

The Franchisee and Franchisor Relationship

An Easy Exit (or Not)

by Harris J. Chernow

The franchise relationship begins once the franchisee (the person or entity receiving the rights to operate the franchised business) and the franchisor (the entity granting the rights to allow the franchisee to operate the franchised business system) have put pen to the franchise agreement, which is the cornerstone of the franchise relationship. The relationship term, at least initially, is usually between five and 10 years, although some run for 20 years or more, during which both parties hope to build a successful relationship. However, problems may, and do, arise during franchise relationships, some of which may require termination of the franchise agreement.

At first glance, it is easy to assume the termination of a franchise relationship is no different than any other contractual relationship. In fact, there are numerous franchise nuances that need to be taken into account, which do not make it easy to simply terminate the relationship from the franchisee or franchisor perspective.

The dynamics of the franchise relationship begin with the concept that there is a brand (the trademark/trademark), an established system of how to operate the business, and a business relationship that 'hides' the true owner (the franchisee) of the franchised business behind the brand, since it is typically only the brand that is known to the general public. Many of the issues that can arise emanate from these questions: Did the franchisor approve an ideal candidate to be a franchisee? Did the franchisee really understand the franchise relationship and what they were getting into? Did the parties really understand the contractual relationship when signing a long-term franchise agreement? And, is the relationship meeting the expectations of one or both parties?

One of the primary reasons for issues with the franchise relationship is the failure of the prospective franchisee to fully understand what the franchise relationship is *really* all about.

The issue begins with the prospect's failure to read and understand the franchise disclosure document (FDD), the required disclosure document pursuant to the Federal Trade Commission Franchise Rule,¹ and failure to engage a lawyer who concentrates in franchise law and a good accountant to analyze the financial aspects of the business *before* entering into the franchise relationship. Too often, prospective franchisees simply rely on their perception that a franchise is a 'guaranteed success.'

Franchisees often go into the relationship thinking they control all aspects of the business, and that—other than the brand and an operating manual—the franchise is no different than if they started their own independent business. The fact that there is more to the relationship often remains unrealized until *after* the franchise agreement is signed.

The franchise industry is, however, a vibrant and significant component of the U.S. economy, with over 760,000 units operating in 2014.² It provides many successful business models, but it does not guarantee success. Like all relationships, some may last and flourish, while others will need to be dissolved.

This article will describe, from the franchisor's perspective, issues that arise when contemplating a termination (other than a sale in the normal course, which in the franchise relationship also has its own nuances and unique issues).

Should You Terminate the Relationship?

If there is a valid reason to terminate the franchise relationship, the franchisor must decide whether to issue a default notice and/or terminate³ the franchisee; or seek an alternative resolution. (While not all defaults result in termination, a franchisor should avoid sending default notices unless the franchisor is ready, willing and able to follow through with a termination should the need arise.) Although, at times, a termination may seem like the clear answer (*e.g.*, if the franchisee

has failed to pay royalties or there are health and safety non-compliance issues) the decision can be difficult. Termination is an acknowledgement that the franchise relationship has failed in one form or another. Terminating a franchisee can do more harm than good, which is sometimes overlooked in the process. Prior to deciding whether to terminate the relationship, the parties should analyze the facts, the law and the intangibles surrounding the proposed termination and whether it really makes sense in that particular circumstance.

Benefits/Costs to Avoiding Termination

There are certain reasons for termination of the franchise agreement that one would think should not be tolerated, the most notable being a refusal to pay fees or a violation of non-competes. Of course, not all breaches are so simple. Just because a franchisor can default and/or terminate a franchisee (even for non-payment) does not mean the franchisor should do so. Instead, the franchisor should realistically assess the benefits and costs that may result from terminating or not tolerating a problem franchisee.

For example, a reason to avoid termination is to actually maintain the flow of royalties, advertising fees and other payments and avoid the effect the closure of a location can have. While the failure to pay royalties and other payments may be the reason a franchisor is considering termination, the actual termination of the franchisee will ensure the franchisor receives no payments (unless the franchisor is confident it can immediately take over the business itself or have a new franchisee in place almost immediately). By examining any possible alternatives to termination, the franchisor may be able to continue receiving some payments from the franchisee. In the case of a franchisee simply falling behind in payments, a default notice

coupled with alternative solutions could salvage the relationship, provide for on-going payments and avoid the costs (direct and indirect) of termination.

Termination not only cuts off the flow of royalty and other payments, it could also mean significant indirect costs for the franchisor that far exceed the loss of royalty payments. While some terminations may appear to be straightforward, they can quickly become very expensive—both in terms of legal fees and resources the franchisor will have to devote to the matter and brand detriment.

A potential concern is the damage to the brand. If the franchise relationship ends, does the business close? And if the business closes, without the franchisor or a new franchisee operating at the same location, the public may perceive that the *entire* system/chain is closing, or that there are problems with the system as a whole, since the general public may not realize the business was owned and operated by an independent franchisee. The franchisor, however, must also consider the costs of not terminating a franchisee. Although the franchisor may avoid some legal and operational costs by not starting the process, failure to do so may simply delay the inevitable, and may allow the unconfirming franchisee to cause greater damage over time. Legal fees should not be the determining factor of whether it is better to keep a non-compliant franchisee in or out of the system.

There are other 'intangible' costs to not terminating a franchisee. Uniformity is a primary goal of any franchise brand, so an unreasonable amount of dissent may be harmful to that brand. Further, a franchisor must be careful to not develop a reputation with its franchisees for an unwillingness to enforce its franchise agreements. For example, violations of non-compete agreements can be particularly harmful to franchise systems that are not well established.

Are There Alternatives to Termination?

When considering whether to terminate a franchisee, a franchisor should assess what, if any, alternatives exist to termination. One of the most common alternatives to terminating a troubled franchisee is to use workouts. A workout is an agreement between the franchisee and franchisor, and any other relevant parties, whereby the franchisor provides some assistance to the franchisee or agrees to waive certain obligations or payments. A workout can be as simple as the franchisor deferring or forgiving certain franchise payments, or it can involve complex financing and leasing arrangements.

Regardless of the precise details of the workout, its primary importance is that all parties involved acknowledge the benefit of the franchisee continuing to operate the franchised business.

How Will the Brand and System be Impacted?

As alluded to, this might be the most important aspect. The termination of a franchisee may directly impact the existing customers of the franchisee and the brand. When the franchisee does shut down, there is the potential that the franchise system will lose those customers, as there is no guarantee the customers will return to that particular unit even if it is re-opened by a different franchisee, or that the customers will seek out another franchised unit. Additionally, the customers identify the now-closed unit with the franchisor's trademarks, and a closing will likely reflect poorly on the quality or viability of the entire franchise system. To what degree the closing reflects poorly on the brand depends largely on the size of the system and the overall strength of the franchise.

Not only could termination impact customers and their perception of the franchise system, a termination also

could have a negative effect on the franchise system with its other franchisees. It is important to consider the effect the termination could have on the morale of other franchisees. Obviously, in large franchise systems, a single termination is not likely to have a considerable effect on franchisee morale. However, if the franchise system is small, or there have been a relatively high number of recent franchisee defaults or terminations, the impact on morale could be substantial. To mitigate the impact of a termination in such circumstances, the franchisor should consider how to present the termination to its franchisees. By focusing on the aspects of the termination that are beneficial to the franchise system—namely protecting the goodwill of the brand—the franchisor can address some of the potential concerns of existing franchisees, but there is still an impact on the general public, and possibly on lenders, vendors, landlords and other third parties. Many lenders, suppliers and vendors may simply choose to stop doing business with a franchisor if they have been on the wrong end of too many franchisee failures.

The termination of a franchisee could also have an effect on prospective franchisees. A franchisor will have to disclose the number of franchisees that have left the system in the FDD.⁴ Also, if litigation occurred as a result of any termination, the litigation will have to be disclosed in the FDD.⁵ These disclosures could create a negative impression on prospective franchisees. Also, if the franchisor's current or former franchisees believe the franchisor is quick to terminate, the perception can get back to prospective franchisees.⁶ A termination affects far more than the terminated franchisee, causing the intangible damage equation.

Termination Methodology

There is no set methodology to initiating the termination process, especially

in light of the inherent direct and indirect issues concerning the brand. But, one can use the following as part of a checklist of items for the analysis.

Often the request to terminate a franchisee lands on the in-house or outside counsel's desk, at which point it may be too late to do anything but issue the termination. Many times it is taken for granted that all avenues of reconciliation and/or addressing the issue have been explored, and that there is no other choice but to terminate the breaching franchisee. However, it is often learned during the termination process that the issue could have been addressed differently, or even resolved well before reaching the point of issuing a termination notice. A franchisor should try to develop procedures where defaults (or signs of defaults) are addressed from the outset, outlining the steps to be taken to attempt resolution before the matter reaches the person responsible for issuing default notices.

A franchisor should first gather the relevant facts and information relating to the franchisee. (As basic as this seems, it is often ignored simply because a franchisor representative said the termination process should be set in motion, and it is then assumed that a thorough review already occurred.) The starting point should be the franchisor's own files pertaining to the franchisee, including electronic communications with the franchisee. The franchisor should review files from the legal department, franchise operations department, accounting department, and any other department with relevant information about the franchisee. Avoid the tendency to focus only on the specific circumstances that gave rise to the possible termination; instead, review all factors, as they are bound to come out in the process.

Also, some of the best information can be garnered from the franchisor's operations personnel, who have interacted directly with the franchisee.

Obtaining personal accounts can help develop a more complete narrative of the franchisee than can be established through documentation in the files alone.

The Franchise Agreement

While it may seem obvious, it is surprising how often the franchisor fails to review the applicable franchise agreement. This is an essential step to ensure that a termination is handled properly. If the requirements in the franchise agreement are not followed, a termination may not be effective, and could expose the franchisor to a wrongful termination claim and a tarnished reputation.

A common mistake is assuming that all of the franchise agreements are identical. Each year the franchise agreement, by virtue of any required FDD updates, may change. Additionally, the particular franchisee in question may have negotiated its own changes to the franchise agreement. Therefore, it is imperative to review the franchise agreement and any amendments/addenda.

State Relationship Laws

To complicate things even more, a number of states have laws addressing the franchise relationship, including the default and termination of franchisees and certain unfair practices and obligations arising post-termination. Prior to proceeding with a termination, the franchisor should investigate if any state relationship laws would be applicable and, if so, what the impact of those laws would be. These states have created franchise-related laws that are applicable once the parties have entered into a franchise agreement. (They are different from those states that have 'disclosure laws' that supplement the FTC Franchise Rule.)⁷ The state relationship laws regulate, at times, how a franchisee can be placed in default and/or terminated, which obviates or supplements the

terms of the franchise agreement.

Often, a franchisor relies solely on the terms of the franchise agreement and forgets to address the state relationship laws. By doing so, a franchisor creates a situation in which it may have *had* the upper hand but has now relinquished it to the franchisee, and may have lost its leverage in connection with the termination process. Further, if an applicable state relationship law has not been followed, the franchisor could incur certain sanctions, for example those pursuant to the New Jersey Franchise Practices Act,⁸ for what would be deemed a wrongful termination. This is another one of the nuances and complexities of the franchise business model that can be addressed with a simple checklist regarding states with franchise relationship laws and/or consults with franchise attorneys to determine the exact means for the termination process

in the relationship states.

In general, the relationship laws extend the notice period for default and/or termination, and determine what situations qualify as a default and allow for termination. Some states even provide for certain remuneration in connection with defaults, such as the buy-back of certain inventory and/or furniture, fixtures and equipment.

Further complications arise in implementing the appropriate state relationship laws. In some cases it is assumed that a franchisee resides in a particular state simply because of the notice address in the franchise agreement. It is important to determine the exact location of the franchisee that is being terminated, as that state's law may be applicable. There could be multiple units being terminated that are in multiple states, and the franchisor may need to apply each and every state's relation-

ship laws that are applicable to the situation for a valid termination. Do not assume the address on the franchise agreement is current; do not assume the notice address is the location of the unit; and do not assume the unit is still located at the address noted in the franchise agreement, which may have been entered into several years ago. Any of these oversights could be very costly to the franchisor in terms of embarrassment and, as previously noted, its leverage in the default and termination process.

There are currently 21 states, plus Puerto Rico and the United States Virgin Islands (there are also various international statutes), that have enacted franchise-related statutes that govern in some form the default and/or termination of the franchise relationship by the franchisor, including New Jersey.⁹ While general trends can be identified, no two



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statutes are exactly the same. Under a number of the statutes, a franchisor must have good cause prior to termination. However, the definition of good cause varies among these state relationship laws.

Similarly, some of these statutes require a franchisor provide notice and an opportunity to cure prior to termination, but the time periods can vary, as well as the exceptions to the notice and cure requirements. Accordingly, a franchisor should identify the applicable state relationship law, if any, that applies and what that state law requires.

Determining which state relationship law applies also requires an analysis of the jurisdictional application of the relevant state relationship law. Some states with relationship laws do not specifically address the jurisdictional application of the termination provisions, but the majority do state when the law applies.¹⁰ Out of the jurisdictions that do address the jurisdictional application, Arkansas, Connecticut, Delaware, Illinois, Iowa, Maryland, Missouri, Nebraska, New Jersey, Rhode Island, Virginia, Wisconsin, and Puerto Rico have the narrowest jurisdictional application. In these jurisdictions, a franchisor must comply with the termination provisions in the relevant law only if the franchised unit is actually located within the state.

The jurisdictional application of the California¹¹ and Indiana¹² relationship laws are slightly broader. As with the states discussed above, the California and Indiana relationship laws apply to situations where the franchised unit is located within the state. The California relationship law, however, also applies if the franchisee is domiciled in California, while the Indiana relationship law also applies if the franchisee is a resident of Indiana.

The states with the most comprehensive jurisdictional application are Michigan and Minnesota. The Michigan relationship law applies if: 1) the franchised

unit is in Michigan, 2) the franchisee is domiciled in Michigan, or 3) the offer to buy the franchise is accepted in Michigan.¹³ The Minnesota relationship law applies if: 1) the franchised unit is in Minnesota, 2) a sale is made in Minnesota, or 3) an offer to sell or purchase is made or accepted in Minnesota.¹⁴

As these states have varying jurisdictional application provisions, a franchisor should familiarize itself with the applicable laws. Franchisors should also recognize that if the franchise agreement has a choice of law provision designating the law of one of the above states, a franchisee may attempt to argue that the relationship law of that state would apply even if the franchisee has no relationship to the state.¹⁵

An example of such an argument took place in *1-800-Got Junk? LLC v. Millennium Asset Recovery, Inc.*, in which the franchisor terminated the franchisee without notice or an opportunity to cure for failing to report revenue and pay monies due.¹⁶ The franchisee sued the franchisor for breach for terminating the franchise agreement without cause.¹⁷ The franchise agreement stated that Washington law would govern the terms of the contract, yet the franchisor sought to apply California law, which would have provided the franchisor with grounds for immediate termination.¹⁸ Following a bifurcated choice of law trial, the trial court held Washington law applied to the action.¹⁹ The court of appeals agreed with the trial court and held that Washington law was applicable because: 1) the franchisor had a reasonable basis for inserting a choice of law provision in the franchise agreement, and 2) Washington law was more protective of the franchisee, which is the more vulnerable party to the agreement.²⁰

Most of the state relationship laws require good cause for termination, and also impose mandatory notice and cure periods. However, the precise details of

these requirements vary among the state relationship laws. A franchisor must closely examine the relevant state law to understand the applicable requirements governing termination.

Good Cause is Obvious, Right?

Out of the states that do have a good cause requirement, a number of them simply provide a general definition of good cause.²¹ While these definitions vary slightly, they generally state that good cause is a failure to comply with the lawful and material provisions of the franchise agreement. Some of these states go further, and outline specific situations that constitute good cause for termination.²²

Other states that require good cause include a more thorough definition of what constitutes good cause. For instance, Iowa law contains the general definition of good cause discussed above, but also includes a requirement that the termination not be arbitrary and capricious.²³ As another example, Wisconsin²⁴ and the Virgin Islands²⁵ define good cause as the failure of the franchisee to comply with material and reasonable requirements of the franchisor. They go on to state that good faith exists only if the franchisee has breached these material and reasonable requirements if the requirements have been uniformly enforced across the franchise system or the franchisee has demonstrated bad faith.

There are two states—Delaware²⁶ and Virginia²⁷—that impose a requirement of good cause for terminations but do not further define what constitutes good cause. In situations such as these, where good cause is not defined, a franchisor can look to what constitutes good cause in other states for general guidance.

Cure and Termination Periods

If a franchisor decides to terminate a franchisee, many states have mandatory notice and/or cure periods. Mandatory

cure periods can vary widely in length of time, but three general trends emerge in state relationship laws. First, a number of states do not mandate a cure period but do require notice of termination. Second, some states mandate a cure period, but do not mandate a specific number of days; instead, these states just require the franchisee be provided a 'reasonable' opportunity to cure. Finally, some jurisdictions require a franchisor to provide its franchisees with a specific number of days to cure.

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

The second group of states require a mandatory cure period, but do not mandate that the cure period be a specific number of days. This group includes California, Hawaii, Illinois, Michigan and Washington. These states require a cure period that is 'reasonable,' which generally means the cure period need not be longer than 30 days.²⁸ These states also require that a franchisor provide a notice of termination, but, as with the cure period, they do not specify how much notice a franchisor must provide.

The final group of states specifically regulates how long the cure period is required to be. This group includes Arkansas, Iowa, Maryland, Minnesota, Rhode Island and Wisconsin. Arkansas, Maryland and Rhode Island require a 30-day cure period; Minnesota and Wisconsin require a 60-day cure period; and Iowa requires a 'reasonable- cure period that is between 30 and 90 days long. The

cure periods in Rhode Island and Wisconsin decrease to 10 days in the case of monetary defaults. Similarly, the cure periods in Arkansas are decreased to 10 days in the case of multiple defaults in a 12-month period. These states also require that a franchisor provide notice of termination to the franchisee. This notice period generally ranges from 60 to 90 days, depending on the state. However, sometimes the notice period is reduced depending on the particular type of default.²⁹

Conclusion

When it comes to considering termination, there are many other issues that may also need to be addressed, such as franchisees claiming discrimination (in terms of treating one franchisee different than another in connection with termination), waiver issues (failing to act timely), good faith and fair dealing issues, tortious interference claims and a



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host of other concerns. The conclusion is that terminations are never simple (even though on their face the reason may be) and need to be well thought out, analyzed not only from a legal basis but from the business/franchise standpoint as well.

Most will probably agree that if termination can be avoided, it is usually the best course of action. But there are times when termination is definitely required (even if simply on principle alone, to demonstrate to the system that the franchisor does enforce its contractual terms), and in those instances the franchisor should be prepared to act.

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

When warning signs arise, a franchisor should promptly reach out to the franchisee to investigate the situation and attempt to forge a resolution. As with most relationships, open and early communication is essential to ensuring any problems are revealed and addressed. ▽

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ENDNOTES

1. FTL Franchise Rule – 16 C.F.R. 436.1, *et seq.*
2. *Franchise Business Economic Outlook for 2015*, prepared for International Franchise Association Educational Foundation, by I. H. S. Economics, March 2015, with a total output of over \$890,000,000,000 for 2015.
3. Assuming the franchise agreement terms provide for the applicable reasons to terminate and also, if applicable, the relevant state franchise relationship laws (see below in the article).
4. 16 C.F.R. § 436.5(t).
5. 16 C.F.R. § 436.5(c).
6. 16 C.F.R. 436.5(t)(4)-(5).
7. Some states have both franchise disclosure and relationship law—the focus here is only on the relationship states.
8. N.J.S.A. 56:10-1, *et seq.*
9. N.J.S.A. 56:10-1, *et seq.*
10. Hawaii, Mississippi, Washington and the Virgin Islands do not have specific provisions addressing the jurisdictional application of the termination restrictions in their franchise relationship laws.
11. Cal. Bus. & Prof. Code § 20015.
12. Ind. Code Ann. § 23-2-2.5-2.
13. Mich. Comp. Laws § 445.1504.
14. Minn. Stat. Ann. § 80C.19.
15. Franchisors often include a carve out in the choice of law provision that the choice of law provision does not include the applicable franchise relationship law if it would not otherwise be applicable.
16. 189 Cal. App. 4th 500 (2010).
17. *Id.*
18. *Id.* at 516.
19. *Id.* at 504.
20. *Id.* at 519-520.
21. These states include California, Connecticut, Hawaii, Illinois, Indiana, Michigan, Minnesota, Nebraska, New Jersey, Rhode Island and Washington.
22. The states that outline specific examples of circumstances constituting good cause include Connecticut, Illinois, Minnesota and Rhode Island. On the other hand, Hawaii allows termination for either good cause or if done in accordance with the franchisor's current terms and conditions if such standards are applied equally across the franchise system. See Haw. Rev. Stat. § 482E-6(2)(H).
23. Iowa Code § 523H.7.
24. Wis. Stat. § 135.02(4).
25. V.I. Code Ann. tit. 12A, § 132.
26. Del. Code Ann. tit. 6, § 2552.
27. Virginia actually requires “reasonable cause.” See Va. Code Ann. § 13.1-564.
28. Washington provides that for defaults that cannot be cured within the statutorily mandated cure period, the franchisee may simply initiate “substantial and continuing action” to cure the default within the cure period. See Wash. Rev. Code § 19.100.180(2)(j).
29. For example, Arkansas does not require notice to be sent if the basis of termination is multiple defaults within a 12-month period. Ark. Code Ann. § 4-72-204(d).