

What Franchise Litigators Wish Transactional Attorneys Knew About Litigation

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I. INTRODUCTION¹

Disputes between franchisors and franchisees occur in every franchise system and occasionally lead to litigation. This paper discusses franchisor/franchisee disputes and what franchise litigators would like transactional attorneys to know about disputes in franchising that arise based on provisions in franchise agreements, representations made in Franchise Disclosure Documents (FDDs), and other aspects of the franchisor-franchisee relationship. Relatedly, this paper discusses how to avoid litigation through pre-litigation negotiations and, should litigation ensue, the potential damages franchisors and franchisees may face.

The paper begins with a discussion regarding the following FDD disclosures required under the FTC Disclosure Requirements and Prohibitions Concerning Franchising (the “Franchise Rule”), 16 C.F.R. § 436.5, that are often the source of litigation disputes: Item 7 (Estimated Initial Investment); Item 8 (Restrictions on Sources of Products and Services); Item 11 (Franchisor’s Assistance, Advertising, Computer Systems, and Training); and Item 19 (Financial Performance Representations). We provide summaries regarding each Item’s disclosure requirements and address the need for transparent and accurate disclosures to minimize litigation risk and maintain sustainable franchisor/franchisee relationships.

The next section discusses terms of franchise agreements that can be the subject of franchise litigation. Franchise litigation can seem quite complex at times, due in part to the statutory overlay that impacts franchising. Often franchise litigators operate on parallel tracks—they must consider and apply both the terms of the franchise agreement (and any related agreements) and applicable statutes. At times, the terms of the franchise agreement and relevant statutes may conflict. For example, a franchise agreement may require a period of 30 days for a notice of default and opportunity to cure before termination while the applicable franchise relationship statute may require a notice period of 60 or 90 days. Franchise litigators must be aware of and account for these differences. Similarly, there may be other state and federal laws that can impact the attorneys’ approach to franchise litigation. The franchise practitioner must work to align several moving parts that are unique to franchising in deriving an appropriate litigation strategy.

The paper will conclude with a discussion on pre-litigation dispute resolution, and potential damages in the event attempts at pre-litigation resolution fail.

I. THE FRANCHISE DISCLOSURE DOCUMENT

A. Discussion of Franchise Disclosure Document Items 7, 8, 11, and 19

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The offer and sale of franchises are regulated under the FTC Franchise Rule, 16 C.F.R. § 436, et seq., and state laws and regulations.² Certain states and territories have also promulgated franchise relationship laws that regulate the franchise relationship once franchise agreements are executed.³

Litigators often prosecute and defend claims challenging franchisor disclosures allegedly made in violation of the requirements of the FTC Franchise Rule. Although there is no private right of action for violations of the Rule,⁴ claims of alleged violations of disclosure obligations may be brought under state statutes governing franchise registration and disclosures, or for unfair or deceptive practices or common law fraud (e.g., fraud in the inducement, fraudulent misrepresentation, and negligent misrepresentation), among others.⁵ Additionally, some state laws, such as the Florida Deceptive and Unfair Trade Practices Act (FDUTPA), Fla. Stat. § 501 et seq., provide that violations of the FTC Franchise Rule constitute violations of the state's unfair and deceptive practices laws.⁶

Below, we discuss considerations franchisors should take into account when drafting Item 7 (Estimated Initial Investment), Item 8 (Restrictions on Sources of Products and Services), Item 11 (Franchisor's Assistance, Advertising, Computer Systems, and Training), and Item 19 (Financial Performance Representations). Transactional attorneys should draft these items, and all FDD items, with a keen aversion to future litigation in

² States that have franchise registration requirements include California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin.

³ Relationship law states include Alaska, Arkansas, California, Connecticut, Delaware, District of Columbia, Hawaii, Illinois, Indiana, Iowa, Louisiana, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, North Dakota, Puerto Rico, Rhode Island, Virginia, Washington, Wisconsin, and the U.S. Virgin Islands.

⁴ *FTC v. Owens-Corning Fiberglas Corp.*, 853 F.2d 458, 464 (6th Cir. 1988) (recognizing that "Congress has clearly limited the invocation of jurisdiction under the FTC Act to the Commission itself") (citation omitted).

⁵ See, e.g., N.Y. Gen. Bus. Law § 691 (creating a private right of action for violation of the state's disclosure requirements and for fraudulent and unlawful practices); N.Y. Gen. Bus. Law § 687 (1-2) (broadly prohibiting untrue statements of material fact "in connection with the offer, sale, or purchase of any franchise" and making it unlawful to make an untrue statement of material fact in an application, notice, statement, offering prospectus, or report filed with the state); Md. Code Ann., Bus. Reg. § 14-227 (creating a private right of action and making it unlawful to offer or sell a franchise "by means of an untrue statement of material fact or any omission to state a material fact necessary").

⁶ See *MTR Capital, LLC v. LaVida Massage Franchise Development, Inc.*, No. 17-CV-13552-TGB, 2020 WL 6536954, at *9, 14 (E.D. Mich., Nov. 6, 2020) (setting forth FDUTPA's recognition that "great weight shall be given to the interpretations of the Federal Trade Commission" and finding that franchisor violated 16 C.F. R. § 436.7 which governs updating disclosures).

mind—making sure that disclosures are accurate, well-supported, reasonable, transparent, and current.⁷

a. Item 7—Estimated Initial Investment

Item 7 addresses a potential franchisee’s entire estimated initial investment to purchase and open a franchised business.⁸ The initial investment disclosures help franchisees compare different franchises and their initial costs, secure necessary funds, develop their business plans, and assess their associated financial risk, among other things. Therefore, it is imperative for a franchisor to provide transparent figures to establish accurate and reliable expectations from potential franchisees, and to minimize potential litigation claims. These disclosures are not to be conflated with financial performance representations triggering Item 19 disclosures.⁹

Item 7 requires uniform disclosures of a franchisee’s typical expenses leading up to the date the franchisee opens an outlet.¹⁰ These expenses are presented in a five-column table.¹¹ For each expense disclosed, franchisors must disclose the type of expenditure, the amount, the method of payment, when it is due, and to whom the payment is to be made.¹² A reproduction of the table’s columns is provided below.¹³

Column 1 Type of expenditure	Column 2 Amount	Column 3 Method of payment	Column 4 When due	Column 5 To whom payment is to be made
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Because the type of initial investment costs vary among franchise systems, the expenses enumerated in 16 C.F.R. § 436.5 (g)(1)(i-iii) are non-exhaustive. The types of costs franchisors should carefully consider disclosing include, but are not limited to: (1) initial franchise fees; (2) training expenses; (3) real property, whether purchased or leased; (4) equipment, fixtures, other fixed assets, construction, remodeling, leasehold improvements, and decorating costs, whether purchased or leased; (5) inventory to begin operating; and (6) security deposits, utility deposits, business licenses, and other prepaid expenses.¹⁴ Additionally, franchisors must list separately any other required payments specific to its business that franchisees will incur to become operable (e.g., training, travel, advertising expenses), expenses incurred before operations begin, and expenses

⁷ See, e.g., *MTR Capital*, 2020 WL 6536954, at *11 (finding that franchisor failed to update the FDD with current information regarding units that opened and closed, material facts franchisees need in making investment decision).

⁸ 16 C.F.R. § 436.5(g).

⁹ FTC Compliance Guide, *supra* note 1, at 48 n.13 (emphasizing that the listing of expenses under Item 7 does not constitute financial performance representations).

¹⁰ 16 C.F.R. § 436.5(g).

¹¹ *Id.*

¹² *Id.*

¹³ *Id.*

¹⁴ 16 C.F.R. § 436.5(g)(1)(i)(A-F).

incurred during the initial period of operations (e.g., a period of at least three months or a reasonable industry-specific period).¹⁵ Any and all initial investment fees should be disclosed under Item 7 so as to prevent blindsiding prospective franchisees.

Any expenses disclosed under Item 7 can be reasonably estimated using a low-high range based on the franchisor's current data/experience if the exact amount(s) are unknown.¹⁶ Moreover, Item 7 requires footnotes disclosing, among other things, whether each expense payment is non-refundable, the circumstances regarding refundable expenses, and information regarding a franchisor or an affiliate's financing of the initial investment, if applicable.¹⁷

A franchisor's failure to provide investment expense information -- or inaccurate investment expense information -- can lead to litigation. In a recent case, certain franchisees alleged that franchisor Sea Tow Services International, Inc. failed to disclose initial investment costs when it did not register an FDD under the New York Franchise Sales Act.¹⁸ The United States District Court for the Eastern District of New York found the franchisees' allegations sufficient to survive Sea Tow's judgment on the pleadings.¹⁹ As an another example, in *A Love of Food*, plaintiff brought claims against franchisor Maoz Vegetarian USA, Inc. for misrepresentation under New York and Maryland law regarding initial start-up costs.²⁰ The United States District Court for the District of Columbia denied the parties' motions for summary judgment, finding that there were issues of material fact regarding plaintiff's claims for misrepresentation—specifically (1) whether franchisor's initial investment estimates were actually false when made, and (2) whether plaintiff reasonably relied on the estimates.²¹

Various grounds are available to a franchisor to defend Item 7 violations. Claims for fraud and intentional misrepresentation may be defeated if a franchisor "exercised reasonable care and in fact did not know, or in the exercise of reasonable care, could not have known of the misstatement or omitted fact."²² Additionally, franchisors may be able to defeat such claims if there is evidence that the franchisee overspent its budget or improperly included certain expenses in its initial investment calculations, among other reasons.²³ However, franchisors must keep in mind that initial investment disclosures are

¹⁵ *Id.* at § 436.5(g)(1)(ii-iii).

¹⁶ *Id.* at § 436.5(g)(2).

¹⁷ 16 C.F.R. § 436.5(g)(7)(i-ii).

¹⁸ N.Y. Gen. Bus. Law § 683 (requiring registration); *Sea Tow Services International, Inc. v. Tampa Bay Marine Recovery, Inc.*, 632 F.Supp.3d 91, 111 (E.D.N.Y. 2022).

¹⁹ *Sea Tow*, 632 F.Supp.3d at 111.

²⁰ *See A Love of Food I, LLC v. Maoz Vegetarian USA, Inc.*, 70 F.Supp.3d 376, 414 (D.D.C. 2014).

²¹ *Id.* at 403-414.

²² *Id.* at 401 (citations omitted).

²³ *See MTR Capital*, 2020 WL 6536954, at *10 (finding that at trial plaintiff failed to prove that franchisor did not have a reasonable basis for the disclosed initial investment costs in the FDD, plaintiff overspent his actual construction budget and improperly included his

intended to contain factual and historical information. Accordingly, it is unlikely that a court will dismiss the claims based on a franchisor’s argument that the investment disclosures are predictions of the future and therefore not actionable under theories of misrepresentation or fraud.²⁴

b. Item 8—Restrictions on Sources of Products and Services

Item 8 contains information about a franchisee’s obligations to purchase products and services from a franchisor’s selected suppliers—these purchases are considered “source-restricted.”²⁵ Consistency, quality control, and uniform branding are critical to franchise systems. They help develop brand recognition among patrons of franchise outlets and attract prospective franchisees to the system. In maintaining brand uniformity, franchisors will often develop and maintain relationships with trusted suppliers who provide products and services that meet the franchisors’ specifications. Depending on the franchise system, certain franchisee purchases may be source-restricted.

Franchisors may obtain benefits in the form of rebates or other consideration from suppliers. The benefits to franchisors may create hurdles for the franchisee if source-restricted suppliers offer higher prices on the cost of their goods and services because of payments they are making to the franchisor. Franchisees might raise alarms if they can find alternative suppliers with lower prices and believe they are not benefiting from the franchisor’s relationship with suppliers. For this reason, franchisor transparency is key and abiding by the disclosure requirements of Item 8 must be prioritized.

Item 8 disclosures are simplified by the fact that if franchisees are free to purchase goods or services from any source, then disclosures are not required.²⁶ However, if franchisees are obligated to purchase or lease goods, services, supplies, fixtures, equipment, inventory, computer hardware and software, real estate, or comparable items relating to establishing or operating the franchised business either from the franchisor, its designee, or suppliers approved by the franchisor, then this must be disclosed.²⁷

As evidenced by the dense requirements of 16 C.F.R. 436.5(h), franchisors must disclose their interests in, and any material benefits received, from their pre-selected supplier—or face increased litigation risk.²⁸ Information regarding rebates is material to a

own salary, and that when properly calculated his actual initial investment came within \$10,000 of the range provided by the FDD—therefore there was no violation of 16 C.F.R. § 436.5(g)).

²⁴ See *Callen v. ILKB, LLC*, No. 220CV3345DRHJMW, 2022 WL 2079651, at *9 (E.D.N.Y., June 9, 2022) (finding initial investment disclosures are not predictions and are therefore actionable under New York law as actionable representations) (citations omitted).

²⁵ 16 C.F.R. § 436.5(h).

²⁶ 16 C.F.R. § 436.5(h); FTC Compliance Guide, *supra* note 1, at 51.

²⁷ 16 C.F.R. § 436.5(h).

²⁸ As it pertains to suppliers, the FTC Compliance Guide clarifies that “supplier” is intended to capture all third parties such as manufacturers and distributors in the supply

prospective franchisee's understanding of how much they are paying for goods and services and how much of the purchase price is being rebated to themselves or to the franchisor. Franchisees have alleged claims challenging Item 8 disclosures or omissions under state franchise laws and common law claims sounding in fraud, among others. Claims brought under these theories often challenge a franchisor's failure to disclose or adequately disclose certain rebates received from vendors based on the sales of products to franchisees.²⁹ Blanket statements that a franchisor might receive unspecified rebates from vendors may not be adequate under federal and state laws that require detailed disclosures.³⁰

When analyzing what, if any, disclosures to make under this rule, franchisors should consider their disclosure obligations in light of their purchasing practices and any relevant state laws that govern the supply of goods in franchise relationships.³¹ Of course, Franchisors must avoid misrepresenting how they utilize supplier income that they receive.³² Ultimately, it is not unreasonable for franchisors to negotiate contracts with suppliers that benefit them, but they must disclose these relationships under Item 8.³³

chain—however, these third parties do not need to be identified. See FTC Compliance Guide, *supra* note 1, at 53.

²⁹ See e.g., *Randall v. Lady of America Franchise Corp.*, 532 F.Supp.2d 1071, 1090 (D. Minn. 2007) (granting summary judgment to franchisor regarding plaintiff's claims under the Minnesota Franchise Act for failing to disclose rebates because franchisee did not proffer admissible evidence to defeat the motion); *Team Tires Plus, Ltd. v. Heartlein*, No. CIV. 01-1197JGL, 2004 WL 3406090, at *5 (D. Minn., Apr. 19, 2004) (granting franchisor's motion for summary judgment as to all Illinois Franchise Act allegations regarding the vendor rebate system because franchisee was free to purchase from any vendor they chose).

³⁰ See *Randall*, 532 F.Supp.2d at 1090, fn. 14 (casting doubt on whether the franchisor adequately disclosed vendor rebates under state and federal laws when it simply included a blanket statement that it may receive unspecified rebates from unspecified vendors).

³¹ For example, Ind. Code Ann. § 23-2-2.7-1 makes it unlawful for a franchisor to require goods, supplies, inventories, or services to be purchased exclusively from the franchisor or sources designated by the franchisor where such products or services are available from other sources at comparable quality. However, the code lists some exceptions. See Ind. Code Ann. § 23-2-2.7-1 (1). Iowa Code Ann. § 523H.12 provides that a franchisor shall allow a franchisee to source equipment, fixtures, supplies, and services from sources of the franchisee's choosing, provided that such products and services meet the franchisor's standards—with certain exceptions. See Iowa Code Ann. § 523H.12 (1-2).

³² See *C.K.H., L.L.C. v. Quizno's Master, L.L.C.*, No. 04-RB-1164, 2005 U.S. Dist. Lexis 42347 (D. Colo. 2005) (dismissing franchisees' fraud claim that Quizno's did not pass supplier rebates to franchisees under an Item 8 disclosure which stated that such arrangements were negotiated to benefit franchisees, but where Quizno's reserved the right to receive and use such revenue without restrictions).

³³ See *Siemer*, 2008 WL 904874, at *7 (finding that "in light of the explicit contractual provisions [disclosing that Quizno's may receive payments and may use all amounts

c. Item 11— Franchisor’s Assistance, Advertising, Computer Systems, and Training

Item 11 requires disclosures of a franchisor’s obligations under the franchise agreement to provide assistance to franchisees (e.g., pre-opening and ongoing assistance).³⁴ An important disclosure under Item 11 is the franchisor’s description of advertising programs. Franchise systems often create advertising funds to which all franchisees must contribute a percentage of their sales. In turn, these contributions are used for the benefit of the franchise system. The collected funds are held in a separate account and used by the franchisor to boost revenue with successful advertising campaigns.

Item 11 advertising disclosures include the (1) franchisor’s obligation, if any, to conduct advertising; (2) circumstances under which franchisees may use their own advertising materials; (3) the existence of an advertising counsel composed of franchisees; (4) whether franchisees must participate in a local or regional advertising cooperative; (5) whether franchisees must contribute to an advertising fund; (6) how franchisors use carryover advertising funds at the end of the fiscal year and whether franchisees receive periodic accounting of advertising expenditures; and (7) the percentage of advertising funds used principally to solicit new franchise sales.³⁵

Similar to their potential dissatisfaction with rebates under Item 8, franchisees may raise concerns over how advertising funds are used and the benefits they actually receive from the advertising. Franchisors have no inherent right to collect franchisee contributions for advertising funds. Rather, they must reserve the right to do so in their franchise agreements—this reservation may be drafted broadly or in great detail.³⁶ If there is no advertising fund created at the outset, it is wise to contractually reserve the right to establish, maintain, and administer one in the future.³⁷ It is, of course, important for franchisors to ensure that advertising funds are spent according to the disclosures in the FDD and the terms of the franchise agreement, to avoid claims for fraud and/or breach of contract based on allegations that the advertising funds were misspent.

In addition to fraud and breach of contract claims, franchisees have brought claims against franchisors for alleged breach of fiduciary duties in maintaining and administering

without restriction], it would be unreasonable for Plaintiffs to have assumed that Quizno’s would not negotiate contracts with suppliers that would benefit Quizno’s”).

³⁴ 16 C.F.R. § 436.5 (k).

³⁵ See generally, 16 C.F.R. § 436.5 (k)(4)(i-vii).

³⁶ See *Microtel Franchise and Development Corp. v. Country Inn Hotel*, 923 F. Supp. 415, 419 (W.D.N.Y. 1996) (finding that Microtel Franchise and Development Corp. had no obligation under the franchise agreement to provide advertising other than its contractual and discretionary right to establish and administer an advertising fund, if it so chooses).

³⁷ *Id.*

advertising funds.³⁸ For example, a franchisee may take issue with a franchisor utilizing advertising funds to benefit other franchise outlets rather than its own, and claim breach of fiduciary duty.³⁹ However, under most state laws, a franchisor-franchisee relationship does not create a fiduciary relationship.⁴⁰ A “person can only be charged with a fiduciary obligation where he ‘either knowingly undertake[s] to act on behalf and for the benefit of another, or must enter into a relationship which imposes that undertaking as a matter of law.’”⁴¹ So long as the franchisor does not make any special promises specific to a franchisee regarding the advertising fund, a fiduciary relationship is not established. To avoid doubt, the FDD and the franchise agreement can include language specifically disclaiming the existence of a fiduciary relationship or the creation of a trust between the franchisor and franchisee as it relates to the advertising fund. Language explicitly indicating the franchisee’s acknowledgment that the advertising funds may be spent on activities that promote the franchise system, rather than the franchisee itself, can also be included.⁴²

d. Item 19—Financial Performance Representations

Financial performance representations under the FTC Franchise Rule, Item 19, showcase a franchisor’s financial results--to that end, some franchisors opt to disclose their financial performance and others choose not to, depending on a variety of strategic considerations, including the age of the franchise system and whether sufficient financial data is available, and the profitability of the system.⁴³ As discussed below, if a franchisor

³⁸ See, e.g., *Oil Exp. Nat., Inc. v. Burgstone*, 958 F. Supp. 366, 370 (N.D. Ill. 1997) (finding that the contractual duty with respect to advertising funds was clearly set forth in the contract between the parties and it was not tantamount to a fiduciary duty under Illinois law).

³⁹ See, e.g., *Huntington Learning Centers, Inc. v. JSY Education, Inc.* (C.D. Cal., June 3, 2010, No. CV 10-1558 SVW (JCX), 2010 WL 11595799, at *1-2.

⁴⁰ *Id.* at *2; see also *Prince Heaton Enterprises., Inc. v. Buffalo's Franchise Concepts, Inc.*, 117 F.Supp.2d 1357, 1365 (N.D. Ga. 2000) (dismissing franchisee’s claims that franchisor breached a fiduciary obligation by converting money held in trust for franchisee’s own benefit on the premise that no fiduciary relationship existed under Georgia law).

⁴¹ *Huntington*, 2010 WL 11595799, at *2 (citation omitted).

⁴² *Id.* at *2 (citation omitted) (giving deference to the franchise agreement’s disclaimer of a fiduciary relationship and a franchisee’s acknowledgement that the Advertising Fund may be spent to promote other Huntington Learning centers); see also *JMF, Inc. v. Medicine Shoppe Intern., Inc.*, No. 3:09-CV-73, 2011 WL 4369475, at *6 (D.N.D. Sept. 19, 2011) (finding that franchisee’s unhappiness with the advertising services received was misplaced because the contract clearly provided that advertising services were to be provided at the franchisor’s sole discretion).

⁴³ 16 C.F.R. § 436.5(s)

opts to make disclosures under Item 19, it must strictly follow the rules or risk future litigation.⁴⁴

The FTC Franchise Rule defines a “Financial Performance Representation” as:

[A]ny representation, including any oral, written, or visual representation, to a prospective franchisee, including a representation in the general media, that states, expressly or by implication, a specific level or range of actual or potential sales, income, gross profits, or net profits. The term includes a chart, table, or mathematical calculation that shows possible results based on a combination of variables.⁴⁵

If a franchisor elects to disclose its financial performance, there must be a reasonable basis for it, the franchisor must have data substantiating the disclosures, and it must abide by the rule’s further requirements for either historical or projected disclosures.⁴⁶ The information disclosed is limited to the actual or potential financial performance of its franchisor-owned and/or franchised outlets.⁴⁷ In addition to the disclosures, a clear and conspicuous admonition that results may differ is also required.⁴⁸ On the other hand, if a franchisor elects not to provide financial performance representations, then it must disclose as much and *absolutely* refrain from making any representations outside the confines of the FDD— sometimes a hard task for franchisor representatives when they are selling franchises.⁴⁹ The exception to either election, is that a franchisor may disclose to a prospective purchaser of a specific outlet only the actual operating results for that outlet without having to comply with the requirements of 16 CFR § 436.5(s).⁵⁰ In addition to these requirements, state laws may mandate additional Item 19 preambles or notes for compliance with their disclosure laws.⁵¹

Keep in mind that the factual information provided under Item 19 disclosures must be the kind a prudent businessperson would rely on when making an investment decision

⁴⁴ See *Hanley v. Doctors Exp. Franchising, LLC*, No. CIV.A. ELH-12-795, 2013 WL 69052, at *23 (D. Md., Feb. 25, 2013) (finding that franchisor, Doctors Exp. Franchising, LLC, was not obligated to disclose financial performance representations under 16 C.F.R. § 436.5, but having decided to do so, it was obligated to make supported representations based on what it knew at the time it made them).

⁴⁵ 16 C.F.R. § 436.1(e).

⁴⁶ *Id.* at § 436.5 (s)(3)(i-iii).

⁴⁷ *Id.* at § 436.5 (s)(1).

⁴⁸ *Id.* at § 436.5 (3)(iv).

⁴⁹ *Id.* at § 436.5 (s)(2).

⁵⁰ *Id.* at § 436.5 (s)(4).

⁵¹ See, e.g. 10 Cal. Code. Reg. § 310.114.1 (governing earnings claim figure(s) which include or refrain from including the costs of sales or operating expenses and requiring a statement under Item 19 which states, “The earnings claims figure(s) does (do) not reflect the costs of sales, operating expenses, or other costs or expenses that must be deducted from the gross revenue or gross sales figures to obtain your net income or profit. . . .”).

and must reasonably support the representations made.⁵² For example, financial performance representations based on projections should be prepared in good faith, with appropriate care by qualified personnel, and using appropriate accounting principles for projections issued by professional organizations.⁵³ Similarly, financial performance representations based on historical performance must be made on a reasonable basis (e.g., the underlying data is verifiable and typical for the system's franchisees).⁵⁴ All financial performance representations must be supported with written quantitative data in the franchisor's possession, at the time the representations are made, and made available for inspection on a franchisee's request.⁵⁵ Such data may include, among other things, statistical analyses and profit and loss statements. When drafting a franchisor's financial representation disclosures, it is good practice to ensure in advance that the disclosures are independently verifiable, and are supported accordingly, and to counsel franchisors against providing contradictory information and financial performance representations to potential franchisees that were not included in Item 19.⁵⁶ Trustworthy reference materials to cross-check when drafting Item 19 disclosures include the FTC Franchise Rule,⁵⁷ FTC Compliance Guide,⁵⁸ NASAA Franchise Commentary,⁵⁹ and state specific regulations.⁶⁰

As set forth above, it is unlawful for franchisors to make financial performance representations outside of the FDD or that do not comport with the disclosure requirements; however, franchisors and their representatives sometimes violate Item 19 during the sales process. Typically, claims are brought for oral representations when there are no Item 19 disclosures (or for representations that are inconsistent with the disclosures), or for inaccurate disclosures.⁶¹ Claims typically sound in fraud (i.e., fraud in

⁵² FTC Compliance Guide, *supra* note 1, at 135.

⁵³ FTC Compliance Guide, *supra* note 1, at 135 (recognizing that projections have a reasonable basis if made in accordance with the standards issued by the American Institute of Certified Public Accountants' *Prospective Financial Information: AICPA Audit and Accounting Guide* (2006)).

⁵⁴ *Id.* at 136 (recognizing historical performance does not have a reasonable basis if the underlying data is based on unusual or non-recurring conditions or inconsistent methods for determining and reporting profits).

⁵⁵ 16 C.F.R. § 436.5 (3)(v).

⁵⁶ FTC Compliance Guide, *supra* note 1, at 138.

⁵⁷ 16 C.F.R. § 436, *et seq.*

⁵⁸ FTC Compliance Guide, *supra* note 1.

⁵⁹ *NASAA Franchise Commentary Financial Performance Representations* (2017), (available at <https://www.nasaa.org/wp-content/uploads/2017/05/Financial-Performance-Representation-Commentary.pdf>).

⁶⁰ *See, e.g.*, New York State Franchise Regulations, 13 C.R.R.-NY 200, *et seq.* (available at <https://ag.ny.gov/sites/default/files/2022-08/part200.pdf>).

⁶¹ *E.g.*, *Sugarlips Bakery, LLC v. A&G Franchising, LLC*, No. 3:20-CV-00830, 2022 WL 210135, at *9 (M.D. Tenn. Jan. 24, 2022) (finding that plaintiffs sufficiently alleged, under Tennessee law, that the corporate representatives personally authored and/or approved the fraudulent statements made about facts relevant to the potential franchisees).

the inducement, fraudulent misrepresentation, and negligent misrepresentation).⁶² Depending on the jurisdiction, however, a violation of the FTC Franchise Rule does not automatically equate to claims under state law. For example, in Florida, liability under the Florida Deceptive and Unfair Trade Practices Act, requires more than a violation of the FTC Franchise Rule—a party must also demonstrate that an alleged unfair practice was likely to deceive reasonable consumers acting under the same circumstances.⁶³

II. THE FRANCHISE AGREEMENT: DISPUTES CAN BE AVOIDED OR RESOLVED WITH CLEAR LANGUAGE IN THE AGREEMENT

The franchise agreement sets forth the material terms of the franchise relationship. An agreement to renew, transfer, terminate, or otherwise modify a franchise agreement may reset the relationship between the franchisor and franchisee and/or create new terms with an incoming franchisee. While royalty, default, termination, and takeover clauses are ripe for litigation, franchise disputes have arisen from a variety of terms in franchise agreements and other contracts affecting the franchise relationship. In many of these disputes, the outcome was determined by individual contract terms, phrases, or words in one of the agreements. The sections that follow discuss strategies for avoiding disputes as well as cases that address conflicts arising from contract language.

A. Term of Agreement

Somewhat surprisingly, even franchise length-of-term provisions are not immune from arguments about their meaning. The drafter may consider that extra clarity and specificity is warranted to define when the franchise term begins, the length of the franchise term, and when the franchise term ends. In addition, drafters should take care to ensure that the length of the franchise term is consistent with other dates set forth in

⁶² See *Sugarlips*, 2022 WL 210135, at *10 (in ruling on a motion to dismiss, the court determined that under Tennessee law governing fraud claims “plaintiffs plausibly alleged that Item 19 gave a false impression of the general viability of the Gigi’s business, which could have induced reasonable reliance by a person who understood that the information was not a promise or a depiction of every Gigi’s store”); see also *Bans Pasta, LLC v. Mirko Franchising, LLC*, No. 7:13-CV-00360-JCT, 2014 WL 637762, at *14 (W.D. Va., Feb. 12, 2014) (finding plaintiff’s allegations that defendants provided financial performance representations outside the context of Item 19 adequately pled a negligence per se claim under Virginia law); see also *SIG, Inc. v. AT & T Digital Life, Inc.*, 971 F.Supp.2d 1178, 1193 (S.D. Fla. 2013) (finding that plaintiff did not establish that the franchisor’s corporate representatives made any intentional misrepresentations that it relied on to its detriment under Fla. Stat. § 817.416 (governing misrepresentations when selling a franchise); see also *Hanley*, 2013 WL 69052, at *21-24 (finding that plaintiffs asserted viable fraud claims, under Maryland Franchise Law and at common law, based on franchisor’s projections and the actual results plaintiffs achieved and that franchisor failed to disclose facts within its possession at the time the statements were made).

⁶³ See *Cluck-U Chicken, Inc. v. Cluck-U Corp.*, 358 F.Supp.3d 1295, 1313 (M.D. Fla. 2017).

the agreement. Lack of clarity has prompted litigation in some cases, including *Church's Fried Chicken, Inc. v. Jim Dandy Fast Foods, Inc.*⁶⁴ Three paragraphs of the franchise agreement at issue in *Jim Dandy* generated conflicting interpretations of the length of the franchise term:

Paragraph 3: [Franchisee] agrees that it will not directly or indirectly engage in the business of selling or dealing in fried chicken under 'Church's Fried Chicken' ... in any territory other than the territory described in the foregoing paragraph for a period of ten (10) years.

Paragraph 5B: In the event [Franchisee] elects to continue after the ten-year period as provided in Paragraph 3 hereof to engage in the business of selling fried chicken as provided in Paragraph 3 hereof, then and in such event this Agreement shall be renewed and extended under the same terms and provisions here granted for an additional ten-year period.

Paragraph 6: [Franchisor] grants to [Franchisee] the following rights and benefits: A. The right to use the name "Church's Fried Chicken" in the territory described ... so long as the amounts agreed to be paid to [Franchisor] ... are paid.⁶⁵

After the franchisor obtained a jury finding that these provisions set a ten-year term with an option for the franchisee to renew, the trial court granted a motion for judgment notwithstanding the verdict and concluded that franchisee was entitled to use franchisor's name in its own territory indefinitely as long as it made timely payments to the franchisor.⁶⁶ The court of appeals, however, reinstated the jury's verdict by relying on the language of Paragraphs 3 and 5B to overcome the ambiguity of Paragraph 6.⁶⁷ The conflict and uncertainty may have been avoided if Paragraph 6 or another section of the franchise agreement clearly defined the beginning, duration, and end of the term of the agreement.

The risks of interpretation concerning the term of the franchise agreement can be particularly pronounced where another agreement modifies, assigns, transfers, renews, or extends an existing franchise agreement. Uncertainty may arise when multiple agreements contain provisions setting forth conflicting or uncertain time periods for the franchise term or where agreements do not define the term at all. Conflicting term provisions prompted litigation regarding a franchisor's ability to terminate its franchisees in *Burger King Corp. v. Horn & Hardard Co.*⁶⁸ In *Horn*, franchisor and franchisee filed competing summary judgment motions to resolve conflicting interpretations of a provision in a settlement agreement executed to resolve prior litigation:

⁶⁴ 608 S.W.2d 242 (Tex. App.—Houston [14th Dist.] 1980, writ ref'd n.r.e.).

⁶⁵ *Id.* at 244.

⁶⁶ *Id.*

⁶⁷ *Id.* at 245.

⁶⁸ 893 F.2d 525, 526 (2d Cir. 1990).

[Franchisee] shall retain 14 Burger King franchises which shall be governed by the existing form of franchise agreement set forth as Exhibit B. Set forth on Schedule 1 is a list by address of each of these 14 franchises indicating the expiration date of the initial term of each.⁶⁹

The form attached as Exhibit B to the settlement agreement set a term of twenty years, but some of the dates listed on Schedule 1 reflected fifteen-year terms.⁷⁰ On appeal from judgment setting a twenty-year term for all franchisees, the franchisor argued that the specific dates listed on Schedule 1 controlled over the general twenty-year term identified in Exhibit B.⁷¹ The Second Circuit concluded that the meaning of the phrase “initial term” in Schedule 1 created an ambiguity in that it could have referred to a term length that had been replaced by the term set in Exhibit B to the settlement agreement or the term length pursuant to the settlement agreement.⁷² The case was remanded to the district court for a trial.⁷³

The *Jim Dandy* and *Horn* cases exemplify the problems that can arise about the length of the franchise term. Plus, ancillary agreements, such as settlement agreements, renewal contracts, franchise transfer agreements, and the like can create inconsistencies as to the term of the franchise relationship. By setting clear dates, identifying which provision controls the length of the franchise term, and maintaining consistency across different documents, drafters may help their franchise clients avoid the costs of protracted litigation or prevent a franchise relationship from inadvertently terminating too early or too late.

B. Royalties, Including Minimum Royalties

A franchisee’s ability to use the franchisor’s trademarks and system in exchange for royalty payments is at the heart of most franchise models. Royalty provisions garner significant attention for this reason. To avoid disputes concerning the meaning of royalty clauses, royalty calculations should set out (1) each category of royalty payment, including basic royalty fees, technology fees, and advertising fund fees, among others; (2) the method of calculating each payment with terms defined for added clarity as needed; (3) the party to whom each payment is owed; and (4) when each payment is due. When a progressive or sliding scale is used to determine the amount of royalty payment owed, based on revenue generated or otherwise, drafters should describe the scale in detail and consider using examples to illustrate how the scale works.

Ambiguous royalty provisions in franchise agreements have led to disputes between franchisors and franchisees. In *Moran Indus., Inc. v. Mr. Transmission of Chattanooga, Inc.*, the United States District Court for the Eastern District of Tennessee

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ *Id.* at 527-28.

⁷² *Id.* at 528.

⁷³ *See id.* at 529.

refused to grant the franchisee's motion to dismiss a franchisor's claim seeking recovery of royalty payments because of ambiguity in the royalty provisions.⁷⁴ The franchise agreement was ambiguous as to whether a 7% or 5% service fee applied and for what periods of time and thus the court found that extrinsic evidence was needed to interpret the agreement.⁷⁵ Specificity as well as consistency across the franchise agreement could help to eliminate similar instances of ambiguity.

Minimum royalty provisions can be both a blessing and a curse. On the one hand, they can provide certainty and clarity, as well as a floor, regarding minimum payments owed to franchisor for the franchisee's use of the franchisor's intellectual property. On the other hand, these provisions can be limiting as some courts have sanctioned use of a minimum royalty provision to calculate lost future royalties sought by a franchisor.⁷⁶ When a franchisor can recover lost future royalties and the franchise agreement contains a minimum royalty provision, there is a risk that a court will treat the minimum royalty provision as a ceiling, which could in turn undervalue the lost profits attributable to a franchisee's breach. This is discussed more in section V.B., below.

C. Notice and Default/Termination Provisions

The patchwork and periodic modification of franchise relationship laws across the states creates challenges for drafting default, termination, and notice provisions in franchise agreements. For example, Wisconsin and Indiana each require good cause and 90 days' notice of termination, but Wisconsin requires 60 days to cure non-financial defaults and 10 days to cure financial defaults while Indiana does not require any opportunity to cure.⁷⁷ Variations in state laws can make drafting clear default, termination, and notice provisions difficult. But even where franchise relationship laws have the effect of modifying a franchise agreement, franchise parties can benefit from contract provisions that accurately reflect a franchisor's power to issue a notice of default and opportunity to cure or send notices of termination or nonrenewal.

For some franchisors, relationship laws present challenges for managing a nationwide system of franchisees. Drafters must weigh the benefits and risks of (1) using a consistent form of franchise agreement that does not account for relationship laws; (2) having multiple forms of franchise agreements that reflect key provisions of relationship laws in states where franchisees operate; and (3) adopting a consistent single form of franchise agreement that accounts for key provisions of relationship laws in multiple jurisdictions through addendums or otherwise. Regardless of how the franchise

⁷⁴ *Moran Indus., Inc. v. Mr. Transmission of Chattanooga, Inc.*, 725 F. Supp. 2d 712, 719 (E.D. Tenn. 2010).

⁷⁵ *Id.*

⁷⁶ *Mister Softee, Inc. v. Omar*, No. CV 23-3845, 2023 WL 6619637, at *4 (D.N.J. Oct. 11, 2023); see also *Radisson Hotels Intern., Inc. v. Majestic Towers, Inc.*, 488 F. Supp. 2d 953, 959 (C.D. Cal. 2007) (applying liquidated damages analysis to minimum royalty provision).

⁷⁷ *Compare* Wis. Stat. §§ 135.03, 135.04 with Ind. Code § 23-2-2.7.3.

agreement is drafted, the intended cure period for each type of default should be set out clearly. Drafters should also consider providing for longer cure or notice periods or other requirements if mandated by applicable law. While this is not legally required, such a provision can be a good “flag” that may have the effect of reminding the franchisor representative to review the notice of default and termination provisions in the franchise agreement as well as laws on notices of default and termination in the relevant state before issuing notices that may create a dispute.

D. Advertising and Marketing Provisions

Advertising methods vary by system. Under the franchise agreement, franchisees are often obligated to support national or local marketing efforts and execute their own advertising campaigns. Franchisors likewise typically develop, protect, and market the brand for the benefit of the system. No matter how advertising responsibilities are allocated, marketing is important for all franchise systems. Disputes can arise when a franchised business struggles to attract or retain customers or where a franchisee relies only on the franchisor’s or other franchisees’ advertising efforts while refusing to conduct its own advertising. Likewise, disputes can occur when a franchisee does not believe a franchisor is conducting sufficient system-wide advertising or marketing. These disputes become more complicated when the franchise agreement does not clearly define which parties are responsible or, just as important, not responsible, for certain advertising efforts. A clear franchise agreement defines (1) what a franchisor must and need not do to support the brand; (2) the level of discretion retained by franchisor in connection with its advertising responsibilities; and (3) the amount of advertising contributions expected from the franchisee such that non-compliance is subject to default and cure rights.

Challenges arise where the boundary between advertising and other responsibilities blur. In *Stuller, Inc. v. Steak N Shake Enterprises, Inc.*, a franchisor sought to require a franchisee to comply with its maximum prices and promotional programs.⁷⁸ The franchisee “acknowledge[d] that advertising, marketing and promotional activities are essential to the furtherance of the goodwill and public image of the [system] and the success of the business franchised hereunder.”⁷⁹ The franchise agreement also provided that “[f]ranchisee will participate in and contribute toward any marketing programs, including but not limited to television and radio marketing programs initiated by the [franchisor] covering all [system] Restaurants.”⁸⁰ Even though the franchisee had acknowledged the importance of promotional programs, advertising, and marketing, the *Stuller* court concluded that the franchisee’s agreement to participate in marketing did not compel the franchisee to honor the franchisor’s promotional campaigns and maximum pricing rules.⁸¹ In light of *Stuller* and similar disputes, drafters should draft provisions regarding the franchisee’s advertising responsibilities that relate to pricing, promotions,

⁷⁸ 877 F. Supp. 2d 674, 689 (C.D. Ill. 2012).

⁷⁹ *Id.* at 690.

⁸⁰ *Id.*

⁸¹ *Id.* at 690 – 92.

or brand standards with specific, detailed, and clear expectations, and should consider the possible impact of certain state antitrust laws on pricing restrictions.

An example of a portion of a franchisee marketing provision is provided in *The Annotated Franchise Agreement*:

B. Local Advertising

Franchisee must use best efforts to promote and advertise the Franchised Business and participate in any local marketing and promotional programs that Franchisor establishes from time to time. In addition to the Advertising Fee, Franchisee is required to spend XX% of Gross Sales on approved local marketing and promotion. Upon Franchisor's request, Franchisee must provide itemization and proof of local marketing and an accounting of the money it has spent on approved local marketing. If Franchisee fails to make the required expenditure, Franchisor has the right to collect and contribute any deficiency to the Fund....⁸²

E. Integration Clauses, Including Incorporation of Items Like the FDD and Operations Manual

Franchise agreements are meant to be a comprehensive statement of the rights and obligations of parties to a franchise relationship. It is prudent for franchise parties to include a provision articulating that a franchise agreement is a fully integrated contract so that communications, negotiations, or representations made before the franchise agreement's execution do not alter the final form of the agreed-upon relationship. An integration clause is especially appropriate because the franchise disclosure process includes the FDD (which a party may not want to be part of the franchise agreement, but the representations of which cannot be disclaimed, 16 CFR § 436.9(h)) and the franchise relationship necessarily includes extrinsic materials like brand standards and operations manuals. An integration clause should also be included in any agreements to renew, extend, transfer or otherwise modify a franchise agreement so that it is clear which agreements remain in effect and which agreements are superseded.

Although franchise agreements commonly reference brand standards or the FDD, the decision to incorporate or not incorporate these materials into the franchise agreement itself is not without impact. In *Upshaw v. Lacado, LLC*, a franchisee sought to apply a \$50,000 actual damages cap referenced in the FDD.⁸³ The court concluded that the damages cap did not apply because the FDD was not incorporated into the franchise agreement.⁸⁴ In another case, *eTeam, Inc v. Hilton Worldwide Holdings, Inc.*, a provision incorporating the franchisor's operations manual exposed the franchisor to potential

⁸² THE ANNOTATED FRANCHISE AGREEMENT 206 (Nina Greene, Dawn Newton, & Kerry Olson eds., 2018).

⁸³ 650 S.W.3d 61, 73 (Tex. App.—Fort Worth 2021, pet. denied).

⁸⁴ *Id.*

claims for vicarious liability.⁸⁵ In *eTeam*, the franchise agreement allowed the franchisor to terminate a franchisee that failed to comply with any provision of the manual.⁸⁶ The court concluded that a jury could determine that the franchisor was vicariously liable for the acts of its franchisee's employee because the manual, which was incorporated by reference into the franchise agreement, possibly allowed the franchisor to control the day-to-day operations of the franchisee, and thus there was an issue of fact about whether the franchisor was vicariously liable. The court denied summary judgment.⁸⁷

The potential impacts of incorporation are not limited to those described in *Upshaw* and *eTeam*. FDDs often include items that are required by regulators and are state specific. These items may conflict with terms in the franchise agreement and in turn create ambiguity and allow for the assertion of arguments about enforceability of the franchise agreement's terms. See e.g. *Laxmi Investments, LLC v. Golf USA*, 193 F.3d 1095 (9th Cir. 1999) (FDD and franchise agreement differed on the required forum for arbitration proceedings and thus there was no meeting of the minds on that provision). To combat this issue, it may be desirable to include a clause stating that the execution of the franchise agreement constitutes a meeting of the minds as to its provisions.

Nevertheless, it can be desirable to incorporate brand standards and operations manuals into the franchise agreement to ease the enforcement of those items and allow for development and changes in those items and the franchise system over time. But before incorporating an FDD, brand standards, operations manuals, and similar documents into the franchise agreement, drafting attorneys should identify risks and specify which document controls in the event of a conflict. Better yet, drafting attorneys should consider identifying "must have" items in ancillary documents and pull those terms into the franchise agreement itself, to eliminate ambiguity and arguments potentially created by incorporation.

F. Waiver/Forbearance Clauses

When a franchisee is in default and does not cure, the franchisor may choose to forego termination of the franchise agreement while the franchisee attempts to resolve the defaults or transfer its franchised business to a new franchisee. In some instances, a franchisor may provide notice of termination to a franchisee and then enter an agreement allowing the franchisee to operate the franchised business on an interim basis pursuant to a temporary license while the franchisee finalizes an exit. Although forbearance agreements and temporary license agreements often have a worthy business purpose, they have the potential to create risk for franchisors while a franchisee remains in the system after termination rights arise. In light of this risk, franchisors should preserve their right to terminate the franchise agreement by including clear forbearance language that

⁸⁵ *eTeam, Inc v. Hilton Worldwide Holdings, Inc.*, No. 2:15-CV-5057, 2017 WL 2539395, at *2, 4 (D.N.J. June 12, 2017).

⁸⁶ *Id.* at *2.

⁸⁷ *Id.* at *1, 3-4.

preserves key defaults and termination rights without regard to the passage of time or intervening events.

Failure to include appropriate preservation language can restrict or cause doubt about a franchisor's ability to enforce its termination rights. In one case, a franchisor sent a signed letter indicating that the franchisor would "forbear from taking any further actions against [franchisees] or the Franchise Restaurants, whether at law or in equity, to enforce our rights and remedies against [franchisees] or the Franchise Restaurants, under or in connection with the franchise agreements, until May 8, 2018."⁸⁸ The franchisor had previously sent cure extension communications expressing an intent to terminate the franchise relationship on April 27, 2018—two days after the forbearance letter was sent.⁸⁹ When the franchisees filed for bankruptcy in the early hours of May 8, 2018, the franchisor sought a declaration that the franchise agreements had terminated before the bankruptcy filing and that franchisor could exercise its post-termination right to take over the franchisee debtors' restaurants.⁹⁰ In support of its declaratory action, franchisor asserted that the expression of intent to terminate in the cure extension communications provided adequate notice of termination.⁹¹ The court concluded that the franchisor had failed to provide evidence of clear and unambiguous notice of termination of the franchise agreements and that the forbearance letter would have precluded any attempt to terminate during the forbearance period.⁹² This case is a useful reminder that even short forbearance before termination can present risks and careful planning in forbearance language is helpful.

G. Holdover Clauses

In some cases, a franchise term comes to an end before a succession plan is in place for the franchisee's business locations or territory. If the franchisee's operations will continue beyond the term of the agreement, the franchise parties should memorialize the end of the franchise term and the conditions allowing the franchisee to remain in place. A continuing contract between the parties may be implied by law in some circumstances, but the relationship is easier to manage where a holdover clause or agreement delineates how long a holdover term lasts, when a holdover term may restart, and how a holdover term may be terminated. The holdover provision should also contemplate how franchisor or franchisee will provide notice of termination of the holdover relationship and when such notice must be given.

Problems may arise where a holdover agreement is not put in place. In *Donut Holdings, Inc. v. Risberg*, a donut shop franchisor attempted to recover unpaid fees where

⁸⁸ *In re RMH Franchise Holdings, Inc.*, 590 B.R. 655, 659 (Bankr. D. Del. 2018).

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ *Id.*

⁹² *Id.* at 662-63 ("The only reasonable interpretation of the Forbearance Letter is that [franchisor] committed to delay enforcing *all* of its rights, not simply its post-termination rights.") (emphasis in original).

the franchisee stopped making payments more than four years after the term of the franchise agreement ended.⁹³ When the franchisee stopped making payments, the franchisor sent a notice that the franchise agreement had expired years earlier and invoked the agreement's post-termination provisions.⁹⁴ The franchisee continued making donuts using the franchisor's system, which prompted the franchisor to send another letter expressly terminating the franchise agreement.⁹⁵ The franchisee continued using the franchisee's system to sell donuts for nearly one year, after which time the franchisee removed the franchisor's trademarks and trade dress but continued to sell donuts of a similar quality for nearly two more years thereafter.⁹⁶ The franchisor sought to recover unpaid fees from the franchisee's donut operations after the franchisee stopped making payments.⁹⁷ The Nebraska Supreme Court affirmed the trial court's determination that an agreement was implied in fact based on the continued operations of the franchised business but that franchisor could not recover any fees after franchisor sent its first letter invoking the franchise agreement's post-termination provisions.⁹⁸ In this case, having a holdover provision in the franchise agreement may have aided the parties in creating specificity and a framework for their post-term relationship.

H. Takeover Clauses

In some cases, termination of a franchisee with significant operational defects, while warranted to protect the system, can cause catastrophic market closures for the franchisor's system. Some franchise agreements include takeover clauses that mitigate this risk by allowing the franchisor to take over the closed franchised business within a certain time after termination. Takeover clauses should identify (1) specific situations that trigger a franchisor's right to terminate and take control of the franchisee's business operations, (2) any documentation that is necessary for takeover, and (3) specific cooperation that is required from the franchisee. A franchise agreement with a takeover provision should also include a requirement that any leases entered into by the franchisee include a lease rider that accounts for franchisor takeover in certain circumstances. Even where a lease form including sample rider language is incorporated into the franchise agreement, franchisors should make sure this rider is actually put into place at the outset of the relationship to allow the franchisor to access the franchised business's premises.⁹⁹

III. FRANCHISE RELATIONSHIPS

⁹³ 885 N.W.2d 670, 672-73 (Neb. 2016).

⁹⁴ *Id.* at 672.

⁹⁵ *Id.*

⁹⁶ *Id.* at 672-73.

⁹⁷ *Id.*

⁹⁸ *Id.* at 674.

⁹⁹ See *Dunkin' Donuts Inc. v. Dowco, Inc.*, No. CIV. 5:98-CV-166, 1998 WL 160823 (N.D.N.Y. 1998) (where the court enforced a lease option which provided that upon franchisee termination, the landlord of the franchise locations would give franchisor the option of assuming franchisee's lease and continuing to operate the locations).

The strength of franchisor/franchisee relationships are dependent upon the success of the system and whether the parties are able, over time, to build a relationship of trust. When the relationship deteriorates, contract claims, such as the implied covenant of good faith and fair dealing, common law fraud, and breaches of state franchise laws, among others, ensue. Below we discuss claims that often arise when the relationship between franchisor and franchisees (individually or collectively) breaks down.

A. Geographic Territories/Encroachment

In the context of franchise law, encroachment generally refers to a franchisor permitting a new franchise location to be built near an existing franchise location. Tension can occur because franchisors may have an interest in licensing new franchisees while franchisees have an interest in protecting their territory, investment, and profitability. Encroachment can lead to competition between franchise locations, decreased sales, saturation of the local market, and the adding of unnecessary strains on the franchisor-franchisee relationship. Encroachment claims can occur when a franchisor fails to properly analyze the market and existing territory rights. Or a franchisee may believe that the location will impact its sales even though the franchisor's analysis shows it will not. Whatever the case, franchisee concerns about encroachment can damage franchisor/franchisee relationships.

Encroachment claims can result in significant damages awards. In *Glen Suh, et al. v. Un Mi Pak, et al.*, a recent case in the Superior Court of California, Los Angeles, an It's Boba Time franchisee brought claims against franchisor Boba Time, Inc. ("Boba Time") for breach of an exclusive territory provision.¹⁰⁰ The trial court found that Boba Time opened additional stores within franchisee's exclusive territory (a 10-mile radius) and awarded a total of \$1,320,288.00 in lost profits to the franchisee.¹⁰¹ Believing the award was too low, franchisee attempted to re-litigate damages on appeal,¹⁰² seeking an additional \$4,714,602.00 for being unable to capitalize on the use of the exclusive area for future franchise opportunities (e.g., obtaining reverse royalties or opening additional locations).¹⁰³ The appellate court is still reviewing this matter and had yet to rule as of the date this paper was prepared.

A drafting point for franchisors to consider is reserving the right to terminate exclusivity. For example, if a franchisor grants exclusivity in area development

¹⁰⁰ *Glen Suh, et al., v. Un Mi Pak, et al.*, No. BC685235, WL, Superior Court California for the County of Los Angeles (June 6, 2022).

¹⁰¹ Judgment, *Glen Suh, et al., v. Un Mi Pak, et al.*, No. BC685235, WL, Superior Court California for the County of Los Angeles (June 6, 2022).

¹⁰² Appellants' Opening Brief, *Glen Suh, et al., v. Un Mi Pak, et al.*, 2023 WL 3478798 (Cal. App. 2 Dist. April 25, 2023).

¹⁰³ *Id.*

agreements, it could contractually reserve the right to terminate such exclusivity.¹⁰⁴ In *Pinnacle Foods of California*, Popeyes contractually reserved the right to rescind Pinnacle's exclusive territories pursuant to their area development agreement.¹⁰⁵ Due to Pinnacle's failure to meet its operational metrics and the requirements of the area development agreement, Popeyes rescinded Pinnacle's exclusive territories and terminated its franchise agreements.¹⁰⁶ The court found that the area development agreement supported rescinding Pinnacle's exclusivity and granted Popeyes' motion to dismiss Pinnacles' good faith and fair dealing claim on this issue.¹⁰⁷

Another drafting point to consider is creating reasonable expectations in the franchise agreement with respect to exclusivity. In *Kazi v. KFC US, LLC*, Kazi owned a KFC franchise in Pueblo, Colorado with a 1.5-mile exclusive territory right.¹⁰⁸ He alleged that KFC breached the implied covenant of good faith and fair dealing when it allowed another franchisee to open a new location 5.3 miles away from his location.¹⁰⁹ According to the provisions outlined in the franchise agreement, Kazi had priority in applying for any new locations proposed by KFC that went beyond his 1.5-mile radius but were in close proximity to Kazi's location.¹¹⁰ Additionally, under a separate incentive program not a part of the franchise agreement, Kazi had the ability to request an impact study from KFC.¹¹¹ If the impact on sales was greater than 15%, then KFC would refrain from opening a proposed new location.¹¹² KFC's impact study resulted in a 13.4% impact—a number displeasing to Kazi.¹¹³ Subsequently, Kazi initiated his own impact study with results reaching a 35% impact on his location's sales.¹¹⁴ Despite Kazi's study, KFC allowed the other franchisee to open its new location.¹¹⁵ The Tenth Circuit determined that “under Kentucky law, to bring a claim for breach of the implied duty of good faith and fair dealing, the party must point to an expectation created by the language of the contract. . .that was defeated by the bad faith of the other party.”¹¹⁶ It concluded that Kazi was unable to identify any specific terms that justified his expectation that KFC would perform a new

¹⁰⁴ See *Pinnacle Foods of California, LLC v. Popeyes Louisiana Kitchen, Inc. Restaurant Brands International, Inc.*, No. 21-21555-CIV, 2022 WL 17736190, at *9-10 (S.D. Fla., Dec. 16, 2022).

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ See *Kazi v. KFC US, LLC*, 76 F.4th 993, 995 (10th Cir. 2023).

¹⁰⁹ *Id.* at 998

¹¹⁰ *Id.* at 996.

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ *Id.* at 997.

¹¹⁴ *Id.*

¹¹⁵ *Id.*

¹¹⁶ *Id.* at 1003.

impact study or abstain from developing the new location.¹¹⁷ Therefore, the court remanded for entry of judgment in favor of KFC.¹¹⁸

Furthermore, the issue of encroachment can arise when a franchisor is acquired by or acquires another similar franchise system (such as two fast-casual restaurant chains combining). In this situation, the competitive landscape may very well change with the introduction of competing businesses in a given territory. Notably, some state franchise relationship laws address this issue via certain encroachment restrictions. For example, Indiana’s franchise relationship laws prohibit provisions in franchise agreements which allow the franchisor to engage in a “substantially identical” business to that of the franchisee within an exclusive territory, or, if there is no exclusive territory, to “compete unfairly” with the franchisee within a reasonable area.¹¹⁹ Likewise Iowa, Washington, and Wisconsin, among other states, impose restrictions related to encroachment by franchisors.¹²⁰ A change of the competitive landscape through acquisition may implicate these regulations. For other states, franchisors may be able to draft carve-outs that permit such acquisitions despite territorial protections for the franchisee. Of course, such provisions must be drafted carefully, and strike a balance between flexibility for the franchisor and fairness for the franchisee.¹²¹

There may be good reasons for a franchisor to provide a franchisee with an exclusive territory. For one, it provides the franchisee with comfort that its sales will not be cannibalized by the franchisor or another franchisee. The safest way to prevent good faith and fair dealing claims for encroachment from being brought, however, is to draft language stating that the franchisee has no rights to exclusive territory and to make clear that competing franchises may be located nearby.¹²² A sample provision demonstrating as much is as follows:

No Exclusive Territory or Other Rights. You must operate the Franchised Business only from the Location, including any catering services of XXX menu items you provide. You acknowledge that the XXX franchise granted under this Agreement is non-exclusive, that we are not granting you any territorial protection or any other exclusive rights, and that we, directly or through one (1) or more affiliates, reserve the right in our sole discretion, and without compensating you or seeking your prior approval: (i) to establish, and grant to other franchisees or licensees the right to establish,

¹¹⁷ See *Kazi*, 76 F.4th 993 at 1003-1004.

¹¹⁸ *Id.* at 1006-1007.

¹¹⁹ Ind. Code. § 23-2-2.7-2(4).

¹²⁰ Iowa Code § 523H.6 (imposing several encroachment restrictions); Wash. Rev. Code. § 19.100.180(2)(f) (similarly imposing encroachment restrictions on franchisors); Wis. Code §§ 135.03, 13.5.04 (governing “changes in competitive circumstances”).

¹²¹ AMERICAN BAR ASSOCIATION, THE ANNOTATED FRANCHISE AGREEMENT 31 (Nina Greene et al. eds., 2018).

¹²² *Id.* at 1004 (citing cases in other circuits that support the proposition that if a franchise agreement addresses encroachment, good faith and fair dealing claims cannot be invoked to expand a franchisee’s protections beyond the agreement’s terms).

a XXX restaurant or any other business using the Proprietary Marks, the XXX System or any variation thereof, in any location other than the approved Location (including locations in the immediate vicinity of your Location), on any terms and conditions that we deem appropriate; (ii) to establish, and grant to other franchisees or licensees the right to establish, any restaurant concept other than XXX in any location on any terms and conditions that we deem appropriate (including locations in the immediate vicinity of the Location); (iii) to sell products identified by the Proprietary Marks or other trademarks, service marks or commercial symbols in any location through any distribution channels, including grocery stores, convenience stores, supermarkets, club stores, vending machines, delivery services and restaurants other than XXX restaurants; and (iv) to take any other action that we are not expressly prohibited from taking under this Agreement.

B. Franchise Associations

Franchisee associations within franchise systems support advocacy on behalf of franchisees' interests. In addition, they can foster, among other things, useful communications between franchisee and franchisor, the sharing of important information regarding the franchise system, best practices, and the organization of educational training sessions.

These associations may vary in structure, depending on the franchise system; however, they usually have similar foundations. An association may be led by a board of directors which oversees the association's activities and strategic direction. Additionally, there may be various committees focused on specific areas like advocacy, education, membership, purchasing, marketing, and technology. There may also be regional chapters to serve franchisees in different geographic territories. General membership will include membership dues and often voting rights.

Careful drafting of the provisions regarding franchisee associations and ensuring compliance with the provisions is critical to avoiding subsequent disputes. The associations should not be organized in ways that strictly favor the franchisor over franchisees or otherwise disadvantage the franchisees.¹²³ Should that occur, the franchisor may be susceptible to claims for breach of contract or of the covenant of good faith and fair dealing. In *Park 80 Hotels, LLC v. Holiday Hospitality Franchising, LLC*, plaintiffs alleged breach of contract on the grounds that Holiday Hospitality violated a

¹²³ Cases have been brought against franchisors asserting allegations of franchisor kickbacks, manipulation of board members, and franchisor oppressive agendas, in connection with the operation of franchisee associations. See e.g., *Jai Sai Baba LLC v. Choice Hotels International Inc.*, No. 5:20-CV-02823, 2021 WL 1049994, at *11 (E.D. Pa., Mar. 19, 2021) (granting motion to compel arbitration for RICO, Sherman Act, and Civil Rights Act claims based in part on similar allegations).

section of the licensing agreement regarding the franchisee association.¹²⁴ The section provided:

....The purposes of the IHG Owners Association will be to consider and discuss, and make recommendations on common problems relating to the operation of System hotels. [Defendants] will seek the advice and counsel of the IHG Owners Association's Board of Directors or, subject to the approval of [Defendants], such committees, directors or officers of the IHG Owners Association to which or to whom the IHG Owners Association Board of Directors may delegate such responsibilities.

...

....Recognizing that the IHG Owners Association must function in a manner consistent with the best interests of all persons using the System, [a given franchisee] and [Defendants] will use their best efforts to cause the governing rules of the IHG Owners Association to be consistent with this License.¹²⁵

Plaintiffs alleged that Holiday Hospitality violated the aforementioned provision by manipulating the selection process of IHGOA board members and incentivizing their loyalty to Holiday Hospitality's agenda.¹²⁶ Despite the board members "elections," Plaintiffs alleged that dissenting voices were unable to gain seats on the board.¹²⁷ Due to the allegedly rigged nature of the board, it basically obviated Holiday Hospitality's obligation to seek advice from the IHGOA Board.¹²⁸ Under these alleged circumstances, Holiday Hospitality was at liberty to ignore genuine franchisee concerns and prioritize self-enrichment.¹²⁹

The United States District Court for the Northern District of Georgia concluded that plaintiffs had adequately alleged breach of contract based on Holiday Hospitality's management of the franchisee association.¹³⁰ It also determined that the terms of the license agreement were silent as to how the board is to be elected, so under Georgia law, Holiday Hospitality is to "exercise...good faith" in the organization of the franchisee association.¹³¹ On these grounds, the court found the plaintiffs' breach of contract claim survived Holiday Hospitality's motion to dismiss.¹³² As of the date this paper was prepared, this matter was still pending.

¹²⁴ *Park 80 Hotels, LLC v. Holiday Hospitality Franchising, LLC*, No. 1:21-CV-04650-ELR, 2023 WL 2445437, at *12 (N.D. Ga., Feb. 16, 2023).

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ *Park 80 Hotels*, 2023 WL 2445437, at *12.

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ *Id.* at 13.

¹³¹ *Id.*

¹³² *Id.*

Franchisors should memorialize their meetings with franchisee associations to ensure that, should disputes arise, they can later establish the degree to which they sought to assist the franchisees, obtained “buy-in” on proposals for system changes, or otherwise worked with franchisees to improve and grow the system. Similarly, they should memorialize, through notes or meeting minutes, the discussions that occurred in any meetings of franchisor/franchisee committees.

C. Changes in System Standards

At the heart of any franchise system are its system standards which protect the trademarked brand, keep franchise outlets uniform and consistent in operation and appearance, and govern various aspects of the franchisor-franchisee relationship. These standards govern operations, customer service, pricing, marketing, approved suppliers and products, training materials, branding, advertising, uniforms, legal compliance, and necessary equipment, among other things. Franchise agreements reserve the franchisor’s right to modify its brand/system standards which are typically detailed at length in the franchisor’s operations manual and oblige a franchisee’s compliance with such standards. When drafting terms regarding system standards franchisors should reserve the right to enforce and modify system standards as necessary and in doing so set out clear and unambiguous guidelines.

The franchisor’s right to enforce and modify its system standards are governed by the contractual bounds of the franchise agreement, which should include the right to make changes to system standards over time.¹³³ In *La Quinta Corp. v. Heartland Properties LLC*, the United States Court of Appeals for the Sixth Circuit considered whether the hotel franchisor had the right to implement new system standards pursuant to the terms of the license agreement and under Wisconsin law.¹³⁴ The court held that the license agreement afforded the hotel franchisor the express right to add, amend, and/or delete system standards and to require the franchisee to participate in such costs.¹³⁵

Below is a sample system/standards change provision:

Service Marks, Operations Manual, and System May Be Changed. You understand and agree that we may add to, subtract from, change or modify

¹³³ See *D.Q.S.A. LLC v. American Dairy Queen Corporation*, No. CV-22-00335-TUC-JGZ, 2023 WL 4365332, at *9 (D. Ariz., July 6, 2023) (finding that master franchisor American Dairy Queen Corp. was authorized under the operative agreements to require territory operator to compel sub-franchisees to install new technology platform); see also *Park 80 Hotels, LLC v. Holiday Hospitality Franchising, LLC*, No. 1:21-CV-04650-ELR, 2023 WL 2445437, at *7 (N.D. Ga., Feb. 16, 2023) (finding a franchisee’s allegations that franchisor arbitrarily altered its standards in bad faith to impose undisclosed costs were not meritorious because franchisor retained the contractual right to modify in its sole judgment and at the sole cost and expense of franchisee).

¹³⁴ *La Quinta Corp. v. Heartland Properties LLC*, 603 F.3d 327, 336-337 (6th Cir. 2010)

¹³⁵ *Id.*

any part of the Service Marks, Operations Manual, or the System from time to time at our sole discretion. This may include changes to the products, equipment, signage, trade dress, décor, design, appearance, operations, programs, services, methods, standards, forms, policies and procedures of the System or abandoning the System altogether in favor of another system in connection with a merger, acquisition, or other business reason. You will accept, use, and protect, for the purposes of this Agreement, all additions, subtractions, changes and modifications as if they were a part of the Service Marks, Operations Manual, and the System at the time this Agreement is executed. You will bear all costs and expenses which may be reasonably necessary as a result of such changes or modifications.

While the intent of modifications to system standards is usually to benefit the franchise system as whole, it would be wise to carefully consider their impact on franchisees. For the sake of keeping the franchise relationship healthy, transparency and communication regarding any potential modifications will help mitigate franchisee resistance and avoid litigation.

Practitioners should be aware that state law can affect the applicability of change provisions. For example, in Washington state it is considered an unfair business practice for a franchisor to “impose on a franchisee by contract, rule, or regulation, whether written or oral, any standard of conduct unless the person so doing can sustain the burden of proving such to be reasonable and necessary.”¹³⁶ This, of course, limits the discretion granted to a franchisor to implement a change provision like the one above,

C. When to Default/Terminate

A franchisor’s ability to justifiably default or terminate a franchisee will be governed by the terms of the franchise agreement, applicable state franchise relationship laws, and considerations regarding its impact on the franchisee-franchisor relationship and the franchise system as a whole. Oftentimes, defaulting or terminating a franchisee, even one who has violated the terms of the franchise agreement, is not an easy decision to make and franchisors have to weigh various interests, including potential loss of revenue, loss of a location, and the risk of allowing a franchisee who has violated the agreement to remain in the system.

Prior to defaulting and/or terminating a franchisee, the franchisor should closely review the franchisee’s conduct, gather all relevant facts, and determine the nature and extent of the franchisee’s breaches. The more thorough this investigation, the more secure the franchisor will be in implementing a course of action. In addition, franchisors need to closely review any applicable relationship acts. For example, under the California Franchise Relationship Act, a franchise may not be terminated prior to the expiration of

¹³⁶ Wash. Rev. Code § 19.100.180(2)(h).

its term, except for good cause.¹³⁷ Good cause is limited to “the failure of the franchisee to substantially comply with the lawful requirements imposed upon the franchisee by the franchise agreement after being given notice at least 60 days in advance of the termination and a reasonable opportunity . . . to cure the failure.”¹³⁸ In addition to this, California provides grounds for immediate notice of termination without an opportunity to cure under certain circumstances (e.g., franchisee’s abandonment, noncompliance with federal, state, or local law, failure to pay franchise fees or other amounts due).¹³⁹ Similarly, Michigan’s Franchise Investment Law, “prohibits any provision in a franchise agreement that ‘permits a franchisor to terminate a franchise prior to the expiration of its term except for good cause.’”¹⁴⁰ It would be prudent for transactional attorneys to consider the varying state laws on defaults and terminations in drafting these provisions. Among other things, attorneys should consider including a clause in the franchise agreement explicitly stating that to the extent a state’s law requires a different cure period for a default, or a different notice period for termination, or otherwise imposes requirements not set forth in the franchise agreement, the state’s law will control.

Termination of a franchisee due to a violation of the terms of the franchise agreement is generally a proper termination.¹⁴¹ As stated above, however, there may be state specific requirements for proper termination. For example, the materiality of the franchisee’s breach of the franchise relationship is a relevant consideration under Florida law.¹⁴² In *Peterbrooke Franchising of Am., LLC v. Miami Chocolates, LLC*, the eleventh circuit vacated a district court’s grant of summary judgment in favor of franchisor Peterbrooke Franchising of Am., LLC’s (“Peterbrooke”) breach of contract claim.¹⁴³ Franchisee Miami Chocolates, LLC (“Miami Chocolates”) was terminated for noncompliance with its contractual obligation to implement a required point of sale system.¹⁴⁴ Although the court found that Peterbrooke contractually had the full and

¹³⁷ Cal. Bus. & Prof. Code § 20020.

¹³⁸ *Id.*

¹³⁹ Cal. Bus. & Prof. Code § 20021 (a-l).

¹⁴⁰ *7-Eleven, Inc. v. CJ-Grand, LLC*, 517 F.Supp.3d 688, 694 (E.D. Mich. 2021) (citation omitted) (finding “7-Eleven’s ‘four strikes’ provision satisfied the statute’s good-cause requirement” and that 7-Elevens termination of a serial breacher was proper).

¹⁴¹ *See, e.g., Sonic Indus., LLC v. Simple Tie Ventures, LP*, CIV-20-183-J, 2021 WL 5988296, at *12 (W.D. Okla. July 12, 2021) (finding that franchisor Sonic Indus., LLC’s termination was proper because the relevant defendants breached the license agreements) (citing *Tsunami Softgoods, Inc. v. Tsunami International, Inc.*, No. 2:00CV738K, 2001 WL 670926, at *4 (D. Utah Jan. 19, 2001) (finding no doubt that defendant had failed to perform and thus plaintiff had demonstrated the termination was proper)).

¹⁴² *See Peterbrooke Franchising of Am., LLC v. Miami Chocolates, LLC*, 21-10242, 2022 WL 6635136, at *4 (11th Cir. Oct. 11, 2022) (finding that under Florida law “termination is only proper where the nonperforming party has breached a material term because an immaterial breach does not excuse continued performance”) (citation omitted).

¹⁴³ *Id.* at *5-6.

¹⁴⁴ *Id.* at *2.

exclusive discretion to designate and change the point of sale system, questions of fact remained as to the materiality of the franchisee's breach.¹⁴⁵ The court observed that the franchise agreement explicitly stated that compliance with certain terms is material; however, the same language was missing from the section governing implementation of point of sale systems.¹⁴⁶ Additionally, the court concluded that when Miami Chocolates was terminated other franchisees were using different systems, the systems had the same functionalities as the new system, and Miami Chocolates gave Peterbrooke full access to their sales information—all these facts cut against a finding that the breach was material.¹⁴⁷ The lesson from *Peterbrooke* is at least in part that, in drafting the franchise agreement, the franchisor should be cautious in asserting that certain provisions are “material,” inasmuch as a court may find that the failure to assert that other provisions are material means they are not. Accordingly, the franchisor should consider refraining from asserting that any particular provision is material. Alternatively, the franchisor could consider omnibus provisions stating that certain key sections of the agreement are material.

D. Renewal of Agreement

A franchisee's right to renew their franchise agreements varies depending on the franchise system and contract language. When facing the renewal or non-renewal of a franchise agreement, it's crucial to consider the application of state relationship laws. Franchisors are obligated to adhere to relevant state relationship laws governing renewals upon the expiration of each franchise agreement and should review the applicable state relationship laws for any non-renewal requirements, cure periods, and notice requirements.

Various state laws prohibit non-renewal without “good cause.” For example, in Hawaii, a franchisor may not terminate or refuse to renew a franchise except for good cause. . . [which] shall include, but not be limited to, the failure of the franchisee to comply with any lawful, material provision of the franchise agreement after having been given written notice thereof and an opportunity to cure. . . .”¹⁴⁸ New Jersey defines good cause as the failure to substantially comply with the terms of the agreement.¹⁴⁹

In *BP Products North America, Inc. v. Hillside Service, Inc.* the United States District Court, for the District of New Jersey, considered whether the franchisor violated the New Jersey Franchise Practices Act (NJFPA) by failing to renew an agreement that

¹⁴⁵ *Id.* at *4-5.

¹⁴⁶ *Id.* at *5.

¹⁴⁷ *Id.*

¹⁴⁸ HI Rev Stat § 482E-6.

¹⁴⁹ N.J.S.A. § 56:10-5 (“For the purposes of this act, good cause for terminating, canceling, or failing to renew a franchise shall be limited to failure by the franchisee to substantially comply with those requirements imposed upon him by the franchise”).

contained no express right of renewal.¹⁵⁰ The court determined that by the plain terms of the NJFPA, the act “prohibits from failing to renew a franchise agreement without good cause. . . .”¹⁵¹ It recognized that the NJFPA was “enacted in large part to counteract the unequal bargaining power between franchisor and franchisee, which would allow a franchisor . . . to insert provisions . . . to sever the franchise relationship at will.”¹⁵² The court concluded that BP Products had not shown good cause and thus could not fail to renew existing franchises—if it did, then it would be liable for damages in accordance with the NJFPA.¹⁵³

Franchisors must also pay close attention to notice requirements and cure periods for non-renewal. In *West L.A. Pizza, Inc. v. Domino's Pizza, Inc.*, the United States District Court for the Central District of California found that the parties’ extension of the current franchise term, prior to its expiration, complied with the required 180 days prior written notice for any intent not to renew.¹⁵⁴ It considered Cal. Bus. & Prof. Code § 20026, which provides, “Nothing in Section 20025 shall prohibit a franchisor from offering or agreeing before expiration of the current franchise term to extend the term of the franchise for a limited period in order to satisfy the time of notice of nonrenewal requirement of that section.”¹⁵⁵ This example illustrates a franchisor’s obligation to confirm any non-renewal requirements under applicable state law.

Non-renewal requirements in franchise agreements often conflict with state law non-renewal requirements. Franchise agreements may not include “good cause” provisions for non-renewal, prior written notice provisions for non-renewal, or provisions that the franchisor must “buy back” the franchisee’s inventory, which several states require. When the franchisor intentionally or unintentionally ignores state law requirements for non-renewals, litigation can result. Franchisors may wish to include language in the franchise agreement that generally acknowledges state law requirements and defers to them, which at the least will alert those attempting to enforce the agreements to review more closely state law requirements and ensure they are followed.

IV. PRE-LITIGATION DISPUTE RESOLUTION

A. Impact on the FDD - including pre-litigation dispute resolution can lessen litigation disclosures

¹⁵⁰ *BP Products North America, Inc. v. Hillside Service, Inc.*, No. CIV. 9-4210, 2011 WL 4343452, at *1 (D.N.J., Sept. 14, 2011).

¹⁵¹ *Id.* at *2.

¹⁵² *Id.* at *3 (citing cases in support of the purpose of the NJFPA); see also *Red Roof Franchising, LLC v. Patel*, 877 F.Supp.2d 124, 137 (D.N.J.2012) (finding that the NJFPA protects franchisee against indiscriminate terminations and nonrenewals) (citation omitted).

¹⁵³ *BP Products North America*, 2011 WL 4343452, at *3-4.

¹⁵⁴ *West L.A. Pizza, Inc. v. Domino's Pizza, Inc.*, No. 207CV07484FMCMANX, 2008 WL 11424181, at *9, (C.D. Cal., Feb. 26, 2008).

¹⁵⁵ *West L.A. Pizza*, 2008 WL 11424181, at *9.

The need for franchisors to disclose litigation in the FDD often informs the decision on whether the franchisor and franchisee will attempt to resolve their disputes before litigation ensues. Federal Trade Commission regulations and some state-specific laws require certain disclosures by franchisors in the FDD if the franchisor was involved in litigation material to the franchise relationship.¹⁵⁶ Further, if a franchisor is found liable for violating franchise laws, engaging in unfair or deceptive practices, or comparable allegations, it is required to include such information in its FDD for 10 years.¹⁵⁷ For this reason, among others, franchisors may consider pre-litigation dispute resolution to try to avoid a litigation filing or an adverse result in litigation that would have to be disclosed in the FDD. Experienced plaintiffs' counsel will often realize this dynamic even in the absence of a pre-litigation dispute resolution requirement and may reach out to the franchisor to seek resolution before filing.

B. Pre-litigation dispute resolution considerations: speed, cost, timing, issue importance, and the possibility of new legal precedent

Opting for direct negotiation or mediation pre-litigation may lessen the time to resolve the dispute.¹⁵⁸ Any litigation—even straight-forward litigation—is time-consuming for the parties and takes away from their focus on their businesses. Further, franchisors may wish to find an early resolution of disputes that carry implications for other franchisees or the system as a whole. And a shorter timeline to resolution generally means lower attorneys' fees. A quick resolution can also avoid a loss of productivity and revenue from protracted litigation. Of course, pre-litigation dispute resolution approaches do not offer the same sort of robust discovery as litigation, so parties will be seeking to resolve the dispute with less knowledge. Despite this, the lower cost and reduced time commitment may be worth foregoing more extensive fact-finding. And depending on the nature of dispute, having to share less information might be preferable.

The inclusion of pre-litigation dispute resolution clauses in the franchise agreement can be helpful. Many such clauses are staged or stepped, including some or all of the following: a period of notice, a period of direct negotiation, a period of non-binding mediation, then a final step of arbitration or litigation. Steps like these can encourage the parties to resolve their disputes early and before the commencement of litigation. These clauses also give the parties time to properly prepare for negotiations, and to gather evidence, determine legal theories, weigh risk, and the like.

As a drafting point, a pre-litigation dispute resolution clause that includes timed steps should be fashioned to the needs of the particular system. For example, a system that is very large and may be engaged in multiple disputes at a time may not benefit from

¹⁵⁶ 16 C.F.R. § 436.5(c)(1).

¹⁵⁷ 16 C.F.R. § 436.5(c)(1)(ii)(B).

¹⁵⁸ In federal court, the average time from the start of a lawsuit to trial is around 2 years. Scott E. Korzenowski, Benjamin B. Reed, & Les Wharton, *The Keys to Successful Negotiation and Early Dispute Resolution*, American Bar Association 42nd Annual Forum on Franchising, at 6.

a clause that calls for direct negotiations to be in-person at a specific place within 20 days of notice of the dispute. Alternatives should be considered and fashioned that may include longer periods of time, alternatives to in-person appearance, or alternative locations.

An example of a stepped pre-litigation dispute resolution clause is found in *N-Tron Corp. v. Rockwell Automation, Inc.*:

The parties will attempt in good faith to resolve any dispute arising out of Member's membership in the Program by negotiations between representatives who have authority to settle the controversy. If unsuccessful, the parties further will attempt in good faith to settle the dispute by non-binding third-party mediation, with fees and expenses of such mediation apportioned equally to each side. Any dispute not so resolved by negotiation or mediation may then be submitted to a court of competent jurisdiction in accordance with the terms of this MoM. These procedures are the exclusive procedures for the resolution of all such disputes between the parties.¹⁵⁹

Another reason to consider using pre-litigation dispute resolution clauses is the potential for creating unfavorable precedent that may result from litigation. While most judgments simply reapply and reassert long-standing doctrine, there is a chance that a court may chip away or overturn current law or will create unfavorable new law. Litigation is inherently unpredictable, especially in the jury context, and resolving a dispute before it proceeds to court or arbitration can lead to more certainty. Of course, in certain circumstances a party may actually want to change or create precedent, in which case a pre-dispute clause may not be helpful. Even if a pre-litigation dispute resolution clause does not lead to early resolution -- there is no mandate that the parties resolve their disputes through negotiation -- it can still be useful to test the parties claims or theories and refine the matter for later resolution. Benefits abound from pre-litigation dispute resolution clauses.

C. Methods of pre-litigation dispute resolution – notice of dispute, direct negotiation, mediation, and arbitration

The first step along the way in pre-litigation dispute resolution often is a notice of dispute requirement.¹⁶⁰ This may be the first time a party learns of the other party's

¹⁵⁹ *N-Tron Corp. v. Rockwell Automation, Inc.*, No. CIV.A. 09-0733-WS-C, 2010 WL 653760, at *3 (S.D. Ala. Feb. 18, 2010).

¹⁶⁰ See e.g., *World Gym, Inc. v. Pla-Fit Franchise, LLC*, No. CIV.A. 12-11620-DJC, 2013 WL 3830164, at *1 (D. Mass. July 19, 2013):

Each franchise agreement contains a “Negotiation and Arbitration” provision (the “Arbitration Clause”) that provides:

dispute, and for the noticing party it is an important chance to define and refine the claim. Notice puts the parties on a path to potential resolution as you cannot solve the problem if it is ambiguous. Sometimes a notice of dispute motivates the parties to meet or connect by phone, and resolve the dispute. If not, more steps can be beneficial.

As a next step, some pre-litigation dispute resolution clauses call for direct negotiation among the parties only. This step can be appealing for several reasons. While the objectivity and arm's-length distance of a neutral might be appealing, mediators, arbitrators, and judges are inevitably less familiar with the details and nuances of the franchisor-franchisee relationship at the center of the dispute and need information and education about the matter to make them effective.¹⁶¹ Direct negotiation clauses may call for certain parties to be together in-person to negotiate. While the players change in any dispute and over time in a system, the drafter may give consideration to the culture of the system as to whether this provision is beneficial or may structure it specific to such considerations. This is a time to be bespoke. Considerations for the drafter include: who should attend, is attendance in person or some other way, how and where do the parties meet to negotiate, how long should the negotiation extend, and is there an ending point to the negotiation. Notably, direct negotiation can be done with or without counsel, which may be appealing depending on the size and type of dispute.

A common step in pre-litigation dispute resolution is mediation prior to arbitration or litigation. Mediation generally features no or very little discovery, so parties will be acting on limited information. Mediation clauses often include terms describing the types of situations where mediation would or would not be appropriate or is not required, pre-mediation procedure, cost allocation, timing of the proceeding, location of the mediation, and documentation of the proceeding.¹⁶² Notably, all these terms can signal the parties' willingness to find a solution without litigation. When drafting a mediation clause in a franchise agreement, it is important to be specific to make it more likely to be enforced.¹⁶³ The language should clearly explain that mediation is *necessary* before resorting to

All controversies, disputes, or claims between the parties, including their respective affiliates, owners, officers, directors, agents, and employees arising from or relating to this [Franchise] Agreement that are not resolved by negotiations within thirty (30) days of the notice of dispute, shall on demand of either party be submitted for arbitration to the American Arbitration Association ("AAA"). The arbitration shall be governed exclusively by the United States Arbitration Act (9 U.S.C. § 1, et seq.), without reference to any state arbitration statutes.

¹⁶¹ Scott E. Korzenowski, Benjamin B. Reed, & Les Wharton, *The Keys to Successful Negotiation and Early Dispute Resolution*, AMERICAN BAR ASSOCIATION 42ND ANNUAL FORUM ON FRANCHISING, at 4 (2019).

¹⁶² THE ANNOTATED FRANCHISE AGREEMENT 233 (Nina Greene, Dawn Newton, & Kerry Olson eds., 2018)

¹⁶³ *Cumberland and York Distributors v. Coors Brewing Co.*, 2002 WL 193323 (D.Me. 2002), at *4 (Court did not enforce mediation provision because the contract language did not specify timing.).

arbitration or litigation. Repeated use of the language, “condition precedent” is a best practice, as several federal District Courts and Courts of Appeals have upheld the notion that failing to satisfy such a condition precludes parties from compelling arbitration or proceeding to litigation.¹⁶⁴

Arbitration or litigation is the last stop in dispute resolution. When considering arbitration, parties must decide whether avoiding a jury, the risk of a class action, or the creation of precedent is worth effectively losing the right to appeal.¹⁶⁵ Arbitration is a creature of contract and it can be formed to the parties’ specific requirements. This is where the drafter can have great impact. Depending on how the parties structure the arbitration provision, arbitration may limit discovery and may limit the ability to seek summary disposition. That said, arbitration comes with some realities, such as the fact that arbitrators are also often limited in their authority to compel nonparties to appear at depositions or produce documents in the arbitration and arbitrators are more likely permit entry of evidence that could be excluded in litigation.¹⁶⁶

Notably, arbitration is not necessarily less costly or time consuming than traditional litigation, but many franchisors prefer it. When drafting an arbitration clause in a franchise agreement, it is can be helpful to the process to be specific and comprehensive. The language should explicitly state that disputes shall be resolved by binding arbitration rather than litigation. Further, arbitration clauses should explain *which* disputes will be subject to arbitration (and which ones will not), who the arbitration provider will be, which rules will apply, how many arbitrators will decide the dispute, the location of the proceeding, the form of the arbitrator’s decision, and the extent of the arbitrator’s authority.¹⁶⁷ The clause might also cover pre-hearing and hearing procedures, the extent of discovery, and which court will enforce the arbitrator’s decision.¹⁶⁸ Of course, this list is not exhaustive, but the key takeaway is that comprehensive and specific language is crucial. Lastly, when negotiating and drafting these clauses, counsel must be mindful to abide by applicable law and lessen risk for common law contract enforcement defenses like unconscionability, fraud, or duress.¹⁶⁹

D. Detail and specificity increase the chances that a court will enforce pre-litigation dispute resolution provisions

¹⁶⁴ *HIM Portland, LLC v. DeVito Builders, Inc.*, 317 F.3d 41, 44 (1st Cir. 2003); *Kemiron Atl., Inc. v. Aguakem Int'l, Inc.*, 290 F.3d 1287, 1291 (11th Cir. 2002); *Synopsys, Inc. v. Siemens Industry Software Inc.*, 2021 WL 1238309 (N.D. Cal., 2021), at *5; *Roybal v. Bachman*, 2022 WL 2307075 (D. Nev., 2022), at *2.

¹⁶⁵ THE ANNOTATED FRANCHISE AGREEMENT 235.

¹⁶⁶ *COMSAT Corp., v. Nat'l Sci. Found.*, 190 F.3d 269, 275 (4th Cir. 1999); *Matria Healthcare, LLC v. Duthie*, 584 F.Supp. 2d 1078, 1080 (N.D. Ill. 2008). One of the few ways to challenge an arbitrator’s award is to assert that the arbitrator improperly excluded evidence. THE ANNOTATED FRANCHISE AGREEMENT 235.

¹⁶⁷ THE ANNOTATED FRANCHISE AGREEMENT 236.

¹⁶⁸ *Id.*

¹⁶⁹ *Id.*

It is important to remember that even though pre-litigation dispute resolution clauses may use mandatory language, *resolution* through negotiation or mediation is ultimately voluntary. In other words, parties have no duty to settle. Despite this, practitioners can draft their pre-litigation dispute resolution provisions to increase the likelihood of enforcement.

Courts sometimes view negotiation or mediation clauses as non-binding agreements to agree.¹⁷⁰ To guard against nonenforcement, drafters should explicitly state that mediation is a “condition precedent” to litigation. Also, courts tend to enforce more specific provisions, so drafters ought to explain which types of disputes shall be mediated and include a detailed mediated procedure and timeline. Also, practitioners should add teeth to their pre-litigation dispute resolution clauses. For example, the drafter may include language which states that if a party fails to follow the terms of the pre-litigation dispute resolution clause, commencing the negotiation or mediation or other provision, they cannot receive attorneys’ fees if they prevail. Consider the following portion of a mediation clause which uses specific and mandatory language:

Before any party may bring an action in court or against the other or commence an arbitration proceeding (except as noted below), the Parties must first meet to mediate the dispute. Any party who fails to do so is precluded from seeking attorneys’ fees in later proceedings. A complaining party must submit all claims to mediation within 30 days after providing notice of the claim to the other party. The mediation shall take place in the City in which Franchisor’s headquarters are located at the time of the commencement of the mediation. Each party shall identify an officer with decision-making authority who shall attend the mediation. Any such mediation will be non-binding and conducted by the American Arbitration Association in accordance with its then current rules for mediation of commercial disputes. The parties shall equally share the costs of the mediation.¹⁷¹

Finally, if a party wishes to enforce a pre-litigation dispute resolution clause in a franchise agreement, it should attempt to do so sooner rather than later. That means bringing it to the attention of the court through a motion to dismiss, affirmative defense, or a pre-discovery motion for summary judgment.¹⁷²

V. DAMAGES ANALYSIS

Common clauses that impact recovery and exposure in franchise litigation/arbitration include provisions for liquidated damages, limitation of liability, waiver of punitive damages, and attorney’s fees and costs, as discussed below. Additionally, personal guarantees aid in the collection of damages awarded to franchisors.

¹⁷⁰ Elizabeth M. Weldon & Patrick W. Kelly, *Prelitigation Dispute Resolution Clauses: Getting the Benefit of Your Bargain*, 31 FRANCHISE LAW JOURNAL 1, 1 (2011).

¹⁷¹ THE ANNOTATED FRANCHISE AGREEMENT 231.

¹⁷² Elizabeth M. Weldon & Patrick W. Kelly, *Prelitigation Dispute Resolution Clauses: Getting the Benefit of Your Bargain*, 31 FRANCHISE LAW JOURNAL 1, 1 (2011).

A. Crafting an Appropriate Damages Provision in the Franchise Agreement

When crafting an appropriate damages provision, or provisions that directly impact damages, consider provisions that maximize a franchisor's recovery or minimize its exposure. An acknowledgment of the franchisor's right to recover from the franchisee and guarantor(s) of all future lost royalty fees and other fees (e.g., service fees) is a maximizing term. It would allow recovery through the original expiration date of all fees when the franchise agreement has been terminated due to franchisee's material breach. Additionally, such a term may be contemplated in a liquidated damages provision, as discussed in Section V(E) below. See Appendix A(D) for a sample provision demonstrating a franchisee's acknowledgment.

Another maximizing term is the inclusion of attorneys' fees provisions, as permitted under applicable state law. Usually, these terms will state that the non-prevailing party will pay all costs, expenses, and interest, including reasonable attorneys' fees, in any action brought to enforce any provision of or to enjoin any violation of the franchise agreement. Additionally, when crafting a personal guaranty, ensure that the guarantor will pay all reasonable attorneys' fees and all costs and other expenses the franchisor incurs in enforcing the guarantee against the guarantor. See Appendix A(E) for sample provisions under a franchise agreement and guaranty demonstrating attorneys' fees provisions.

An example of a provision minimizing exposure will be a punitive damages waiver. Some state laws allow for the recovery of punitive damages; however, keep in mind that some states may find waivers of punitive damages contrary to public policy.¹⁷³ To avoid a court finding a punitive damages waiver unconscionable, it is recommended to insert language where punitive damages are waived "to the fullest extent permitted by law."¹⁷⁴

B. Drafting For Damages for Wrongful Termination

There are often contractual and statutory considerations in assessing damages for wrongful termination claims. Some relationship law jurisdictions specify damages for wrongful terminations of franchise agreements. For example, California's relationship law provides that the damages for wrongful termination in violation of the California franchise relationship statutes is "the fair market value of the franchised business and franchise assets and any other damages caused by the violation of this chapter."¹⁷⁵ But

¹⁷³ See *infra* fn. 193.

¹⁷⁴ See *Meadows v. Dickey's Barbecue Restaurants Inc.*, 144 F.Supp.3d 1069, 1086 1087 (N.D. Cal. 2015) (finding the arbitration provision did not waive any statutory remedies that may be available under the California Franchise Investment Law because it contained "to the fullest extent permitted by law").

¹⁷⁵ See Cal. Bus. & Prof. Code § 20035(a). The remedy available to franchisees (recovery of "fair market value" of business and assets plus other damages) was added to California's franchise relationship law via amendment effective January 1, 2016. For

if the law of a non-relationship state applies or if the claim is not asserted under the relationship law, the damages will more likely be general breach of contract damages, which may include actual damages or lost profits.¹⁷⁶

The types of wrongful termination vary. Termination can be wrongful where the franchisor has terminated the franchise agreement based on an incorrect or insufficient notice of default, as a franchisee may claim in a breach of franchise agreement case. But termination can also be wrongful where the franchisee has unilaterally terminated the franchise agreement, sometimes claimed in the case of a franchisee abandoning a franchised business. Both the franchisor and franchisee can wrongfully terminate the franchise agreement, and there are multiple ways in which they can do so.

Due to the wide range of wrongful termination claims, it is not standard to see contractual damages provisions that are specific to damages for wrongful termination. Such contractual provisions are sometimes employed, however, when a franchisee abandons the franchise or otherwise terminates the agreement prematurely, and in these circumstances a liquidated damages provision may be used. That said, more certainty addressing damages for a wrongful termination claim may be useful, especially in a non-relationship law state. It can be important to have a way to calculate those damages despite claims of speculation or uncertainty and despite limits on consequential damages and the like that are common in franchise agreements.

Where a franchisee abandons its franchised business, a franchisor often claims its lost future royalties for the remainder of the franchise term.¹⁷⁷ “The theory is that a franchise agreement requires a franchisee to operate a franchise unit for a full term. If the franchisee fails to do so, the franchisor has lost profits, which can be recovered as damages.”¹⁷⁸ But the franchisor must prove those damages to a reasonable degree of

that reason, this remedy is only available if the franchise agreement at issue was entered into or renewed since the start of 2016. See Cal. Bus. & Prof. Code § 20041(b).¹⁷⁶ *Grupe v. Glick*, 26 Cal. 2d 680, 692 (1945) (“Where a party breaches a contract, lost prospective profits are generally recoverable because they are “ascertainable with reasonable certainty from past volume of business and other provable data.” (citations omitted)).

¹⁷⁷ See e.g., *Meineke Car Care Centers, Inc. v. RLB Holdings, LLC*, 423 F. App'x 274 (4th Cir. 2011) (where franchisees ceased operations during term of agreement, franchisor could be entitled to future royalties and advertising contributions); *Am. Speedy Printing Centers, Inc. v. AM Mktg., Inc.*, 69 F. App'x 692, 698 (6th Cir. 2003) (awarding future royalties where franchisee unilaterally ended franchise relationship); *It's Just Lunch Franchise, LLC v. BLFA Enterprises, LLC*, No. 03CV0561 BTM(LSP), 2003 WL 21735005 (S.D. Cal. July 21, 2003) (amount in controversy exceeded \$75,000 because franchisor could be entitled to future royalties where complaint alleged franchisee terminated agreement).

¹⁷⁸ Julie Cowan Lusthaus & Peter Silverman, *The Franchisee Lawyer's Checklist: What Every Franchisee Lawyer Should Know*, 34th ANNUAL FORUM ON FRANCHISING W-17, at 25 (2011).

certainty. If a franchisor can re-franchise the territory within a reasonable period of time, its lost profits may be limited to its losses from the date the franchisee abandoned to the date by which the franchisor is likely to find a new franchisee.

At times, it may be easier to prove lost future royalties in a wrongful termination claim for damages with a minimum royalties clause.¹⁷⁹ In *Meineke Franchisor SPV, LLC v. Atta*, “Defendants were obligated to pay “Annual Minimum Royalties” to Meineke in the amount of \$20,800 per year, or \$400 per week.”¹⁸⁰ The court found it was reasonably certain that the franchisor would have received the minimum royalties for the remainder of the term of the franchise agreement, but for the franchisee’s breach, and awarded damages for the period of almost four years.¹⁸¹

An example of minimum royalty language comes from a Liberty Tax franchise agreement and provides a stepped-approach to minimum royalties:

d. Royalties.

You must pay a royalty to Liberty in the amount of 14% of Gross Receipts subject to the following minimums (“Minimum Royalties”):

i) Year One. For the period ending April 30 following the Effective Date of this Agreement, if you operated or were required to have operated an office in the Territory for any part of Tax Season ending in that April, the minimum royalty is \$5,000 per Territory.

ii) Year Two. For the period beginning May 1 following the Effective Date of this Agreement through the following April 30, the minimum royalty is \$8,000 per Territory.

iii) Year Three and Beyond. Thereafter, the minimum royalty is \$11,000 per Territory for each successive period beginning May 1 through the following April 30.¹⁸²

Minimum royalties can be appealing to a trier of fact as a way to compute lost future royalties because it is a “floor” and creates certainty. Using this method avoids certain arguments about whether the amount of future damages is speculative. The clear downside to this measure of damages for lost future royalties is that it is a minimum, or the least amount due, and may lessen the amount of a damages claim. It may be easy for a court to use this minimum number as a default number, and perhaps

¹⁷⁹ See *Meineke Franchisor SPV, LLC v. Atta*, No. 3:20-CV-480, 2021 WL 5567422, at *2 (W.D.N.C. Nov. 29, 2021) (awarding minimum royalties, finding it “reasonably certain” they would have been realized but for the franchisees’ breach).

¹⁸⁰ *Id.* At *2.

¹⁸¹ *Id.*

¹⁸² 8 *Model Agreements for Corp. Counsel* § 52:14 (Liberty Tax, Inc., Franchise agreement).

not consider other evidence of damages or not award amounts based on actual royalty calculations that are often higher than the minimum royalty.

The dollar amount of the royalty is not the only driving issue in calculating lost future royalties. The trier of fact may find the calculated royalty amount correct but may question the use of the entire length of the remaining term for the calculation, since the franchisor may be in a position to mitigate its losses. One way to address this is to agree in advance to a period of time that would be used in a lost future royalties claim, such as the lesser of the remaining term of the franchise agreement or three years. These authors have not seen such a provision in practice outside of a liquidated damages clause, but it addresses a common issue in these types of damages calculations. There are creative ways to anticipate and address arguments that damages are speculative by contracting with greater specificity.

A liquidated damages provision is another way to address wrongful termination damages, though that principle is discussed more below in section V.E. “Some franchise agreements, particularly those in the hotel industry, contain liquidated damages clauses. A typical liquidated damages clause provides that the franchisee agrees to pay, as damages, a fixed sum or a sum based on a fixed formula in the event of a breach of the franchise agreement. In examining whether a liquidated damages provision is enforceable, courts will generally look at (1) the reasonableness of the amount agreed upon in relation to the actual damages that are likely to be suffered as a result of a breach, and (2) the difficulty in assessing actual damages at the time of contracting.”¹⁸³

An example of such a clause is below:

Article 17.4—Liquidated Damages: “If XXX terminates this Agreement for Licensee's fault, the actual damages that XXX would suffer for the loss of prospective fees and other amounts payable to XXX under Article 5 would be difficult if not impossible to ascertain.... [Liquidated damages] is calculated as the lesser of two times the amount payable to XXX under Section 5.2 for the immediately preceding 12 months, or the number of months remaining until the commencement date of a Termination Window provided herein or expiration of the Term, whichever is sooner, times the average monthly Royalty Fees payable to XXX under Section 5.2 for the immediately preceding 12 months. Licensee must also pay taxes on such payment in accordance with Section 5.9.”¹⁸⁴

C. Franchisor’s Ability to Obtain Damages

¹⁸³ Stephanie J. Blumstein & Maisa Frank, *Basics Track: Franchise Litigation*, INTERNATIONAL FRANCHISE ASSOCIATION 53RD ANNUAL LEGAL SYMPOSIUM (Virtual May 4-6, 2021).

¹⁸⁴ *Radisson Hotels Int'l, Inc. v. Majestic Towers, Inc.*, 488 F. Supp. 2d 953, 956 (C.D. Cal. 2007).

Franchisors may obtain actual damages in the event of a franchisee's breach of their obligations under their franchise agreements. Additionally, depending on the jurisdiction, attorneys' fees may be awarded. For example, in *Little Caesar Enterprises, Inc. v. Walters Investments, Inc.*, on a motion for default, the court considered the appropriate measure of damages to be unpaid royalties, advertising fees, technology fees, and fees for unpaid deliveries of equipment, ingredients, and supplies.¹⁸⁵ The court found these figures were supported with reasonable certainty by a sworn declaration of Little Caesar's Vice President of Compliance.¹⁸⁶ Moreover, the court held that Little Caesar's was entitled to an award of attorneys' fees and costs because under Michigan law, provisions for attorneys' fees are judicially enforceable.¹⁸⁷ Similarly, in *Howard Johnson International, Inc. v. Kunwar*, the court assessed damages available to the franchisor on a motion for default judgment.¹⁸⁸ On such a motion, allegations pertaining to damages need to be proven—they are not automatically treated as true.¹⁸⁹ Howard Johnson sought recurring fees as computed with the formulas provided for in the parties' franchise agreement.¹⁹⁰ The court found that the itemized statement provided by Howard Johnson reasonably supported the \$121,589.00 sought in recurring fees.¹⁹¹ In addition, the court granted reasonable liquidated damages, as discussed in Section V(E) below.

D. Provisions Limiting Damages

Both franchisors and franchisees may have an interest in provisions limiting damages. Parties may agree on limitations of damages to create certainty and to prevent runaway types of damages, such as punitive, exemplary, and consequential damages. But, in drafting these provisions, the attorney must consider state laws as to whether these are waivable and to what extent.

Punitive damages waivers can be enforceable.¹⁹² But in some situations, courts will not allow waiver of damages that are permitted by statute, such as punitive damages or attorneys' fees.¹⁹³ A possible remedy for that issue is careful drafting that waives the

¹⁸⁵ *Little Caesar Enterprises, Inc. v. Walters Investments, Inc.*, No. 2:21-CV-12829-TGB, 2023 WL 373869, at *2 (E.D. Mich., Jan. 24, 2023).

¹⁸⁶ *Id.*

¹⁸⁷ *Id.* at *3.

¹⁸⁸ *Howard Johnson International, Inc. v. Kunwar*, No. CV2119287JXNJSA, 2023 WL 3199174, at *3-4, (D.N.J., May 1, 2023).

¹⁸⁹ *Id.*

¹⁹⁰ *Id.*

¹⁹¹ *Id.*

¹⁹² See e.g., *Bombardier Aerospace Corp. v. SPEG Aircraft Holdings, LLC*, 572 S.W.3d 213, 234 (Tex. 2019)(reversing judgment for exemplary damages because contract waived punitive damages).

¹⁹³ See e.g., *Armendariz v. Found. Health Psychcare Servs., Inc.*, 24 Cal. 4th 83, 103 (2000) (in context of an employment case, finding "The principle that an arbitration agreement may not limit statutorily imposed remedies such as punitive damages and attorney fees appears to be undisputed" and ruling that clause was unlawful).

particular remedy or damage, *except* in the context of statutory claims where the remedy or damage is recoverable.¹⁹⁴

Most states allow parties to limit remedies contractually.¹⁹⁵ Many franchise agreements contain provisions that limit other remedies, such as consequential damages. A sample damage waiver clause from The Annotated Franchise Agreement is below:

T. Damages Waiver

Franchisee hereby waives to the fullest extent permitted by law, any right to or claim for any punitive, exemplary, incidental, direct, special or consequential damages (including, without limitation, lost profits) against Franchisor arising out of any cause whatsoever (whether such cause be based in contract, negligence, strict liability, other tort or otherwise) and agrees that in the event of a dispute, Franchisee's recovery is limited to actual damages. If any other term of this Agreement is found or determined to be unconscionable or unenforceable for any reason, the foregoing provisions will continue in full force and effect, including, without limitation, the waiver of any right to claim any consequential damage.¹⁹⁶

In dealing with damages waiver or limitation clauses, there is a body of case law about whether lost future royalties are consequential or direct damages, and most cases find that lost profits from royalty fees under a franchise agreement are considered direct damages.¹⁹⁷ For example, in *Burger King Corp. v. Berry*, where the franchisee had abandoned the franchise agreement, the franchisor sought rent, advertising fees,

¹⁹⁴ See *id.* at 104 (employer argued the waiver of damages was limited to contract claims, but court found the provision as a whole showed otherwise).

¹⁹⁵ See e.g., § 672.719, Fla. Stat. Ann.; see also *Doctor Diabetic Supply, Inc. v. POAP Corp.*, 41 So. 3d 916 (Fla. 3d DCA 2010) [enforcing a contractual provision barring the recovery of consequential damages]; *Certain Underwriters at Lloyd's of London v. Black Gold Marine, Inc.*, No. 19-23586-CIV, 2022 WL 4643559, at *7 fn 6 (S.D. Fla., Aug. 23, 2022) [same]; see also Earsa R. Jackson & Glenn Plattner, *Picking a Poison Pill: Selecting, Enforcing, and Defending Against Liquidated Damages, Lost Profit Damages, and Damages Waivers*, ABA 44TH ANNUAL FORUM ON FRANCHISING W-3, at 33 (2021).

¹⁹⁶ THE ANNOTATED FRANCHISE AGREEMENT 273 (Nina Greene, Dawn Newton, & Kerry Olson eds., 2018).

¹⁹⁷ See *Burger King Corp. v. Berry*, 18-20435-CIV, 2020 WL 8254494, at *7 (S.D. Fla. Dec. 22, 2020); see also *Burger King Corp. v. Barnes*, 1 F. Supp. 2d 1367, 1370 (S.D. Fla. 1998) (franchisor awarded lost profits, including royalties, on its breach of contract claim against franchisee where franchisee abandoned franchise without the consent of franchisor); *Lady of America Franchise Corp. v. Arcese*, 2006 WL 8431025, at *5 (S.D. Fla. May 26, 2006) (citing *Barnes* and similar holding); see also Earsa R. Jackson & Glenn Plattner, *Picking a Poison Pill: Selecting, Enforcing, and Defending Against Liquidated Damages, Lost Profit Damages, and Damages Waivers*, ABA 44TH ANNUAL FORUM ON FRANCHISING W-3, at 33-34 (2021).

and royalties under the franchise agreement for the remaining term of the franchise agreement.¹⁹⁸ The franchisee argued that the franchisor was seeking consequential damages in the form of future royalty payments.¹⁹⁹ The court disagreed, stating “it is plain that the obligation to pay royalties, lease payments, and advertising fees flow directly and immediately from the relevant agreements. Defendants’ promises to make those payments are evident from the face of the agreements.”²⁰⁰ As such, the court awarded fees for rent, advertising fees, and royalties under the franchise agreement. If a party wanted to limit recovery of lost future royalties, a more specific limitation would be necessary, such as calling out the limitation against recovering lost future royalties or lost profits.²⁰¹

Regardless of what the waiver is, to make it most likely to be enforced the drafter should make it clear, mutual, and conspicuous. Consider using items like bold and underline to draw attention to the provision. While this should not legally be necessary, it certainly does not hurt and is a helpful fact to point to in underscoring the parties’ knowledge of the waiver and lack of surprise.

E. Liquidated Damages Provisions

Liquidated damages provisions govern predetermined amounts of money that must be paid upon a party’s failure to comply with certain contractual obligations and are enforceable under applicable state law. The provisions may also specify the terms of payment. When determining the enforceability of such provisions, courts will consider the parties’ intention to liquidate damages at the time of contracting, the provision’s reasonableness in the amount specified, and the difficulty in determining actual damages upon breach.

For example, under Iowa law, liquidated damages clauses are favored—so long as they are not penalties.²⁰² The question of whether a liquidated damages clause is a penalty is one of law and the court’s review of the construction of the operative contract.²⁰³ A liquidated damages clause is against public policy if it is considered a penalty.²⁰⁴ Iowa courts consider the following two factors in penalty determinations: (1) what is the anticipated or actual loss caused by the breach of contract, and (2) the difficulty of proof of loss.²⁰⁵ In other words, “[t]he greater the difficulty either of proving that loss has

¹⁹⁸ *Burger King Corp. v. Berry*, 18-20435-CIV, 2020 WL 8254494, at *7 (S.D. Fla. Dec. 22, 2020).

¹⁹⁹ *Id.*

²⁰⁰ *Id.*

²⁰¹ Earsa R. Jackson & Glenn Plattner, *Picking a Poison Pill: Selecting, Enforcing, and Defending Against Liquidated Damages, Lost Profit Damages, and Damages Waivers*, ABA 44TH ANNUAL FORUM ON FRANCHISING W-3, at 35 (2021).

²⁰² See *City of Davenport v. Shewry Corp.*, 674 N.W.2d 79, 85 (Iowa 2004).

²⁰³ *Id.*

²⁰⁴ *Id.*

²⁰⁵ *Id.*

occurred or of establishing its amount with the requisite certainty, the easier it is to show that the amount fixed is reasonable.”²⁰⁶ “If the difficulty of proof of loss is great, considerable latitude is allowed in the approximation of anticipated or actual harm. If, on the other hand, the difficulty of proof of loss is slight, less latitude is allowed in that approximation.”²⁰⁷ Iowa courts undertake a liquidated damages analysis based upon the time the agreement was made.²⁰⁸

Similarly, under Michigan law, liquidated damages are enforceable “if the amount is reasonable with relation to the possible injury suffered and not unconscionable or excessive” and if it was the parties’ intent to contract for them.²⁰⁹ If liquidated damages are not contemplated in the agreement, then courts will not enforce them.²¹⁰ In *Little Caesar Enterprises, Inc., v. S&S Pizza Enterprises, Inc.*, the court found that franchisee breached its contract and had to pay the requisite liquidated damages.²¹¹ It concluded that Little Caesar’s affidavit, obtained from its Vice President for Compliance, contained a reasonable basis from which to calculate such damages.²¹²

The metric for reasonable liquidated damages may also vary by type of franchise system. In *Howard Johnson International, Inc. v. Kunwar*, franchisee discontinued operating his hotel as a Howard Johnson guest lodging establishment.²¹³ The franchise agreement between the parties set liquidated damages at \$2,000.00 for each guest room that franchisee was authorized to operate at the time of termination—in total this amounted to \$116,000.00 plus \$20,055.63 in interest in liquidated damages for 58 guest rooms.²¹⁴ The court found these liquidated damages amount reasonable.²¹⁵

Depending on the jurisdiction, guaranteed minimum royalties may be considered akin to a permissible liquidated damages provision.²¹⁶ If minimum royalties are the metric for calculating liquidated damages, ensure that your provisions clearly state as much. There is case law contemplating royalties as liquidated damages where the provision states as much, however, we were unable to locate case law where in the absence of a liquidated damages provision minimum royalty provisions are *de facto* treated as a liquidated damages provision.

²⁰⁶ *Id.*

²⁰⁷ Restatement (Second) of Contracts § 356(1) (1981).

²⁰⁸ See *Great Plains Real Estate Development, L.L.C. v. Union Cent. Life Ins. Co.*, No. 4:05-CV-002204, 2007 WL 6908824, at *9 (8th Cir. 2008).

²⁰⁹ *Little Caesar Enterprises, Inc. v. S&S Pizza Enterprises, Inc.*, No. CV 21-11776, 2023 WL 5489021, at *5 (E.D. Mich., Aug. 24, 2023) (citation omitted).

²¹⁰ See *id.*

²¹¹ *Id.* at *6.

²¹² *Id.*

²¹³ *Howard Johnson International*, 2023 WL 3199174, at *4.

²¹⁴ *Howard Johnson International*, 2023 WL 3199174, at *4.

²¹⁵ *Id.*

²¹⁶ See, e.g., *Body Glove IP Holdings, LP v. Exist, Inc.*, No. 1:21-CV-01181 (JLR), 2023 WL 3568955, at *17 (S.D.N.Y., May 17, 2023) (citation omitted).

VI. CONCLUSION

In the world of franchising, litigation occurs with some frequency. Much of the litigation ensues based upon provisions in FDDs and franchise agreements. As a result, it is important for transactional attorneys to carefully consider existing case law and franchise statutes and regulations when drafting franchise documents. Good drafting by counsel, along with providing sound advice to franchisors regarding their dealings and communications with franchisees, ensures that franchise systems can remain strong and can avoid the significant costs and distractions associated with litigation.