



2024 > LEGAL  
SYMPOSIUM

MAY 5-7 > WASHINGTON, DC



IFA®

INTERNATIONAL FRANCHISE ASSOCIATION

# Speakers

- Brian Balconi, Authority Brands
- Christina Kennedy, Foley & Lardner LLP

**There's nothing “basic” about defaults and terminations.**

# Steps Before Issuing Default/Termination Notice

- Due Diligence
  - Gathering facts and information
- Reviewing franchise agreement(s)
- Reviewing potential counterclaims and defenses
- Reviewing all applicable state relationship laws

# Identifying Potential Issues Before They Arise



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



Some warning signs are more overt and obvious than others

# Identifying Potential Issues Before They Arise

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

# Identifying Potential Issues Before They Arise

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

# Identifying Potential Issues Before They Arise

- Respond to Early Warning Signs!
  - Communicate and visit with franchisees early and often
  - Send pre-default warnings
  - Negotiate workout/forbearance agreements

## Key Takeaway

- Learning how to recognize and address warning signs can help franchisors minimize legal costs and avoid disruptions to their systems.
- Proactively monitoring and communicating with franchisees about these issues also can better preserve relationships with the franchisees.

# Due Diligence

- Gather Facts and Information re: Accounting, Operations, etc.
  - Relevant documentation
  - Franchisee history
  - Prior resolution attempts
- Evaluate the Severity of the Conduct at Issue
- Consider Respective Costs of Issuing a Default/Termination versus Inaction or Interim Measures.

# Review Franchise Agreement

- Identify Contractual Basis for Default
  - Monetary?
  - Operational?
  - Selling unauthorized goods or service?
- Identify Cure Requirements
  - Cure period
  - Curative actions

# Review Franchise Agreement

- Consider Materiality.
  - *Peterbrooke Franchising of America LLC v. Miami Chocolates, LLC*, 2022 WL 6635136 (11<sup>th</sup> Cir., Oct. 11, 2022).
  - Reversing trial court's grant of summary judgment to franchisor on franchisee's wrongful termination claim.
  - Finding that there were material issues of fact as to whether franchisee's breach by not implementing a franchisor-required Point-of-Sale system was a **material** breach that warranted termination.

# Potential Franchisee Defenses & Counterclaims

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

# Franchisee Defenses: Good Faith and Fair Dealing/Good Cause

- One party cannot prevent the other contracting party from receiving the benefits of the contract, particularly in the exercise of discretion afforded to the party.
- However, this defense cannot be used to circumvent the clear terms of a contract.
- Does motivation matter?
  - *Dayan v. McDonald's Corp.*, Bus. Franchise Guide (CCH) ¶ 8,223 (Ill. App. Ct. 1984).
  - *Dunkin' Donuts of America, Inc. v. Minerva, Inc.*, 995 F.2d 1566, 1569 (11<sup>th</sup> Cir. 1992.)

# Franchisee Defenses: Waiver

- *CJ Rest. Enterprises, Inc. v. FMS Mgmt. Sys., Inc.*, 699 So. 2d 252, 253 (Fla. Dist. Ct. App. 1997).
- *E2W, LLC v. Kidzania Operations, S.a.r.l.*, No. 1:20-cv-2866 (S.D.N.Y., April 9, 2020).

# Franchise Defenses Cont'd...

- Late Cure
- Franchisor's Fault
- Fore Majeure

# Franchisee Defenses: Compliance with State Laws

- State relationship laws regulating termination, non-renewal, and substantial changes in competitive circumstances
- Franchise disclosure laws and “Little FTC Acts”
- Common law misrepresentation claims.

# Review Franchise Agreement

- Notice Requirements
  - Delivery methods – e.g., overnight courier, certified mail, e-mail, etc.
  - Timing and effective date of notice
  - Notice recipients – e.g., guarantors, franchisee owners/co-owners, franchisee’s in-house or outside counsel, etc.

# Impact of State Relationship Laws on Default and Termination

# State Relationship Laws

- Govern material aspects of the franchise relationship, including:
  - Defaults and terminations (today's focus)
  - Transfer of ownership
  - Non-renewal and substantial changes
- These laws were passed to protect the franchisee's significant investment in the relationship
- They provide a counterbalance to the franchisor's perceived greater power and potential abuses

# 18 States and 2 Territories with Relationship Laws Governing Default/Termination

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

# Impact of State Relationship Laws

- Critical to assess the applicability and impact of these laws before issuing a notice of default or termination
  - If protections under the law (*i.e.*, good cause required, mandatory notice and cure periods, etc.) are greater than those in franchise agreement, relationship law generally controls.
- Failure to consider these laws may give rise to wrongful termination claim and entitled franchisee to compensatory and punitive damages, injunctive relief, and attorneys' fees.

# Applicability of State Relationship Laws

- Generally, there are three jurisdictional touchstones that impact applicability:
  - Franchised outlet located in the state
  - Franchisee is domiciled in the state
  - Sales activities are conducted in the state

# Franchised Outlet Located in State

- Arkansas' law provides, for example:

***This subchapter applies only to a franchise entered into, renewed, or transferred after March 4, 1997, the performance of which contemplates or requires the franchise to establish or maintain a place of business within the State of Arkansas.***

# Franchisee is Domiciled in the State

- California's law provides, for example:

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

# Sales Activity in the State

- Minnesota's law provides, for example:

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

# Drafting Point: Governing Law

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

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

# “Good Cause” for Termination

- Most state relationship laws prohibit a franchisor from terminating a franchise agreement without “good cause”
- The “good cause” requirement is best understood as speaking to the materiality of the basis for termination
- A number of state laws provide specific guidance as to what constitutes “good cause”
  - Generally, a failure to comply with the lawful, reasonable, and material provisions of the franchise agreement

# Statutory Examples of “Good Cause”

- Franchisee’s bankruptcy or insolvency
- Voluntary abandonment of franchise
- Failure to pay amounts due
- Conviction of felony offense related to business
- Material impairment of system good will or trademarks
- Unauthorized transfer of franchise
- Repeated defaults

# Statutory Wind Down and Cure Periods

- Certain states require a minimum notice period before termination is effective
  - A failure to comply with a notice period can be an independent basis for wrongful termination claim, even if “good cause” exists
- Other states require a minimum cure period for certain defaults
- Some states require both
- Note that there are often exceptions to these minimum periods

# Mandatory Wind Down Period

- Vary from state-to-state, but between 60- and 120-days' notice is most common
- For example, Missouri's law provides:

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

# Mandatory Minimum Cure Period

- Certain states require a “reasonable” cure period, but do not mandate specific period of time
  - Michigan’s statute requires that franchisors provide a “reasonable” time to cure and affirmatively states that anything longer than a 30-day cure period is presumptively reasonable
- Other states specify a specific cure period depending on the nature of the default
  - Iowa’s statute mandates a cure period of 30 to 90 days, unless the default relates to the franchisee’s nonpayment of moneys due, in which case the cure period need not exceed 30 days

# Certain States Require Both Notice and Cure Periods

- For example, the Wisconsin Fair Dealership Law provides:

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

# Incurable Defaults

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

# Franchisor's Repurchase Obligations Upon Termination

- Certain states require a franchisor to repurchase inventory and other items from a franchisee after termination
- Conditions under which franchisor's repurchase obligations arise and the items subject to repurchase vary, but can include:
  - In all cases of termination, but generally only at franchisee's election
  - Generally, only if franchisee was not terminated for good cause
  - Only inventory items sold by franchisor to franchisee that bear franchisor's mark
  - Inventory, supplies, equipment, and furnishings purchased from franchisor or its approved suppliers that are in possession of franchisee or used in franchised business

# Valuation at Repurchase

- Methodologies vary from state to state
  - Fair market value or fair wholesale market value
  - Franchisee's net cost less a reasonable deduction for depreciation
  - Price paid less depreciation
- Possible exclusions exist
  - Franchisor does not prevent franchisee from retaining control of the principal place of franchise business on termination due to franchisor's publicly announced and nondiscriminatory decision to withdraw from market. *E.g.*, California and Washington

## Key Takeaway

To comply with franchise agreement and applicable relationships laws, you must carefully review both!

# Additional Considerations Before and After Issuing Defaults and Termination Notices

# Dealing with Other Franchisees

---

Selective Enforcement

---

Impact of Termination on Other Franchisees

---

Information Provided to Other Franchisees About a Termination

---

Impact of Termination on Potential Franchisees

# Dealing with Other Franchisees: Selective Enforcement

- *Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd*, 970 F.2d 273 (7<sup>th</sup> Cir. 1992)
  - “The 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.”

# Enforcement Considerations

- Protecting the Brand, Trademark, and System
- Preparing for Unit Closure and Possible Brand Image Issues
- Avenues for Enforcement:
  - Self Help
  - Mediation
  - Litigation/Arbitration
    - What venue?
    - What action to take?
    - TRO/Injunctive Relief?

# Injunctive Relief as Enforcement

- Injunctive Relief/TRO Elements:
  - Likelihood of success on the merits
  - Irreparable harm if injunction is not issued
  - The harm if injunction is not issued is greater than the harm to the non-moving party if injunction is issued
  - The public interest favors issuance of the injunction.

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

# Injunctive Relief as Enforcement

- Injunctive Relief/TRO:
  - Courts often focus most on “likelihood of success” and “irreparable harm” elements
    - Is the terminated franchisee still using trademarks, trade dress, or trade secrets? Those are favorable facts.
  - Franchisees can use injunctive relief/TROs to enjoin unlawful terminations
    - Some state relationship laws impose presumptive “irreparable harm” if wrongful termination is alleged. This can make a franchisee’s path to an injunction smoother.

# QUESTIONS?

THANK YOU!