the franchisor had waived its right to terminate the stipulation on these grounds as the franchisee reasonably concluded that the late payments were not a default under the stipulation.²¹

While most franchise agreements include an anti-waiver provision, a terminated franchisee may still attempt to argue that the inconsistent enforcement of the agreement was not proper. Even if ultimately unsuccessful, such arguments may be sufficient to survive a motion to dismiss and further prolong litigation. As such, a franchisor may conclude that when evaluating whether to issue a notice of default, it should err on the side of issuing such a default so as to protect its right to terminate down the line.

4. Tortious Interference

Another claim that a terminated franchisee may assert is that the franchisor tortiously interfered with the franchisee's business relationships. These claims typically suggest that the franchisor's termination of the franchisee interfered with the franchisee's business relationship with its customers and therefore damaged the franchisee. For instance, in *Machine Maintenance & Equipment Co. v. Cooper Industries, Inc.*, a court upheld a jury verdict that found that a manufacturer tortiously interfered with one of its distributors.²² The manufacturer had terminated the distributorship without providing the full notice period as required in the agreement. The manufacturer also attempted to lure away customers from the distributor before giving the distributor the termination notice. Due to these actions, a jury awarded the distributor actual and punitive damages.

While a franchisee may raise tortious interference claims, they can be difficult to prove.²³ For instance, in one case, the court did not find tortious interference on the part of the franchisor because state law required a showing of malice.²⁴ The court held

²⁰ 699 So.2d 252 (Fla. Dist. Ct. App. 1997).

²¹ *Id.*

²² Bus. Franchise Guide (CCH) ¶ 8,896 (E.D. Mo. 1987).

²³ As an initial matter, a franchisee cannot claim that the franchisor tortiously interfered with the franchise agreement. See, e.g., *Cromeens, Holloman, Sibert, Inc. v. AB Volvo*, Bus. Franchise Guide (CCH) ¶ 12,746 (7th Cir. 2003) ("a party cannot tortiously interfere with its own contracts").

²⁴ *Romacorp, Inc. v. TR Acquisition Corp.*, Bus. Franchise Guide (CCH) ¶ 10,360 (S.D.N.Y. 1993).

that the franchisor had legitimate business reasons for terminating the franchise agreements and did so without malice.²⁵ In another case, a court found that a farm equipment dealer was not entitled to an award for tortious interference because the manufacturer had properly complied with the termination provisions of the contract.²⁶

5. Compliance with Local Law

Most franchise agreements are governed by the law of the state where the franchisor is located. However, in some cases, because of public policy considerations and states' desire to protect their citizens, franchisors also need to follow the state laws where their franchisees operate. If they fail to comply with such state laws, a franchisee may have a basis to defend against a franchisor's claims. State relationship and disclosure laws should be reviewed when defending any claim against a franchisee. Additionally, some states have restrictions or limitations on the enforcement of non-competition provisions in franchise agreements.

A franchisee may be able to defend against a claim by asserting that the franchisor did not follow the applicable state relationship law. Notwithstanding choice of law provisions, the relationship law where the franchisee operates must be followed. For example, if the franchise agreement is governed by Illinois law, but the franchisee is located in Connecticut, the franchisor would have to give proper notice under Connecticut law. Only providing 30 days' notice with opportunity to cure a default is sufficient under Illinois law,²⁷ but not under Connecticut law, which requires 60 days' notice.²⁸ Under Connecticut law, a franchisee may recover damages and obtain injunctive relief for violation of the notice requirement.²⁹

Another possible defense a franchisee may have against default or termination is that the sale of the franchise was improper in the first instance.³⁰ Like state relationship

²⁵ *Id.*

²⁶ *Crothwait Equipment Co., Inc. v. John Deere Co.*, Bus. Franchise Guide (CCH) ¶ 10,364 (5th Cir. 1993).

²⁷ 815 Ill. Comp. Stat. Ann. 705/19 (Illinois requires good cause for termination; however, the statute identifies four situations where notice is not required).

²⁸ Conn. Gen. Stat. Ann. § 42-133f(a) (Connecticut also requires good cause for termination. Several other states require 30 days' notice, including New Jersey, Rhode Island and Washington.).

²⁹ Conn. Gen. Stat. Ann. § 42-133f(n).

³⁰ See, *Brader v. Minute Muffler*, 914 P.2d 1220, 1222 (Wash. Ct. App. 1996) (where the trial court granted a franchisee's summary judgment motion finding that the franchisor violated the Franchise Investment Protections Act by failing to register and distribute required pre-sale information.).

laws, a franchisor must comply with the disclosure law of the state where a franchisee operates. A defense against a franchisor may be that it provided a FDD not registered in the franchisee's home state. A franchisee may be able defend on the basis of impropriety even if the statute of limitations for an affirmative claim has expired.³¹

Often times, when a franchise agreement has been terminated or expires, a franchisee continues to operate a business similar to the franchise. Here, a franchisor is likely to seek to enforce a non-competition provision of a franchise agreement. There are a number of defenses related to these provisions.³² A franchisee may demonstrate that the clause is over broad, or that that the franchisor has failed to enforce them against other franchisees.³³ And, in California, most non-competition agreements are prohibited.³⁴

E. Assess Benefits to Avoiding Termination

If the franchisor has reached the stage where it is considering terminating a franchisee, the franchisor likely believes it has good reasons for the termination. A franchisee may owe considerable royalties or advertising fees, or has continually refused to comply with certain aspects of the franchise system. The franchisor may have a good basis for termination and believes that the franchisee will not have good defenses or counterclaims to the termination. However, this should not be the end of the franchisor's considerations. The franchisor should also assess the benefits that may result from not terminating a problem franchisee.

One primary reason to avoid termination is to maintain the flow of royalties, advertising fees and other payments. While the failure to pay royalties and make other payments may be part of the reason the franchisor is considering termination, the actual

³¹ 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.").

³² See *Fantastic Sams Salons, Corp. v. Maxie Enterprises, Inc.*, No. 3:11-CV-22 CDL, 2012 WL 210889, at *3 (M.D. Ga. Jan. 24, 2012)) (where the court found a non-competition clause prevented a former franchise from competing for two years was "unenforceable due to its unreasonable scope restrictions).

³³ See *Baskin-Robbins Inc. v. Patel*, 264 F. Supp. 2d 607, 611 (N.D. Ill. 2003) (citing *Quizno's Corp. v. Kampendahl*, 2002 WL 1012997, *7 (N.D.Ill.2002)) (discussing irreparable harm and disregard of non-competition agreements).

³⁴ 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).

termination of the franchisee ensures that the franchisor no longer will receive any such payments.³⁵ Even if the franchisee had been paying such fees previously, that franchisee will likely immediately stop payment once termination proceedings start. By examining available alternatives to termination, the franchisor may be able to 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 also serve to increase the payments collected by the franchisor.

Termination not only cuts off the flow of royalty and other payments, it could also lead to a dramatic increase in legal fees for the franchisor. While certain terminations may appear to be straightforward, even these terminations can quickly become very expensive – both in terms of legal fees and in resources the franchisor will have to devote to the matter. For instance, if the franchisee does not immediately cease operations under the franchise trademarks, injunctions and litigation will likely follow. Such expenses might be avoided on the front end by pursuing a course of action that does not involve the termination of the franchisee.

F. Assess Impact on System and Other Franchisees

As an initial matter, the termination of a franchisee will directly impact the existing customers of that franchisee. When the franchisee does shut down, there is the potential that the franchise system will lose these customers – there is no guarantee that these customers will return to that particular unit if it is re-opened by a different franchisee or that the customers will seek out another unit. Additionally, these customers may identify the now-closed unit with the franchisor's trademarks and reflect poorly on the quality or viability of the entire franchise system.

Not only could termination impact customers and their perception of the franchise system, a termination may have a tangible effect on the franchise system and other franchisees. One consideration is the effect of the termination on the other franchisees' view of the franchisor and the brand. In large franchise systems, a single termination is not likely to have a considerable effect on franchisee sentiment. However, if the franchise system is relatively small or there have been a number of other recent franchisee defaults or terminations, then the impact of the termination on other

³⁵ While it is true that the franchisor could seek lost future royalties, such claims can be difficult to obtain. See, e.g., *Postal Instant Press, Inc. v. Sealy*, Bus. Franchise Guide (CCH) ¶ 10,893 (Cal. Ct. App. 1996), where a California appellate court held that lost future royalties were not a proper element of contract damages for three reasons (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 is 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. Additionally, the franchisee could be judgment proof, which would prevent recovery. For further discussion see *infra* Section VIII.B.1.

franchisees could be substantial. To ameliorate the impact of a termination in such circumstances, the franchisor should consider how to present the termination to its franchisees. By casting the termination as a benefit to the franchise system – because it protects the goodwill of the brand – the franchisor can address some of the potential concerns of existing franchisees. In some situations with particularly poor operators, other franchisees may actually appreciate the termination.

Consideration also should be given to possible increased costs of goods to the system, negative PR to the brand, impact on nationwide accounts serviced by that franchisee, notice to lenders and landlords that may be required, and the impact on the relationships with those parties.

The termination of a franchisee could also have an effect on prospective franchisees. First, a franchisor will have to disclose the number of franchisees who have left the system in Item 20 of its next franchise disclosure document (“FDD”).³⁶ If litigation occurred as a result of any termination, this litigation will have to be disclosed in Item 3 of the FDD.³⁷ These disclosures could create a negative impression upon prospective franchisees. Second, if the franchisor’s current franchisees believe that the franchisor is quick to terminate, this negative perception can get back to prospective franchisees. Thus, the franchisor should carefully consider how a termination may affect prospective franchisees.³⁸

G. Assess Viable Alternatives to Termination

When considering whether to terminate a franchisee, a franchisor should assess whether alternatives exist to termination. One of the most common alternatives to terminating a troubled franchisee is by using workouts. A workout is an agreement between the franchisee and franchisor, and any other relevant parties, whereby the franchisor provides some assistance to the franchisee or agrees to waive certain

³⁶ 16 C.F.R. § 436.5(t). As a result of the most recent NASAA commentary on financial performance representations (“FPRs”), 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.

³⁷ *Id.* § 436.5(c).

³⁸ If the franchisor terminates a large number of franchisees, consideration may need to be given as to whether the FDD should be amended. 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).

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 its obligations under the franchise agreement, all defaults, the franchisor's remedies; agreed repayment terms or agreed terms for the cure of non-monetary defaults; the franchisor's agreement to forbear from exercise of its remedies; a release; any modification of terms of the franchise agreement; and a cross-default provision providing that a default under the workout agreement would be a default under the franchise agreement. Regardless of the precise details, the primary importance of the workout is that all parties involved acknowledge the benefit of the franchisee continuing to operate the franchised unit.

V. Navigating the Labyrinth of State Relationship Laws³⁹

As noted in Section IV.C., a number of states have laws addressing the franchise relationship, including the default and termination of franchisees and certain unfair practices and obligations arising post-termination. In general, depending on the state, the relationship laws may extend the notice period for default and/or termination, determine what qualifies as a default, and/or provide for certain remuneration in connection with defaults. It is critical that a franchisor determine what, if any, state relationship laws may apply, as a failure to do so could complicate the situation or create liability for the franchisor. It, therefore, is important to determine the exact location of the franchisee and the unit and not to assume the information in the franchise agreement remains accurate.

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

Currently 19 states, and Puerto Rico and the Virgin Islands, have enacted franchise statutes that govern termination of the franchise relationship by the franchisor. While general trends can be identified, no two statutes are exactly the same. For instance, under most of these statutes, a franchisor must have good cause prior to termination. However, the definition of good cause can vary among these state relationship laws. Similarly, some of these statutes require that a franchisor provide notice and an opportunity to cure prior to termination but the time periods can vary as well as the exceptions to the notice and cure requirements. Accordingly, a franchisor should identify the applicable state relationship law, if any, that applies and what that state law requires.

B. Jurisdictional Application of State Relationship Laws

Determining what state relationship law applies requires an analysis of the jurisdictional application of the relevant state relationship law. A handful of the states with relationship laws do not specifically address the jurisdictional application of the

³⁹ See Appendix A for a Summary of State Restrictions on Termination.

termination provisions, but the majority do state when the law applies.⁴⁰ Out of the states that do address the jurisdictional application, Arkansas, Connecticut, Delaware, Illinois, Iowa, Maryland, Missouri, Nebraska, New Jersey, Rhode Island, Virginia, Wisconsin, and Puerto Rico have the narrowest jurisdictional application. In these jurisdictions, a franchisor must comply with the termination provisions in the relevant law only if the franchised unit is actually located within the state.

The jurisdictional application of the California⁴¹ and Indiana⁴² relationship laws are slightly broader. As with the states discussed above, the California and Indiana relationship laws apply to situations where the franchised unit is located within the state. The California relationship law, however, also applies if the franchisee is domiciled in California, while the Indiana relationship law also applies if the franchisee is a resident of Indiana.

The states with the most comprehensive jurisdictional application are Michigan and Minnesota. The Michigan relationship law applies if (1) the franchised unit is in Michigan, (2) the franchisee is domiciled in Michigan, or (3) the offer to buy the franchise is accepted in Michigan.⁴³ The Minnesota relationship law applies if (1) the franchised unit is in Minnesota, (2) a sale is made in Minnesota, or (3) an offer to sell or purchase is made or accepted in Minnesota.⁴⁴

As these states have varying jurisdictional application provisions, a franchisor should familiarize itself with the applicable laws. Franchisors should also recognize 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.⁴⁵

C. Conditions Required Prior to Termination

⁴⁰ Hawaii, Mississippi, Washington and the Virgin Islands do not have specific provisions addressing the jurisdictional application of the termination restrictions in their franchise relationship laws.

⁴¹ Cal. Bus. & Prof. Code § 20015.

⁴² Ind. Code. Ann. § 23-2-2.5-2.

⁴³ Mich. Comp. Laws § 445.1504.

⁴⁴ Minn. Stat. Ann. § 80C.19.

⁴⁵ To head off such claims, franchisors often elect to include a carve-out in the choice of law provision that designates that the laws of a particular state apply but then specifically states that the choice of law provision would not serve to make any franchise relationship law applicable if it would otherwise not be applicable.

As mentioned above, most of the state relationship laws require good cause for termination and also impose mandatory notice and cure periods. However, the precise details of these requirements vary among the state relationship laws. A franchisor must closely examine the relevant state law to understand the applicable requirements governing termination.

1. Good Cause

Out of the states that do have a good cause requirement, a number of them simply provide a general definition of good cause.⁴⁶ 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 agreement. Some of these states go further and outline specific situations that constitute “good cause” for termination.⁴⁷ The situations outlined in these statutes typically 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. Franchisors should keep in mind that, when specific situations are outlined, these laws typically provide that the outlined situations are not exhaustive of what constitutes good cause.⁴⁸

Other states that require good cause include a more thorough definition of what constitutes good cause than what was discussed in the preceding paragraph. For instance, Iowa has the general definition of good cause discussed above but also includes a requirement that the termination not be arbitrary and capricious.⁴⁹ Wisconsin⁵⁰ and the Virgin Islands⁵¹ define good cause as the failure of the franchisee

⁴⁶ 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.

⁴⁷ The states that outline specific examples of circumstances constituting good cause include Connecticut, Illinois, Minnesota and Rhode Island. On the other hand, 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).

⁴⁸ See, e.g., Conn. Gen. Stat. § 42-133f(a) (“good causeshall 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.”).

⁴⁹ Iowa Code § 523H.7.

⁵⁰ Wis. Stat. § 135.02(4).

⁵¹ V.I. Code Ann. tit. 12A, § 132.

to comply with material and reasonable requirements of the franchisor. They go on to state that good cause exists only if the franchisee has breached these material and reasonable requirements if such requirements have been uniformly enforced across the franchise system or the franchisee has demonstrated bad faith.

The jurisdiction with arguably the highest “good cause” standard is Puerto Rico.⁵² Puerto Rico’s relationship law states that “just cause” is required for termination. “Just cause” only occurs when (1) the franchisee fails to perform under an essential provision of the franchise agreement or (2) 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. In addition to the “just cause” requirement, the Puerto Rico relationship law has added requirements for certain types of terminations. 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 in an adverse or substantial manner the interests of the franchisor.⁵³ If the termination is based on a provision in the franchise agreement outlining rules of conduct or distribution goals, the franchisor must show that the rule of conduct or distribution goal was reasonable in light of the “realities of the Puerto Rican market” at the time of the violation.⁵⁴

Finally, two states, Delaware⁵⁵ and Virginia,⁵⁶ impose a requirement of good cause for terminations but do not further define what constitutes good cause. In situations such as these where good cause is not defined, a franchisor can look to what constitutes good cause in other states for general guidance.

2. Cure and Termination Periods

If a franchisor decides to terminate a franchisee, many states have mandatory notice and/or cure periods. Mandatory cure periods can vary widely in length of time, but three general trends emerge in state relationship laws. First, a number of states do not mandate a cure period but do require notice of termination. Second, some states mandate a cure period but do not mandate a specific number of days; instead, these states just require that the franchisee is provided a “reasonable” opportunity to cure. Finally, some states require a franchisor to provide its franchisees with a specific number of days to cure.

⁵² P.R. Laws Ann. tit. 10, § 278a-1.

⁵³ *Id.* § 278a-1(a).

⁵⁴ *Id.* § 278a-1(c).

⁵⁵ Del. Code Ann. tit. 6, § 2552.

⁵⁶ Virginia actually requires “reasonable cause.” See Va. Code Ann. § 13.1-564.

Connecticut, Delaware, Indiana, Mississippi, Missouri, Nebraska, New Jersey, and the Virgin Islands are the jurisdictions that do not require a cure period but do require notice prior to termination. Connecticut, Nebraska and New Jersey require a notice period of 60 days; Delaware, Indiana⁵⁷, Mississippi and Missouri require a notice period of 90 days; and the Virgin Islands requires a notice period of 120 days.

The second group of states require a mandatory cure period but do not mandate that the cure period be a specific number of days. This group includes Hawaii, Illinois, Michigan and Washington. These states require a cure period that is “reasonable,” which generally means that the cure period need not be longer than 30 days.⁵⁸ These states also require that a franchisor provide a notice of termination but, as with the cure period, they do not specify how much notice a franchisor must provide.

The final group of states dictate how long the cure period is required to be. This group includes Arkansas, California, Iowa, Maryland, Minnesota, Rhode Island and Wisconsin. Arkansas, Maryland 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 not less than 60 days or more than 75 days;⁵⁹ and Iowa requires a “reasonable” cure period that is between 30 and 90 days long. The cure periods in Rhode Island and Wisconsin decrease to 10 days in the case of monetary defaults. Similarly, the cure periods in Arkansas are decreased to 10 days in the case of multiple defaults in a 12-month period. These states also require that a franchisor provide notice of termination to the franchisee. This notice period generally ranges from 60 to 90 days depending on the state. Sometimes the notice period is reduced depending on the particular type of default.⁶⁰

D. Incurable Defaults

For certain defaults that are particularly damaging to the franchise system or trademarks, a franchisee will be unable to cure the default. Examples of incurable

⁵⁷ Indiana allows a contract provision to override the statutory requirement. 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.”)

⁵⁸ 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).

⁵⁹ 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.

⁶⁰ 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).

defaults include the commission of a crime by the franchisee, a declaration of bankruptcy by the franchisee or a violation of standards that affects health or safety.⁶¹

Many of the states that require a mandatory cure period recognize the reality of incurable defaults and attempt to specifically identify such defaults.⁶² These states allow the franchisor to immediately terminate without providing a cure period for certain identified defaults. For instance, Washington allows for termination without giving the required notice or cure period if the franchisee (1) is bankrupt or insolvent; (2) assigns the assets of the franchised business to creditors; (3) voluntarily abandons the franchised business; or (4) is convicted of violating any law relating to the franchised business.⁶³

While the examples outlined in various state relationship laws provide an indication of what types of defaults are deemed incurable, case law may provide additional guidance as to what constitutes an incurable default. Generally, 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 had admitted that it had deliberately diverted business to a subsidiary in order to hide profits and avoid paying royalties to the franchisor.⁶⁴ In this case, no franchise relationship law was applicable but the franchise agreement required notice of termination and an opportunity to cure. 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.⁶⁵

While many courts recognize that defaults going to the "essence" of a contract are incurable, at least one court has rejected this idea. In *Manpower Inc. v. Mason*, an employment agency franchisee failed to provide required I-9 forms to its temporary employees.⁶⁶ The franchisor contended that obtaining completed I-9 forms was essential because the franchised business is supplying *legally qualified* temporary workers. Instead of using the "essence of the contract" standard for an incurable breach, the court defined 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

⁶¹ See generally Jason J. Stover, *No Cure, No Problem: State Franchise Laws and Termination for Incurable Defaults*, 23 Franchise L.J. 217 (Spring 2004).

⁶² Arkansas, California, Illinois, Maryland, Minnesota, Rhode Island, Washington and Wisconsin allow for immediate termination in certain circumstances.

⁶³ Wash. Rev. Code § 19.100.180(2)(j).

⁶⁴ Bus. Franchise Guide (CCH) ¶ 14,058 (Pa. 2009).

⁶⁵ *Id.*

⁶⁶ Bus. Franchise Guide (CCH) ¶ 13,155 (E.D. Wis. 2005).

to meet a sales quota within a specified time.”⁶⁷ The court stated that breaches that go to the “essence of a contract” allow for rescission of that contract but not termination.⁶⁸

In states with relationship laws, courts have also found that various actions by a franchisee can excuse the franchisor from complying with statutorily mandated notice and cure periods. In *Harnischfeger Corp. v. Superior Crane Corp.*, a dealer had misappropriated a manufacturer’s designs and proprietary information and was manufacturing its own unauthorized replacement parts for the manufacturer’s equipment.⁶⁹ The court held that the manufacturer was not required to provide the dealer an opportunity to cure, required under Wisconsin’s relationship law, because the dealer’s “bad faith” acts were not subject to the cure provision in that statute.⁷⁰

In *NOVUS du Quebec, Inc. v. NOVUS Franchising, Inc.*, a subfranchisor failed to require its franchisees to comply with the franchise system and the subfranchisor also franchised units associated with another franchisor.⁷¹ The court found that the franchisor was not required to provide the statutorily mandated cure period because the cure period would be “futile” given the widespread violations by the subfranchisor.⁷²

If a franchisor encounters a situation where it considers a default to be incurable, state relationship laws and case law may provide guidance. If the default at issue is not addressed by an applicable statute or the case law, a franchisor will have to weigh the value of terminating the franchisee without a cure period against the risk of claims of unlawful termination.

E. Buyback Provisions

In addition to good cause and notice/cure provisions, some state relationship laws also require the franchisor to repurchase, or “buyback,” certain items upon termination of the franchisee. The states with such buyback provisions are Arkansas, California, Connecticut, Hawaii, Maryland, Rhode Island, Washington and Wisconsin.⁷³ As with good cause and notice/cure provisions, these buyback provisions can vary widely. These provisions differ as to under what circumstances a franchisor has to

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ Bus. Franchise Guide (CCH) ¶ 10,618 (E.D. Wis. 1995).

⁷⁰ *Id.*

⁷¹ Bus. Franchise Guide (CCH) ¶ 10,823 (D. Minn. 1995).

⁷² *Id.*

⁷³ See Appendix A.

buyback items, what items must be repurchased and what price must be paid for those items.

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, upon a lawful termination, the franchisor must repurchase items from the franchisee except under certain defined scenarios.⁷⁴ In Maryland, the buyback provision applies in all cases of termination except for certain enumerated “egregious” acts or omissions by the franchisee.

As to what a franchisor has to buyback, 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 the possession of the franchisee or used by the franchisee in the franchised business.⁷⁵ Maryland limits this requirement to merchandise sold by the franchisor to the franchisee. Some states further limit the buyback requirement. For instance, 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.

Finally, state buyback provisions differ as to what price a franchisor has to pay to repurchase the required items. In many states, the fair market value or the fair wholesale market value is used. However, 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

⁷⁴ 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.

⁷⁵ 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 the franchisee’s current resalable inventory.

price paid, minus depreciation. In Maryland, the price depends on a variety of factors including the type of item and the timing of the original purchase.

VI. Steps in the Default/Termination Process

Broadly speaking, a franchisee's failure to comply with a franchise agreement falls into two general categories: monetary defaults and non-monetary defaults. For each of these categories, the steps that begin the default/termination process vary somewhat.

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 a franchise agreement. When a franchisee payment is deficient or delinquent, the accounting department should investigate and confirm the nature and extent of the delinquency. If the accounting department confirms that a payment was not timely received or could not be successfully auto-debited from the franchisee's account, consideration should be given to whether to "jump" right to a notice of default or whether the franchisor's staff should reach out less formally to the franchisee to determine why payment was not received. An initial "friendly warning" by the accounting department can put the franchisee on notice that payment has not been made and that the franchisor expects prompt steps to remedy any deficiency, without escalating the situation.

The accounting department's initial overture to the franchisee may assume a variety of forms or tones, depending on the nature of the monetary default, and the particular franchisee's history of non-compliance. For a first-time, or unwitting, offender, a simple inquiry may be all that is necessary to prompt the franchisee to remit all amounts owed to the franchisor. However, the friendly warning may not necessarily result in compliance, in which case the franchisor's legal department may need to be brought in.

Even if an initial overture by the accounting department is unsuccessful and the legal department is brought in, the franchisor may not choose to default the franchisee at this juncture. Instead, a more formal notice, or request for compliance, can be sent. Such an approach may make the franchisor appear reasonable and cordial, which may encourage the franchisee to respond in a similar cordial manner and also may shine a positive light on the franchisor in the event that litigation ultimately ensues.

2. Non-Monetary Defaults

Just as the franchisor's accounting department is the first line of defense in monetary defaults, franchise business consultants and field representatives are the first line for operational defaults. A franchisor's field representative is typically the one who will first observe an operational default, in the course of either a routine visit or a formal inspection, and inform the franchisee of the deficiency. What happens next will depend on the severity of the default.

For run-of-the-mill operational deficiencies, the field representative may provide the franchisee a task list noting the issues and the required actions for addressing the same. If the franchisee takes the required corrective action, and the field representative confirms the same, the situation ends there.

If the franchisee does not comply with the actions requested by the field representative, the franchise administration and legal department should be notified, as it may be necessary to formally default the franchisee to force compliance. For more serious issues - for example, issues that may jeopardize the health or safety of customers - it may not be appropriate for the field representative to work informally with the franchisee to address the defaults and fashion a cure. A formal notice of default may be more appropriate and necessary to mirror the severity of the situation.

Regardless of the severity of the default, and whether it is initially addressed more informally at a lower level or through more formal default proceedings, the franchisor and its staff should take care to ensure that all issues are thoroughly and carefully documented. Establishing a complete record is a good practice generally, and will be useful should the franchisee's non-compliance become an issue again or if the franchisee and franchisor end up in litigation.

B. Notice of Default

Unless the franchisor is prepared to terminate the non-compliant franchisee, a default notice should not be sent. If the franchisor does not follow through, the franchisor has signaled to the franchisee in question and the larger franchise community that it will accept non-compliant behavior.

Once the franchisor has made the decision to formally place a non-compliant franchisee in default, a notice of default must be prepared. A notice of default should serve three primary functions. First, it should formally notify the franchisee of a default of the franchise agreement, identifying and referencing the specific provisions being violated and the actions causing the violations. Second, it should identify what actions, if any, the franchisee can take to cure the default. Finally, it should provide the necessary groundwork in case the franchisor needs to terminate the franchisee including a clear statement of the consequences of the franchisee's non-compliance. When drafting a notice of default, a franchisor should review the franchise agreement and relevant state relationship laws and take time to consider what specifically to include in the notice.

1. Franchise Agreement/State Statutes

As discussed above, some state relationship laws specifically require franchisors to send notices of default and provide the franchisee an opportunity to cure the default.⁷⁶ Sometimes a state relationship law mandates cure periods of different lengths depending on the type of default.⁷⁷ If there is a relevant state relationship law, the franchisor should review such a law to confirm the relevant cure periods and any other requirements.

As an initial matter, the franchisor should confirm that there is an actual basis for declaring the franchisee to be in default of its obligations. The franchisor should then review the default provisions in the franchise agreement to determine whether there are any mandated cure periods and how long such a cure period is required to be. Generally, if the cure period in the franchise agreement differs from that mandated by state law, the longer cure period should be used. Finally, the notice provisions in the franchise agreement should be reviewed. These provisions will inform the franchisor exactly how the notice of default can be delivered (*e.g.*, first-class mail, courier, email, etc.) as well as tell the franchisor where to send the notice. These provisions may also indicate when to start the cure period. For instance, should the franchisor begin counting from the day the notice is sent, the day it is received, or should the franchisor use some other date?⁷⁸

2. Content

As mentioned above, a notice of default should clearly state the facts constituting the default (or defaults), the requirements for a successful cure, 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 default or defaults apply. Additionally, if the default concerns a single franchise agreement, but a “cross-default” is permitted and the franchisor intends to cross-default other units, this fact needs to be specifically stated.

Finally, 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 outlined in the franchise agreement, a duplicate notice should be sent to wherever the franchisor thinks is necessary so that the franchisee receives actual notice. The franchisor should also forward the notice to any guarantors and consider forwarding it to

⁷⁶ See *supra* Section IV.C.

⁷⁷ For example, Rhode Island and Wisconsin require 30 and 60 day cure periods respectively, but these cure periods are reduced to 10 days for monetary defaults. See *supra* Section V.C.2.

⁷⁸ Consideration also should be given to sending a second copy of the default notice by another method (*e.g.*, UPS, Federal Express or first class mail) to minimize the risk of the franchisee claiming that he or she did not receive the notice.

other parties with an interest in the franchisee, such as a lender. Obtaining proof of delivery also is recommended so that the franchisor can calculate when the cure period commences.

C. Notice of Termination

A notice of termination formally ends the franchise relationship. Generally a notice of termination will follow a notice of default after any required cure period has expired. However, a cure period is not always required and the notice of termination will be the only formal notice received by the franchisee. In other situations, a franchisor may decide to send a hybrid notice of default and termination.⁷⁹ Such notices are often called a “self-executing default notice” because they provide notice of the default and automatically terminate the franchise relationship if the default is not cured.⁸⁰ Regardless of the type of termination notice, a franchisor should review termination restrictions in the franchise agreement and state relationship laws and then consider what to include in the actual termination notice.

1. Franchise Agreement/State Statutes

If a notice of default was previously sent, or a franchisor determined that a default notice was not required, the franchisor should already be familiar with any relevant cure or notice periods required 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 has 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 circumstances giving rise to the franchisee’s termination.⁸¹

In addition, the franchisor should review state relationship laws and the franchise agreement to determine any post-termination obligations required of the franchisor. 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.⁸² Franchise agreements typically include a number of post-termination

⁷⁹ The most common situation when hybrid notices are used is when a state relationship law requires both a cure period and notice of termination. See, e.g., Minn. Stat. Ann. § 80C.14 (requiring the provision of 60 day cure period and 90 days notice prior to termination).

⁸⁰ If a self-executing notice is used, the franchisor may want to send a “letter of termination” that formally states that the franchise agreement has been terminated and reminding the franchisee of its post-termination obligations.

⁸¹ Arkansas, Connecticut, Delaware, Illinois, Iowa, Maryland, Minnesota, Nebraska, New Jersey, Rhode Island and Wisconsin all require a notice of termination to describe the basis of the franchisee termination.

⁸² See *supra* Section IV.E.

obligations of the franchisee (such as de-identification with the brand) in the event of termination or non-renewal. The franchisor should become familiar with such post-termination obligations so it will know how to proceed once the termination is effective.

2. Content

As stated above, many state relationship laws require a notice of termination to include all bases for termination. Even if not required by the state relationship law, it generally is a good idea to include the reasons why the franchise agreement is terminated. The notice of termination should also specifically state the effective date of termination.⁸³ This date could be upon the franchisee's receipt of the termination notice, the expiration of any required cure period, or some other date.

In addition to the basis for termination and effective date of termination, the notice of termination should set forth the post-termination obligations of the franchisee as well as any post-termination covenants that apply to the franchisee. For some post-termination obligations, such as any requirement that the franchisee de-identify the unit, the franchisor may also request written confirmation or proof from the now-terminated franchisee that these obligations have been met.

Finally, 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 of the termination notice should also be sent to any guarantors or other necessary parties.

D. Cease and Desist

Ideally, after receiving a notice of termination, the noncompliant franchisee will cease operations as demanded by the franchisor (or reach an agreement with the franchisor via a workout agreement). In some cases, however, a terminated franchisee will effectively ignore a notice of termination and continue to operate as the franchised business. In such cases, the standard "last ditch" effort by the franchisor prior to enforcing its rights through judicial action is to send a "cease and desist," or demand letter. A standard cease and desist letter will recount the events leading up to the default and termination, and emphasize that the former franchisee's continued operations and unauthorized use of the franchisor's marks constitutes a violation of both the franchise agreement and laws such as the Lanham Act,⁸⁴ which protects against trademark infringement and unfair competition. The letter typically will demand that the franchisee not only cease operations and comply with its post-termination obligations, but also certify its compliance with those obligations.

⁸³ California and Maryland both expressly require that the notice of termination include the effective date of the termination.

⁸⁴ 15 U.S.C. § 1051 *et. seq.*

The effect of a cease and desist demand will depend on the specific franchisee. If the letter does not result in compliance, the franchisor will have to consider more formal ways to enforce termination.⁸⁵

E. Workout Agreements

As discussed above, workout agreements can be an alternative to termination.⁸⁶ 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 of default can lay the groundwork for a later termination if the franchisee repeats its defaults. If the franchisor and franchisee have not executed a workout agreement, a default notice can lay out the details of a proposed workout agreement in the notice and require the execution of the workout agreement as a requirement to cure the default.

VII. Dealing With Other Franchisees

A. Selective Enforcement

In the default and termination context, a franchisor must consider not only how its decisions will affect the non-compliant franchisee, but also how its actions will be viewed by the broader franchisee community. Specifically, when a franchisor decides to enforce a standard that is not widely observed in its system against a particular franchisee, members of the franchise community may view the franchisor's individualized treatment of a particular franchisee in a default or termination situation as unacceptable discriminatory treatment.

In an effort to preempt franchisee objections, many franchise agreements include explicit acknowledgements by the franchisee that franchise agreements entered into by other franchisees may include different terms, and that the franchisor's decisions with respect to other franchisees, including its decision or failure to enforce other franchise agreements, do not constitute a waiver of any rights the franchisor may have with respect to other franchisees, or as to a subsequent violation by the same franchisee. Even with such 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 franchisee.⁸⁷

⁸⁵ See *infra* Section VIII.

⁸⁶ See *supra* Section III.G.

⁸⁷ 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).

Generally speaking, a franchisor is permitted to selectively enforce the standards and provisions of its franchise agreements, and courts typically reject claims that selective enforcement by a franchisor is improper. For example, in the oft-cited case of *Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd.*, 970 F.2d 273 (7th Cir. 1992), 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." Other courts have reached similar conclusions.⁸⁸

Franchisee complaints of selective enforcement have largely been unsuccessful with the courts when the franchisor can show it had legitimate reasons for not taking similar actions against other franchisees that may have committed similar violations. For example, in *Bonanza, International v. Restaurant Management Consultants, Inc.*, 625 F. Supp. 1431 (E.D. La. 1986), 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.⁸⁹

⁸⁸ 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; 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*, Bus. Franchise Guide (CCH) ¶ 14,265 (M.D. Fla. 2009) (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; the covenant does not require 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; the court concluded that "[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.").

⁸⁹ 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.*,

Along similar lines, franchisees sometimes challenge a franchisor's efforts to enforce franchise agreement provisions by contending that the franchisor excused or waived the franchisee's non-compliance by failing to strictly enforce the franchise agreement. These arguments are generally unsuccessful when the franchise agreement contains standard anti-waiver language.⁹⁰

Discrimination claims, discussed in detail above, are closely related to complaints of "selective enforcement". Specifically, franchisees may assert that the franchisor's selective enforcement of its franchise agreements constitutes a violation of state 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 that the franchisor treats "similarly situated" franchisees in approximately the same manner and it has rational, non-arbitrary reasons for engaging in any type of alleged discrimination between or among franchisees.⁹¹

B. Communication With Other Franchisees

In the default and termination context, a franchisor must not only consider issues relating directly to the non-compliant franchisee, but also how the franchisor's actions will be viewed by the remainder of its franchisees. A franchisor should take care to ensure that its franchisees view the franchisor's actions as reasonable and fair.

A franchisor's 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 franchise 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 particular franchisee's defaults, it is important that a franchisor reassure the franchisee

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; violations of terminated franchisee were more serious, and the franchisor had warned the offending franchisee); *Petland, Inc. v. Hendrix*, Bus. Franchise Guide (CCH) ¶ 12,904 (S.D. Ohio 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).

⁹⁰ 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).

⁹¹ See *supra* Section III.D.2.

community as a whole that the franchisor is responding to the offensive conduct, and taking action to protect the system.⁹²

Of course, routine franchise defaults typically will not garner outside attention. In such contexts, the franchisor may elect to be the primary source of information to franchisees regarding system defaults and terminations. For instance, a franchisor may speak to its enforcement efforts at its annual franchisee convention, or communicate information to its franchisee advisory council, if such a council exists in the system. Communicating this information can serve dual purposes: it can reassure the broader franchisee community that the franchisor is actively working to protect the system and goodwill of all franchisees by enforcing franchise agreements and system standards, and it also can send a message to the community that the franchisor takes defaults seriously and enforces its agreements.

The flip side of communication to franchisees regarding actions the franchisor has taken to address system defaults is the potential negative perception that may result – of the franchisor as an unrelenting bully willing to mercilessly punish franchisees for their failures. Accordingly, it is important that the franchisor carefully craft its message and how it communicates with franchisees regarding defaults, so it comes across more positively as a defense of the system, and not picking on the “little guy.” Given the ease with which a franchisee can tell his side of the story, particularly through the use of social media, a franchisor must consider whether default and termination will have any impact on the brand beyond the franchisee community.

⁹² Many franchise agreements may prohibit a franchisor from disclosing whether or not a particular franchisee is in default under the franchise agreement. Such statements to the franchisee community may, therefore, need to be couched in more general terms.

VIII. Enforcing Termination

A. Non-Judicial Enforcement

1. Self-Help Remedies for Franchisors

Most franchise agreements will 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 – for example, by removing signs, symbols, logos, devices, forms and other items associated with the franchised system. Many franchise agreements include language allowing the franchisor to take certain of these actions on the franchisee's behalf, if the franchisee does not timely comply with such obligations itself. Such language may provide, for example, that if the franchisee does not properly modify and de-identify the premises of the former franchised location, the franchisor will have the right (at the franchisee's expense) to do so, without being guilty of trespass or other tort.

Even if provided for in the franchise agreement, exercise of self-help remedies may not be practical. The former franchised location may be in a place that is not geographically convenient to any of the franchisor's personnel, making it logistically difficult for the franchisor to take steps to de-identify the formerly franchised location. In addition, absent permission from the property owner, self-help is fraught with legal risk. Even if the franchise agreement provides that actions by the franchisor will be at the franchisee's expense, any effort by the franchisor to collect monies it expends in engaging in self-help likely would be challenging, given that the former franchisee is one who by definition has refused to comply with its contractual obligations.

In situations where the franchisor holds the site of the franchisee's business through a lease or sublease arrangement, hurdles to the franchisor engaging in such "self-help" decrease, since the franchisor is the ultimate owner or lessor of the premises with right of access to the same. However, even in these circumstances the franchisor will incur expenses in removing the vestiges of the terminated franchisee.

In short, while it is potentially helpful for a franchisor to reserve its right to engage in self-help, it may not always be practical to do so, and the franchisor may have to turn to other avenues for enforcing the termination of a franchise agreement – through judicial or other non-judicial remedies.

2. Mediation

Much has been written about non-judicial alternative dispute resolution ("ADR") as a means to resolve disputes. Mediation is one such non-judicial alternative. Mediation is a form of ADR in which an impartial third party – the mediator – helps parties in a dispute to negotiate a mutually-agreeable solution. Mediation is generally seen as an efficient and cost-effective way of achieving the resolution of a dispute, and is touted as offering various benefits: the parties control the mediation, mediation is confidential in nature, and mediation can facilitate the prompt settlement of disputes.

In view of these potential benefits, some franchisors include mediation clauses in their franchise agreement. Typically, the clauses will require the parties to submit certain (or all) disputes to nonbinding mediation upon the request of either party. In the event that mediation does not resolve the dispute, the clause would provide that either party may then initiate litigation.

Although mediation is controlled by the parties, and therefore varies from case-to-case, the proceedings generally assume a similar format. After a mediator is selected, he or she will typically solicit input from both parties regarding the issues in dispute (through a process established by the mediator or set forth in the parties' agreement) and receive such input prior to the actual mediation. During the mediation proper, the mediator will meet with the parties, usually in both group and individual sessions, and receive additional input regarding the issues in dispute and the parties' disagreements. After hearing both sides, it is the mediator's role to make various suggestions as to how the parties might resolve the controversy, and to assist the parties in finding potential mutually-beneficial solutions. Various organizations offer mediation services, such as the National Conflict Resolution Center, American Arbitration Association, CPR Institute, and state and local ADR organizations.

Courts are generally amenable to enforcing non-binding mediation clauses, such as those that may be set forth in a franchise agreement. Since most jurisdictions do not have laws requiring enforcement of mediation clauses, courts have extended the scope of arbitration laws⁹³ to include mediation clauses grouping arbitration and mediation under the general rubric of ADR.⁹⁴ The rationale for this extension is that both arbitration and mediation evidence the parties' desire to pursue an alternative to litigation, and that it is appropriate to apply arbitration laws to mediation agreements.⁹⁵

A handful of courts, however, have refused to enforce mediation clauses, finding that arbitration laws are not applicable because mediation is different from arbitration. For example, in *Lynn v. General Electric Co.*, the federal District Court in Kansas applied a two-step test to determine that mediation does not fall under the purview of

⁹³ The Federal Arbitration Act, 9 U.S.C. §§ 1-15 governs the enforcement of arbitration agreements. See *infra* Section VII.A.3.

⁹⁴ 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 enforceable a mediation provision, and that the lower court should have granted the motion to compel arbitration under the FAA).

⁹⁵ See *CB Richard Ellis, Inc. v. Am. Envtl. Waste Mgmt.*, 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).

arbitration.⁹⁶ The first step examined how closely the questioned procedures resembled classic arbitration, and the second step looked at whether treating the procedure the same furthered the purposes of Congress. Applying this test to mediation, the court found that arbitration laws should not extend to mediation clauses. In its analysis, the court specifically noted that arbitration is binding while mediation is not, and that there is no evidence suggesting Congress intended to include mediation in the Federal Arbitration Act.⁹⁷

3. Arbitration

Like mediation, arbitration is a form of ADR that franchisors and franchisees might pursue as an alternative to litigation. Arbitration is a form of binding ADR in which a dispute is submitted, by agreement of the parties, to one or more third parties – arbitrators – who make a binding decision on the dispute. Arbitration is an explicit alternative to going to court.

The Federal Arbitration Act (“FAA”), 9 U.S.C. §§ 1-15, strongly favors enforcement of arbitration clauses in commercial contracts.⁹⁸ 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 be valid, irrevocable, and enforceable, save upon grounds as exist at law or in equity for the revocation of any contract.”⁹⁹ 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.

Arbitration can offer various advantages over dispute resolution through 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 proceedings.¹⁰⁰

Arbitration is not without its disadvantages. Franchisors may be hesitant to include arbitration provisions in their agreements since the scope of judicial review is limited. Additionally, some criticize what is perceived as a tendency by some arbitrators to issue compromise awards, and object to instances of arbitrators who shy away from applying bright-line legal rules.

⁹⁶ 2005 WL 701270 (D. Kan. 2005).

⁹⁷ *Id.*

⁹⁸ See, e.g., *Moses H. Cone Mem’l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983).

⁹⁹ 9 U.S.C. § 2.

¹⁰⁰ See, e.g., American Arbitration Association Commercial Arbitration Rules, R-31(a) (“Conformity to legal rules of evidence shall not be necessary.”).

In view of the potential benefits of arbitration, some franchise agreements include provisions that mandate arbitration for some or all disputes arising under the agreement or in the franchise relationship.¹⁰¹ These provisions commonly carve out certain exceptions, such as the franchisor's right to seek injunctive relief in court for violations of its intellectual property rights or unauthorized disclosure of its confidential or proprietary information or the propriety of termination, particularly for monetary defaults.

Just as multiple organizations can oversee mediation, various bodies can administer an arbitration proceeding. Frequently designated bodies include the American Arbitration Association ("AAA") and JAMS (formerly Judicial Arbitration and Mediation Services). An arbitration proceeding begins when one party submits a "Demand for Arbitration," which is akin to the filing of a complaint in a court proceeding.¹⁰² The responding party then will have an opportunity to file an answer and/or counterclaims. Following submission of these initial filings, an arbitrator generally will be selected in accordance with the provisions of the franchise agreement and the procedures of the body conducting the arbitration. The process of the arbitration will be guided by the parties and the arbitrator and will generally include preliminary hearings, discovery, substantive hearings at which testimony and evidence is presented, and post-hearing submissions. At the conclusion of the proceedings, the arbitrator will issue a decision.

Once an arbitration proceeding concludes, the prevailing party typically will seek to enforce the arbitration award in federal court. The FAA provides that if a party, pursuant to its arbitration agreement, applies to a 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]."¹⁰³ These sections set forth certain egregious grounds for vacating an award and technical grounds for modifying or correcting an award, for example when the award is procured by corruption, fraud, or undue means.¹⁰⁴

In 2008, the U.S. Supreme Court held in *Hall Street Associates, LLC v. Mattel, Inc.*, that Sections 10 and 11 of the FAA are the exclusive grounds for vacating, modifying or correcting of an arbitration award, and cannot be supplemented by contract.¹⁰⁵ This ruling created uncertainty regarding the viability of a judicially-created

¹⁰¹ 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).

¹⁰² See, e.g., www.adr.org.

¹⁰³ 9 U.S.C. § 9.

¹⁰⁴ 9 U.S.C. §§ 10-11.

¹⁰⁵ 552 U.S. 576, 584 (2008).

standard for vacating arbitration awards in “manifest disregard of the law.”¹⁰⁶ Federal circuit courts remain split regarding whether manifest disregard of the law is still a viable ground on which to overturn an arbitration award,¹⁰⁷ leaving some uncertainty for parties seeking to enforce an arbitration award regarding the possible bases on which such an award may be overturned.

B. Judicial Enforcement

1. Damages

The franchise agreement likely will define the types of damages that may be available to a franchisor following a franchisee’s breach and the subsequent termination of the franchise agreement. For example, many franchise agreements contain liquidated damages provisions. Although these are drafted in different ways, typically the provisions will 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 specified preceding period. Courts will scrutinize these provisions to assess their reasonableness before enforcing them.¹⁰⁸

Following termination of a franchise agreement, a franchisor also may seek to recover lost future royalties.¹⁰⁹ While an award of lost royalties certainly can mitigate the franchisor’s losses, the recoverability of such damages is not certain, and varies by jurisdiction. In the frequently-cited case *Postal Instant Press, Inc. v. Sealy*, the California Court of Appeals held that a franchisor that terminated its franchisee for

¹⁰⁶ In dicta in the 1953 case of *Wilko v. Swan*, the Supreme Court commented on the power to vacate arbitration awards and used “manifest disregard” language in such discussion, spawning a significant body of case law that treated manifest disregard as a separate judicially-created basis to vacate arbitration awards. *Wilko v. Swan*, 346 U.S. 427 (1953).

¹⁰⁷ See *Abbott v. Mulligan*, 440 F. App’x 612 (10th Cir. 2011) (noting Circuit split in continued application of manifest disregard of law standard).

¹⁰⁸ 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.”).

¹⁰⁹ 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).

failure to pay royalties was not entitled to recover lost future royalties.¹¹⁰ The court reasoned that the franchisee's *breach* was not the proximate cause of the franchisor's damages; instead, the franchisor's *termination* was the proximate cause. The court further reasoned that recovery of such amounts would be unconscionable.¹¹¹

Following *Sealy*, courts split regarding whether lost future royalties were awardable damages in the franchise termination context.¹¹² In 2011, the Fourth Circuit weighed in on this issue in *Meineke Car Care Ctrs., Inc. v. RLB Holdings, LLC*, a case involving a franchisee that closed its four units prior to the end of the franchise term.¹¹³ Following the unauthorized closure, the franchisor terminated the franchises and filed suit for, among other things, prospective royalties and advertising fund contributions. The Fourth Circuit ultimately determined that the franchisee's breach of the agreements, rather than the consequent termination by the franchisor, was the proximate cause of the franchisor's lost profits," and that the lower court should not have granted summary judgment on the franchisor's claim for lost profits.¹¹⁴

Other damages that may be available to franchisors following termination are set forth in statutes. 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 provides various potential remedies for trademark infringement and counterfeiting. In cases of infringement, Section 32 authorizes recovery of any actual damages proximately caused by infringement of a registered trademark.¹¹⁵ A court may issue treble damages if it finds such damages necessary to compensate the trademark

¹¹⁰ 51 Cal. Rptr. 2d 365 (Ct. App. 1996).

¹¹¹ *Id.*

¹¹² See, e.g., *Kissinger, Inc. v. Singh*, Bus. Franchise Guide (CCH) ¶12,747 (W.D. Mich. 2003) (agreeing with the analysis in *Sealy* and finding that the franchisor was not entitled to recover future royalty payments, as the proximate cause of that loss was the franchisor's decision to terminate the franchise agreement); *Lady of Am. Franchise Corp. v. Arcese*, Bus. Franchise Guide (CCH) ¶13,561 (S.D. Fla. 2006) (finding that a franchisor could bring a lost future profits claim because the franchisee had effectively terminated her franchise agreement by sending a letter indicating her intention to close her franchised unit).

¹¹³ Bus. Franchise Guide (CCH) ¶ 14,586 (4th Cir. 2011) (not for publication).

¹¹⁴ 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 does not expressly provide that the licensee's obligation to pay license fees survives termination).

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

owner; such damages may be particularly appropriate if the court finds the defendant acted willfully.¹¹⁶

A franchisor also may be able to recover damages under the counterfeiting provisions of the Lanham Act when a terminated franchisee continues to use the franchisor's marks without authorization.¹¹⁷ Unlike the trademark provisions of the Lanham Act, which allow treble damages, the counterfeiting provisions of the Lanham Act 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.¹¹⁸ Accordingly, counterfeiting remedies are of significant economic value to franchisors, particularly in light of the fact that a judgment for willful infringement may not be dischargeable in bankruptcy.

2. Injunctive Relief

It is not uncommon in the franchise termination context to encounter a resistant franchisee that refuses to cease operations and comply with the post-termination obligations of the franchise agreement. To enforce termination and compliance with the franchise agreement, a franchisor may seek preliminary and permanent injunctive relief from the courts. Injunctions are considered to be "an extraordinary and drastic remedy,"¹¹⁹ and therefore are closely scrutinized by the courts.

Although the specific standards differs by jurisdiction, generally speaking, the party moving for an injunction must demonstrate (1) a likelihood of success on the merits; (2) that it will be irreparably harmed if the injunction is denied; (3) 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 (4) that the public interest favors issuance of the injunction.¹²⁰ Courts vary in how these standards are applied and weighed regarding, for example, whether each element must clearly favor the moving party or if a "sliding scale"

¹¹⁶ 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).

¹¹⁷ See, e.g., *Century 21 Real Estate, LLC v. Destiny Real Estate Props.*, 2011 WL 6736060 (N.D. Ind. 2011).

¹¹⁸ 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.

¹¹⁹ *Mazurek v. Armstrong*, 520 U.S. 968, 972 (1997).

¹²⁰ See, e.g., *Winter v. Natural Res. Def. Council*, 555 U.S. 7 (2008).

approach is appropriate (with a strong showing on one element able to offset a weaker showing regarding another).¹²¹

In deciding whether an injunction may properly issue, the merits of the termination are often the threshold inquiry. If a franchisor cannot show, for example, that the franchise was properly terminated and that the franchisee is continuing to operate without authorization, then it would not be able to show likely success on the merits and be granted an injunction.

In cases where the franchisor seeks an injunction to shut down a holdover franchisee, the franchisor generally will have a strong case that the franchisor will succeed on the merits of an infringement claim. As one leading commentator explained: “[T]he law is simple. If, 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.”¹²²

The second required showing for an injunction is a showing of irreparable harm. Irreparable harm, by definition, is a harm that cannot be remedied by a subsequent award of monetary damages.¹²³ Courts historically have been willing to presume that trademark infringement, and a mark holder’s loss of control over its marks, constitutes irreparable harm as a matter of law; in some respects, this reasoning essentially conflates the “likelihood of success” and “irreparable harm” elements of the preliminary injunction standard.¹²⁴ Following various Supreme Court decisions regarding preliminary injunctions,¹²⁵ courts have been more critical about the propriety of presuming irreparable harm.¹²⁶ Even if irreparable harm is not presumed, in the case of

¹²¹ See, e.g., *Century 21 Real Estate*, 2011 WL 6736060.

¹²² J. Thomas McCarthy, TRADEMARKS AND UNFAIR COMPETITION § 25:31 (4th ed. 2011); see also *S&R Corp. v. Jiffy Lube Int’l, Inc.*, 968 F.2d 371, 375 (3d Cir. 1992); *Pappan Enters., Inc. v. Hardee’s Food Sys., Inc.*, 143 F.3d 800, 804 (3d Cir. 1998).

¹²³ *GNC Franchising, LLC v. Masson*, 2005 WL 3434076 (W.D. Pa. 2005) (denying franchisor’s request for preliminary injunction, finding that any harm suffered could be remediated by monetary damages and therefore was not irreparable.)

¹²⁴ See, e.g., *Pappan Enters., Inc.*, 143 F.3d at 805 (“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.*, 968 F.2d at 378 (“[b]ecause we have concluded that [the franchisor] is likely to prove at trial that [the franchisee] is infringing its trademark, we find that [the franchisor] as a fortiori alleged irreparable injury.”) (emphasis in original)

¹²⁵ See, e.g., *eBay, Inc. v. MercExchange L.L.C.*, 547 U.S. 388 (2006).

¹²⁶ *Century 21 Real Estate, LLC v. All Prof. Realty, Inc.*, Bus. Franchise Guide (CCH) ¶ 14,538 (E.D. Cal. 2011) (granting preliminary injunction despite questioning viability of

a franchisor seeking an injunction to enforce termination of the franchise agreement, irreparable harm can be demonstrated in various ways, for example by the franchisor showing that the franchisee's unauthorized use of the franchisor's trademarks causes a loss of control over the franchisor's reputation.¹²⁷

Other factors may be relevant to the irreparable harm analysis. For example, many franchise agreements include covenants against competition that may be a basis on which the franchisor seeks injunctive relief. Courts have recognized the importance of covenants against competition in the franchise context in protecting against consumer confusion, loss of goodwill and loss of control over reputation. See, e.g., *Economou v. Physicians Weight Loss Ctrs. of Am.*, 756 F. Supp. 1024, 1032 (N.D. Ohio 1991). The court in *Economou* aptly summarized the harm that accrues to a franchisor as a result of the franchisee's breach of a post-termination covenant against competition:

This danger, first, is a potential harm to [the franchisor's] goodwill. In such a situation, the franchisee has gained knowledge and experience from the franchisor, and to allow the franchisee to use this knowledge and experience to serve former or potential customers of the franchisor would work a hardship and prejudice to the latter. . . . Moreover, customer confusion is always a danger in this situation, especially where the former franchisee is operating his new business out of a center previously used to serve another principal. Such confusion has the potential of leading to damage to the franchisor's tradename and reputation.

In challenging the franchisor's request for injunctive relief, a franchisee commonly will attempt to shift the irreparable harm focus to the asserted irreparable harm that the franchisee will suffer from enforcement of the termination of the franchise agreement. This speaks to the balance of harms considered as the third prong in analyzing the propriety of injunctive relief. In the case of a holdover franchisee, courts typically find the harms to the franchisee to be self-inflicted and not cognizable,¹²⁸ and therefore harms that should not preclude the franchisor from enforcing its rights.¹²⁹

presumption because of risk of damages to Century 21's marks, goodwill and reputation).

¹²⁷ See J. Thomas McCarthy, TRADEMARKS AND UNFAIR COMPETITION § 30:47 (4th ed. 2011) (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.

¹²⁸ See *Pappan Enters.*, 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

The final prong in the injunction analysis considers the public interest. A franchisor seeking an injunction to enforce termination of a franchise agreement can cite various ways the public interest would favor an injunction. For example, a franchisor could cite to the public interest in enforcing valid contracts and to avoid confusing the public into believing that the outlet is still an authorized outlet.¹³⁰

A franchisor seeking injunctive relief may request not only that the court issue an injunction to enforce the termination and discontinue the franchisee's operations, but also that the court enforce the provisions prohibiting the former franchisee from engaging in certain competitive businesses (such prohibitions being set forth in the franchise agreement).¹³¹ Although variable state laws govern the enforcement of covenants not to compete,¹³² courts will generally analyze the reasonableness of the covenant in terms of duration of the restriction, geographic scope of the restriction, and

continuing to use the ROY ROGERS 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").

¹²⁹ *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."); *Pappan Enters.*, 143 F.3d at 805 ("any difficulties [defendants] now face [ar]e brought on by [their] own conduct in continuing to use the [franchisor's] marks despite the termination of the franchise agreement[.]").

¹³⁰ In the trademark context, public interest "is most often a synonym for the right of the public not to be deceived or confused." *Pappan Enters.*, 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.")

¹³¹ See generally, Jason M. Murray and Michael R. Gray, *The Enforcement of Covenants Against Competition*, American Bar Association, 28th Annual Forum on Franchising (2005).

¹³² *Covenants Against Competition in Franchise Agreements*, Michael R. Gray and Natalama M. McKnew, Third Edition, American Bar Association Forum on Franchising (2012).

the nature of the activities that are prohibited.¹³³ If the court finds the covenant to be unreasonable, it does not necessarily mean that the franchisor is out of luck. Some jurisdictions allow courts to modify or “blue pencil” a covenant to make it enforceable,¹³⁴ and other states permit courts to delete offensive components of the covenants to make it reasonable.¹³⁵ In other jurisdictions, however, a court will decline to enforce altogether an unreasonable covenant.¹³⁶ Accordingly, a franchise seeking to enforce a covenant not to compete following termination must carefully review any applicable statutory and case law, to determine the viability of enforcement.

¹³³ See, e.g., *Jackson Hewitt, Inc. v. Dupree Roberts*, 2013 WSL 4039021 (D.N.J. Aug. 7, 2013) (finding restrictive covenant’s two year prohibition on providing tax preparation services in within a five zip codes and ten mile radius of former franchised location to be reasonable to protect franchisor’s legitimate business interests in transferring existing customers to other franchisees).

¹³⁴ See, e.g., *Armstrong v. Taco Time Int’l, Inc.*, Bus. Franchise Guide (CCH) ¶ 7,755 (Wash. Ct. App. 1981) (covenant prohibiting competition for five years post-term in the continental United States was modified to proscribe competition for two-and-a-half years post-term within the franchised territory or any other franchisee’s territory). See, also e.g., *Rockford Mfr., Ltd. v. Bennet*, 296 F. Supp. 2d 681 (D.S.C. 2003) (severability is permitted where restrictions are separately expressed or where the agreement includes a severance clause).

¹³⁵ See also, e.g., *Welcome Wagon Int’l, Inc. v. Pender*, 120 S.E.2d 739, 742 (N.C. 1961) (“The court is without power to vary or reform the contract by reducing either the territory or the time covered by the restrictions. However, where, as here, the parties have made divisions of the territory, a court of equity will ... enforce the restrictions in the territorial divisions deemed reasonable and refuse to enforce them in the divisions deemed unreasonable.”).

¹³⁶ See, e.g., *Alston Studios, Inc. v. Gress & Assocs.*, 492 F.2d 279, 285 (4th Cir. 1974) (Virginia law) (declining “to read into the agreement limitations which simply are not there”); *Watson v. Waffle House, Inc.*, 324 S.E.2d 175 (Ga. 1985) (covenant in franchise agreement strictly construed against franchisor and deemed void). See, also e.g., *Daston Corp. v. MiCore Solutions, Inc.*, 80 Va. Cir. 611 (Va. Cir. Ct. 2010) (holding that judicial reformation of restrictive covenants is discouraged). *But see*, Ga. Code Ann. § 13-8-53(d). Georgia’s restrictive covenant act adopted in 2011 made significant changes to that state’s law, including granting courts that statutory power to modify overbroad covenants.

APPENDIX A

SUMMARY OF STATE RESTRICTIONS ON TERMINATION

State	Statutory Reference	Restricts Termination	Notice/Cure Requirements	Buyback Requirement
Arkansas	Arkansas Franchise Protection Act, Ark. Code of 1987, Title 4, Ch. 72, §§ 4-72-201 through 72-210	Good cause required which includes failure to comply substantially with franchisor's nondiscriminatory practices; to act in good faith and in a commercially reasonable manner; to pay within 10 days after receipt of notice of sums past due.	90 days written notice setting forth the reasons for termination with 30 days to cure default; if multiple defaults within 12 month period 10 days period required to cure.	Yes, if termination is not for good cause
California	California Franchise Relations Act; California Business and Professions Code, Division 8, Chapter 5.5, §§ 20000 through 20043	<p>For franchise agreements entered into or renewed on or after Jan. 1, 2016, good cause required, which includes failure to substantially comply with lawful requirements of franchise agreement.</p> <p>For franchise agreements entered into or renewed prior to Jan. 1, 2016, good cause required, which includes failure to comply with lawful requirements of franchise agreement.</p>	<p>Termination: For franchise agreements entered into or renewed on or after Jan. 1, 2016, at least 60 days' notice plus reasonable (not less than 60 or more than 75 days) opportunity to cure. Some exceptions including: failure to pay amounts due within 5 days after receiving written notice; reasonable determination that continued operation will result in danger to public.</p> <p>For franchise agreements entered into or renewed prior to Jan. 1, 2016, notice plus reasonable (up to 30 days) opportunity to cure. Some exceptions including: failure to pay amounts due within 5 days after receiving written notice; reasonable determination that continued operation will result in danger to public.</p> <p>Includes other statutory requirements as to form and content of notice.</p>	<p>Yes, except for certain defined scenarios for franchise agreements entered into or renewed on or after Jan. 1, 2016.</p> <p>Yes, if termination is in violation of the statute for franchise agreements entered into or renewed prior to Jan. 1, 2016.</p>

State	Statutory Reference	Restricts Termination	Notice/Cure Requirements	Buyback Requirement
Connecticut	Connecticut Franchise Law; Connecticut Gen. Statutes, Title 42, Chapter 739, §§ 42-133e through 42-133h	Good cause required which includes refusal or failure to comply substantially with any material and reasonable obligations of the franchise agreement.	60 days written notice stating reason for termination.	Yes
Delaware	Delaware Franchise Security Law; Delaware Code Annotated, Title 6, Chapter 25, §§ 2551 through 2556	Termination or failure to renew shall be unjust if without good cause or done in bad faith—good cause and bad faith are undefined.	90 days notice must be provided.	No
Hawaii	Franchise Rights and Prohibitions; Hawaii Revised Statutes, Title 26, Chapter 482E, § 482E-6	Good cause required to terminate in accordance with current terms and standards applicable to all franchisees required, unless franchisor proves discriminatory treatment reasonable, justifiable and not arbitrary. Good cause includes failure to comply with lawful, material provisions of franchise agreement. Franchisor and Franchisee must deal with each other in good faith.	Written notice with opportunity to cure the failure in reasonable period of time.	Yes
Illinois	Illinois Franchise Disclosure Act, Chapter 815-551, §§ 705/1 through 705/44	Good cause required which includes the failure to comply with any lawful provisions of the franchise agreement.	Notice and a reasonable opportunity to cure, which need not be more than 30 days.	No
Indiana	Indiana Deceptive Franchises Practices Act, Indiana Code, Title 23, Article 2, Chapter 2.7, §§ 1-7	It is unlawful to terminate a franchise without good cause, which includes any material violation of franchise agreement, or in bad faith.	At least 90 days notice prior to termination must be provided.	No
Iowa	Iowa Franchises Law; Iowa Code, Title 523, §§ H.1 through H.17	Good cause (a legitimate business reason) only, which includes failure to comply with lawful provisions of franchise agreement provided that termination is not arbitrary or capricious compared to actions of franchisor in similar circumstances.	Termination- written notice and reasonable cure period—between 30 and 90 days.	No

State	Statutory Reference	Restricts Termination	Notice/Cure Requirements	Buyback Requirement
Maryland	Maryland Fair Distributorship Act, Annotated Code of Maryland, Article-Commerce Law, Title 11 §§ 11301-11307	Termination: Yes, within 30 days after receipt of notice, distributor may oppose termination or non renewal and, if so, distributor and grantor must make good faith effort to adapt plan to cure.	60 days when applicable.	Yes except for certain egregious acts or omissions by franchisee
Michigan	Michigan Franchise Investment Law; Michigan Compiled Laws, Chapter 445, § 445.1527	Good cause required, which includes failure to comply with lawful provisions of franchise or failure to cure.	Written notice and reasonable opportunity to cure – up to 30 days.	No
Minnesota	Minnesota Franchise Law; Minnesota Stats., Chapter 80C, §§ 80C.01 through 80C.22	Good cause is required, which includes failure to substantially comply with reasonable requirements of franchise.	Termination: 90 days written notice setting forth the reasons for termination and franchisee fails to cure within 60 days of receipt of the notice. Some exemptions.	No
Mississippi	Mississippi Franchise law; Mississippi Code Annotated, Title 75, Chapter 24, §§ 75-24-51 through 75-24-61	No	Must provide 90 days written notice, except for criminal misconduct, fraud, abandonment, bankruptcy, insolvency or giving insufficient funds check.	No
Missouri	Missouri Franchises Law; Revised Statutes of Missouri, Chapter 407, §§ 407.400 through 407.410, 407.413 and 407.420	No	Must provide 90 days written notice, except for criminal misconduct, fraud, abandonment, bankruptcy, insolvency or giving insufficient funds check.	No
Nebraska	Nebraska Franchise Practices Act, Revised Statutes of Nebraska, Article 4, §§ 87-401 through 87-410	Good cause required, which is failure to substantially comply with requirements imposed by franchise.	Must provide 60 days written notice, some exceptions.	No
New Jersey	New Jersey Franchise Practices Act; New Jersey Revised Statutes, Title 56, Chapter 10, §§ 56:10-1 through 56:10-12	Good cause required, which is failure to substantially comply with requirements imposed by franchise.	Must provide 60 days written notice, some exceptions.	No

State	Statutory Reference	Restricts Termination	Notice/Cure Requirements	Buyback Requirement
Rhode Island	Rhode Island Fair Dealership Act; General Laws of Rhode Island, Title 6, Chapter 50, §§ 1 - 9	Good cause required, which is failure to comply with the reasonable requirements imposed by the franchisor or any of a number of reasons enumerated	Must provide 60 days written notice and 30 days to cure, some exceptions.	Yes
Virginia	Virginia Retail Franchising Act; Virginia Code §§ 13.1-557, 13.1-564 and 13.1-574	Reasonable cause required.	No	No
Washington	Washington Franchise Investment Protection Act; Revised Code of Washington, Title 19, Chapter 19.100, §§ 19.100.180 and 19.100.190	Good cause required, which includes failure of franchisee to comply with lawful, material provisions of franchise agreement and failure to cure.	Termination: written notice and cure period up to 30 days. Some exceptions.	Yes, upon failure to renew
Wisconsin	Wisconsin Fair Dealership Law; Wisconsin Statutes, Chapter 135, §§ 135.01 through 135.07	Good cause required, which is failure to comply with essential and reasonable nondiscriminatory requirements or bad faith by dealer in carrying out terms of dealership. Provision covers termination, cancellation, nonrenewal and substantial change in competitive circumstances.	Must provide notice 90 days with written explanation and 60 days cure period. Some exceptions.	Yes
Puerto Rico	Puerto Rico Dealers' Contracts Law; Laws of Puerto Rico, Title 10, Chapter 14, §§ 278-278d	Just cause required, which includes nonperformance of essential obligations or act adversely and substantially affecting promotion or distribution.	No	No
Virgin Islands	Virgin Islands Franchised Business Law; Virgin Islands Code, Title 12A, Chapter 2, Subchapter III, §§ 130 through 139	Good cause required, which is failure to substantially comply with essential and reasonable requirements imposed by franchise or franchisee's bad faith in carrying out terms of franchise.	Must provide 120 days written notice.	No