AS MY FRANCHISOR LAY DYING – FRANCHISEE AND FRANCHISOR OPTIONS IN A STRUGGLING SYSTEM

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October 18-20, 2017
Palm Desert, CA

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AS MY FRANCHISOR LAY DYING – FRANCHISEE AND FRANCHISOR OPTIONS IN A STRUGGLING SYSTEM

Struggling franchise systems present many significant and difficult issues for franchisors, franchisees, and their counsel. Sometimes these issues can threaten the very existence of the franchise system, which understandably magnifies the importance of every issue, every dispute, and every proposed solution confronting franchisor and franchisee counsel and their respective clients.

The problems in a struggling system present interconnected challenges implicating franchise relationship issues, financial issues, concerns on how to best respond to significant disruptions in the markets for the goods and services sold through the franchise system, and a variety of high stakes legal issues. This paper examines some of the internal and external causes for the problems of struggling franchise systems, discusses potential solutions, and looks at some of the legal challenges that franchisees and franchisors and their counsel face in attempting to resolve these issues.

I. INTERNAL CAUSES IN STRUGGLING FRANCHISED SYSTEMS

A variety of internal reasons may cause a franchise system to struggle. The leaders of the franchise system, both franchisors and franchisees, must first identify these causes to begin to correct them. Complicating this task is the fact that system troubles rarely arise from a single readily identifiable cause. Rather it is often a toxic mix of internal factors that has caused the system to face significant problems. These factors can include: (1) management of the franchisor; (2) poor products or services; (3) competition; (4) financial pressures or distress; (5) the franchisor’s relationship with the franchise community; (6) marketing and advertising problems; (7) legal issues; and (8) problems that develop when the franchise system acquires or is acquired by a competitor. In addition, some issues that cause systems to struggle may be caused or exacerbated by the actions of franchisees.

A. Franchisor Management Issues

A search for the origins of the problems in troubled franchise systems often leads back to management issues at the franchisor. The entrepreneurial skills that enable a founder to create an innovative product or service and exploit a market niche to develop it may be ill-suited to the demands of developing and managing a franchise system. This is particularly true in the early stages of a franchise system. The entrepreneurial founder faces complex issues related to implementing a franchisee selection process, a supply and distribution system, site selection and location design criteria, and access to capital for both the franchisor and its franchisees in sometimes unfriendly lending environments. It is important for the founder to understand when the time is right to bring in more experienced management personnel for the franchise system. This is particularly true where the founder lacks experience in the operation of franchise systems.

Identifying qualified candidates to manage the system is important, but it is equally important for the founder to understand the appropriate balance between letting the experienced professional managers run the system and having the founder maintain a level of involvement often sought by franchisees. Failure to achieve this balance can lead to problems in the franchise system. Management issues also arise when a wildly successful founder retires and transitions management of the franchisor to the next generation of the founder’s family, who may be ill-suited by background or experience to manage a franchise system.
Franchise system problems also may arise from poorly conceived or executed attempts by a franchisor’s management personnel to implement system changes. A franchisor may decide to convert exclusively or primarily to company operated locations for future development, resulting in a decreasing level of services to franchisees. Franchisors may also respond ineffectively to disruptions within the market for the system’s products and services by a poorly conceived or poorly executed decision to focus on other means of distribution. Similarly, franchisors may opt to maintain an emphasis on brick and mortar locations while innovative competitors focus on more efficient means of distribution.

Management issues also may arise when a franchisor is purchased by a private equity group that brings in management personnel who are unfamiliar with franchising.

**B. Poor Products and Services**

Disruptions in the market for goods and services are all around us. Industries such as local transportation, lodging, travel services, and book sellers have all been turned upside down by new products, services, and methods of distribution. Franchised industries have been impacted by market disruptions, often because of issues related to the system’s products and services or methods of distribution.

The problems faced by many distressed franchise systems often originate with poor products or services. These products and services may be simply outdated. For example, changing consumer behavior, including healthier eating habits, a preference for delivered products versus in-restaurant dining, and the proliferation of fresh food offerings in convenience stores and supermarkets can have a profoundly disruptive effect on franchised restaurant concepts that focus on dine-in consumers. Systems that fail to recognize and adapt to these changing habits may find themselves facing serious issues.

Franchise systems will have problems when their products are not competitively priced. Whether it is price alone or the price value combination perceived by consumers, franchise systems that fail to compete in these areas will struggle. Constant advances in technology make it easier to compare prices, and consumer reviews of perceived price and value are readily available.

Distribution issues can lead to product and service quality problems at franchised locations. A strong and efficient network of suppliers and distributors can be critical to the delivery of quality products and services to customers of franchise systems. Suppliers must be held to compliance with high standards of product and service quality, and distributors must provide these

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1. *See Carvel Corp. v. Baker*, 79 F. Supp. 2d 53 (D. Conn 1997) where the court determined there was an issue of fact regarding whether Carvel had acted in good faith when implementing a program to sell products at grocery stores, when these products had previously been sold only through retail locations.

2. *See discussion of industry disruption issues at Section II.B. infra.*

3. For an example of a franchise system that modified its product and aggressively adopted new technologies to improve its performance, see the discussion regarding Domino’s, *infra*, note 75.

4. Ronald T. Coleman, Jr., *Franchisor’s Use of Customer Satisfaction Survey Results in Disputes with Franchisees*, 36 Franchise L.J. 1 (Summer 2016).

products to franchise and company locations in a timely and cost effective manner. The failure by a franchisor to negotiate the best possible prices with suppliers of goods and services to a franchise system and to enforce requirements that franchisees use approved suppliers and distributors can significantly impact the ability of a system to deliver high quality and competitively priced products and services to consumers.

One of the key responsibilities of a franchisor is the strong and consistent enforcement of product and service quality standards throughout the system. Perhaps more than any other factor, the failure of franchise and company operated locations to consistently deliver high quality products and services will negatively impact the brand and the system. Failure to develop and communicate product and service quality standards, and to consistently and fairly enforce these standards, will contribute mightily to the problems of a franchise system.

The location of outlets in a franchise system is an important factor in the success of the system. Convenience is an important consideration to consumers faced with an ever-increasing variety of choices. Shifting demographics may cause once high quality locations to no longer meet consumer needs.

Units at good locations will harm the system when their appearance becomes outdated. A "tired" look and feel for a system will drive customers away. Vigorous promotion and enforcement of upgrading and remodeling standards by franchisors, sometimes accompanied by remodeling incentive programs, may be necessary to ensure the locations are up to date and attractive to consumers.

C. Competitive Issues

A variety of competitive issues can lead to problems within a franchise system. The system may simply be in an industry that has several high-quality competitors. This may create issues for the system because it needs to make bold and costly moves to compete on product and service development and quality, price/value, locations, and methods of delivery. Systems may also fall behind their competitors when the franchisor lacks a well-conceived and executed development strategy. A system may have too few units or the franchisor may have permitted development in too many geographic areas, resulting in the lack of critical mass for marketing and promotional activities in any single area. Conversely, the lack of a solid development strategy may lead the system to be overbuilt in certain areas, impairing unit level economics and profitability. A franchise system may also struggle when the franchisor lacks a robust research and development function. A consistent flow of innovative products and services can be critical in achieving continued consumer acceptance, particularly in the face of more effective competitors. A franchise system may also face competitors who are adept in the use of new forms of technology.

D. Financial Issues

Undercapitalization issues can have a profound negative impact on franchise systems. A franchisor with an innovative product or service may rush into franchising without a sufficient understanding of the capital required to develop the infrastructure needed to develop and maintain a franchise system. This may result in such things as a flawed franchisee selection process, a poor site selection and approval process, a weak research and development program, insufficient training programs, poor advertising and marketing efforts, and haphazard policing of system standards, trademarks, and trade secrets.
Undercapitalized franchisees also can put significant stress on a franchise system. Lack of adequate capitalization may lead franchisees to attempt to save money by using unauthorized products or services, failing to properly staff their locations, or deferring required repairs, maintenance, or remodels. Ultimately undercapitalization can lead to the closing of franchised locations, resulting in loss of fee revenue to the franchisor and damage to the franchise brand. Franchisees who lack adequate capitalization will find it difficult to implement changes proposed or required by the franchisor to address issues within the system. As a result franchisors must keep franchisee capitalization issues in mind when considering the cost and return on investment of proposed system changes.

The problems faced by franchisors and franchisees in distressed systems can be further compounded by difficulty in obtaining loans from banks and other lending institutions under favorable terms. Poor unit level economics, a poor reputation of the franchise system among lenders, the general reluctance of some lenders to make loans to franchise companies, and the overall lending environment can combine to make it difficult for even good franchisees in troubled systems to obtain loans under favorable terms. Higher interest rates and shorter amortization periods can make debt service more difficult for franchise locations.

The sources of capital for franchisors and franchisees may create issues in franchise systems. In recent years private equity companies have increasingly invested in franchise systems and multiple unit franchisees, attracted by their perception of steady revenue streams from these businesses. Although some private equity companies are well versed in franchising, others are not as familiar with the franchise business model. It is not unusual for private equity companies to plan to exit ownership of franchise businesses within three to seven years. This can place pressure on franchisors and their franchisees to focus on short-term financial results to the detriment of longer term planning for the franchise system.

Activist investors increasingly are making their presence known in franchise companies. These investors, which often are hedge funds, target companies whose stock is underperforming. After taking a substantial stake in the company, the activist investor may pressure the company to cut costs, make management changes, or sell all or part of the company. As an example, an activist investor group acquired a substantial stake in the franchisor of the Buffalo Wild Wings system. The head of this investor has been very vocal in seeking changes in how the franchisor operates. He is urging the company to have a higher percentage of franchised locations and to do more in implementing new technologies. Franchisors and franchisees must consider the opinions of activist investors when considering strategies for making changes in their system.

E. Franchise Community Issues

Disagreements between franchisors and franchisees often lie at the root of the problems within a franchise system. Many factors may have led to these issues, which can seriously impair the system’s ability to address these concerns. A franchisor may have engaged in poor franchisee

6 Roark Capital is an example of a private equity company that is heavily involved in franchising. According to its website, it has acquired fifty-nine franchised or multi-unit concepts, which generate $24 billion in system revenues in fifty states and seventy-eight countries. About Roark Capital, https://www.roarkcapital.com/about (last visited July 20, 2017).


selection. Particularly in the early years of the system, a franchisor may have focused more on the franchisee’s ability to pay the initial fee and less on the prospective franchisee’s ability to be a good long-term operator of franchised locations. Even when the franchisor has a good franchise selection process, issues can arise when early franchisees do not adapt to changes in the environment for the franchise business—believing that they are responsible for the franchise system’s success and know better than the franchisor how to adapt to a changing business climate.

Franchisors can exacerbate problems within the franchise community by failing to provide proper support to franchisees or to enforce system standards, and by having poor communications with the franchise community. This can be particularly harmful to the system when the franchisor selectively enforces system standards against perceived problem franchisees who may have significant support within the franchise community.

Where the franchisor becomes complacent in its communications with its franchisees, whether due to incompetency or lack of focus, or where the franchisor is acquired by owners who are not familiar with the operation of a franchised system and overlook the importance of communication with the franchisees, problems can be exacerbated, simmering until they explode, damaging the system. A changing market for the system’s products or services, as mentioned earlier, can affect the unit economics dramatically. If the franchisor is not communicating effectively with its franchisees, it may be unaware of the causes for a climbing franchisee failure rate. On the other hand, franchisees are normally talking among themselves. A franchisee revolt may be the result. What might have been an external problem becomes a serious internal problem. Management time and resources will be unnecessarily diverted just to get the system back to normal operations.

F. Marketing and Advertising

The development and execution of an effective marketing and advertising strategy can be critical to the growth of a strong franchise system. Conversely, poor marketing and advertising strategies can significantly complicate the efforts of embattled franchise systems to recover market share. The profound changes that have occurred in marketing and advertising in recent years make it increasingly difficult to develop these comeback marketing strategies. The rapid decline in print advertising, the proliferation of available television channels, the increase in “cord cutting” by cable television subscribers in favor of services such as Netflix, Hulu and Amazon Prime, and above all the rise of social media, make it more and more difficult to select the right media to convey the franchise system’s message.

Moreover, selection of the right media is only part of the issue—the best use of each of the various media available is critical. Who are the users of each type of media? How does the system best reach them? What is the most effective message in each? The dynamic nature of technology brings difficult challenges. What is available and how best to use it is constantly and rapidly changing. Failure to keep up can destroy the franchise system.

An important component of advertising and marketing programs is the franchise system’s pricing strategy. Distressed systems will be eager to win back customers and attract new customers as part of the system’s recovery plan. That often leads to consideration of aggressive discounting strategies. Although these strategies may increase revenues for both franchisors and

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9 Recent media reports indicate that Facebook is approaching two billion users worldwide.
franchisees in the short run, long term reliance on discounting can erode unit level margins and diminish the value of the system’s products and services in the eyes of consumers. As discussed later in this paper, the franchisor of the Burger King system faced breach of contract and covenant of good faith and fair dealing claims in connection with the franchisor’s implementation of certain value menu items where the franchisees asserted that these items caused the franchisees to lose money on each transaction.

G. Legal Issues

The legal issues faced by franchisors and franchisees in addressing the problems and potential solutions for struggling systems are discussed in part V. of this paper. However, legal issues are sometimes important causes of problems in franchised systems. Franchisor-franchisee discord may have resulted in a significant number of franchise terminations, some resulting in litigation or arbitration. Franchisees may bring claims under theories such as breach of contract, the covenant of good faith and fair dealing, common law fraud, or claims under state franchise laws. These claims by both franchisors and franchisees may be both a cause of system distress and an impediment to the recovery process, as legal fees and business distraction issues drain financial and human resources from franchisors and their franchisees.

H. Purchase of System by Competitor

The purchase of a franchise system of a competitor or by a competitor can place significant stress on a franchise system or magnify existing issues within a system. Problems may arise as the new owner attempts to enforce changes on the acquired system. The new owner may want to merge the systems, notwithstanding the desire of all or part of the franchise communities in each system to remain separate, each under its own brand and operating system. Or the new owner may seek to implement a system emphasizing company operated locations or move the focus of the system to other products and services or platforms for delivering these products and services. Encroachment claims may result when there are overlapping exclusive territories, or when the new owner has company or franchise units near a franchise location in the acquired system, even though the franchise agreement and franchise disclosure document note that such acquisitions may occur. Issues will also arise when the new owner lacks the experience, the competence, or both to run a franchise system.

10 Franchisors have a greater ability to direct the prices set by franchisees following the decision of the U.S. Supreme Court in Leegin Creative Leather Products, Inc. v. PSKS, Inc., 551 U.S. 877 (2007). However, such activities by franchisors still must withstand rule of reason scrutiny under federal antitrust law and face risks from state laws that do not follow Leegin. See Scott Hansen and Robert Lauer, Franchise Systems in Distress, ABA 32nd Annual Forum on Franchising W-15 at 6 (2009) (hereinafter cited as “Hansen-Lauer”).


12 For a discussion of the issues that can arise when competing brands have common ownership, see Charles S. Modell and Sherin Sakr, Competing Brands Under Common Ownership, ABA 37th Annual Forum on Franchising W-19 (2014).


14 In its discussion of Item 12 of the franchise disclosure document, the FTC Rule Compliance Guide states that one of the topics to be covered is “any present plans on the part of the franchisor to operate a competing franchise system offering similar goods or services.” FTC Amended Franchise Rule Compliance Guide at 73 (2008), https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-rule-compliance-guide.pdf (last visited July 20, 2017).
I. Franchisee Actions That Contribute to System Struggles

To this point our review of the internal causes in struggling franchise systems has focused on the franchisor. However, this does not present the entire picture, because the individual or collective actions of franchisees can contribute to the problems experienced in franchised systems. These issues can begin with franchisees who are ill-suited for the type of franchise they have selected. Some prospective franchisees do not do thorough due diligence of the franchise system to determine if their skills, talent, background, financial circumstances, and experience make the franchise a good fit for them, even though they may satisfy the franchisor’s criteria for new franchisees. Others misunderstand the system requirements, or the franchisor’s rights and responsibilities. The result is an unhappy franchisee who may struggle to operate a successful franchise location.

Franchisees may also be undercapitalized as they begin and maintain a franchise relationship. Despite the disclosures provided in Item 7 of the franchise disclosure document, franchisees may still purchase the franchise without adequate financial resources to properly operate a franchised location. Likewise, despite Item 5 and 6 disclosures, franchisees may underestimate the costs of doing business. This may lead to problems complying with the franchisor’s standards for performance and appearance of the franchisee’s location to the detriment of the system. Similarly, the franchisee may underestimate the time the franchisee must devote to the operation of the business to be successful. A franchisee may try to operate as an absentee owner with predictably poor results.

Just as marketing and advertising issues of the franchisor can lead to problems in franchise systems, poor marketing decisions by franchisees may result in underperforming locations. Also, failure to follow the franchisor’s established marketing programs can negatively impact a franchisee’s sales and profits, particularly in systems in which those programs were developed with input from the franchisee community. Selecting the best available advertising outlets presents challenges to both franchisors and franchisees.

The selection, training, and compensation of good employees is an important part of ensuring the successful operation of franchised locations. In tight labor markets, franchisees must pay competitive wages and treat their employees well to maintain a strong workforce. A failure to adopt and follow good human resources policies and practices will make it very difficult for franchisees to run good operations.

There is an inherent tension in the franchise model where franchising is seen as a way for entrepreneurs to run their own business, but to do so within the parameters of an established franchise system. As discussed in this paper, compliance with system standards can be crucial in the turnaround efforts of struggling systems. When franchisees, whether individually or collectively, resist the franchisor’s standards on such issues as new products and services, marketing decisions, or the need to update the appearance of locations, systems often face significant problems in seeking to improve the performance of a distressed system. On the other hand, in struggling systems, franchisees may work in concert with each other and approach the franchisor with suggested solutions for the benefit of the system. This might include waiting to roll out décor changes in locations where franchisees are already investing significantly in other franchisor initiatives without a profit in return. Franchisees may work together to form purchasing or other co-ops to reduce costs. Good communications and collaboration between franchisors and franchisees can help to ameliorate these issues, but inevitably franchisees are expected to give up some freedom of choice in return for participating in an established system.
II. EXTERNAL CAUSES IN STRUGGLING FRANCHISED SYSTEMS

When considering the external causes in struggling franchised systems and the ability of systems to withstand external challenges, both the size of the system and its age or maturity matter.

In a larger system, the loss of one unit could be so *de minimis* that no one at the franchisor’s home office notices; in a new or smaller system, the loss of one unit, particularly a long-standing and visible physical location, could have a significant impact on the entire chain.

In a new system, sometimes the emphasis on franchise sales leads to a franchisor whose sales team is significantly stronger than its system as a whole. Franchisees' problems might go unnoticed or be understated by the franchisor. By the time the franchisor becomes aware of the problems in the system, it may be too late to successfully address the external issues. Also, in a new system, the franchisor might not have had enough time and experience to refine the concept or train its team and its franchisees to best prepare itself to withstand external impacts.

Even if the unit doesn’t fail, the difficulties in competing may be enough to reduce royalty payments, perhaps to zero, create collection issues with vendors, and result in late or non-payment of rent, which might affect the franchisor even more if the franchisor or an affiliate holds or guarantees the lease. When vendors start to see a pattern of franchisees in a chain slow to pay the bills, they may reduce credit and begin to provide less inventory. This can create a spiraling effect, when customers do not find what they are looking for in the franchised locations, and go elsewhere. Where the franchisor owns a majority of the units, it suffers more of the economic impact when the chain struggles to compete. In that circumstance, the franchisor bargained for the chance to benefit from more of the return it originally anticipated as it developed the concept, in exchange for the risk that if the system struggled it would bear more of the financial loss, and have fewer independent franchisees paying royalties and contributing to advertising or other chain-wide funds.

External causes for struggling franchised systems include macroeconomic issues, such as: (1) recession; (2) tight credit markets; (3) tight labor markets; and (4) governmental regulations affecting the industry. External causes also include industry disruption, which could result from: (i) e-commerce and on-line providers of goods and services; (ii) innovative competitors; (iii) a change in the relevance of the concept; and (iv) a shortage of licensed employees in a regulated industry.

A. Macroeconomic Issues

1. Recession

In conversations with franchise professionals, Bennigan’s is often cited as a victim of economic downturn. In 2008, Bennigan’s announced its bankruptcy filing. As middle-class Americans gathered around their kitchen tables and fretted about higher gas costs, lay-offs and work-force reductions, and economic uncertainty, more often they ate-in and saved the dollars they may have otherwise spent on a casual dining experience.

During a recession, franchisors may need to consider the most cost-effective strategies for servicing franchisor-owned and franchisee-owned units. Especially for untried franchisors, this may even include closing franchisor-owned units that are in some way disparate from the majority, whether because of geography or some other market difference. Focusing on specific
geographic areas can allow for more efficient service and support, while growth in limited areas can develop brand awareness in those specific areas. This strategy allows the franchisor to focus on efficiently operating, while reserving capital and resources for growth in target markets. It also permits more focused advertising, which will benefit both franchisor and franchisees.

Franchise growth might also stall as franchisors slow recruiting and invest only in less expensive media like Facebook and Twitter, and as prospective franchise buyers hold their capital and wait for the economy to improve.

On the other hand, during a recession, when no one seems to want credit, interest rates typically fall to entice borrowing. In an established global chain, a recession may provide a growth opportunity. Franchisors might be able to appeal to the prospective franchisee’s ability to borrow cheap, particularly if that prospective franchisee has been downsized or is otherwise recently unemployed due to the recession. But, with profits falling, unemployment rates rising, and an unstable stock market, all common during a recession, it may be too difficult to convince a prospective franchisee to part with her money.

2. Tight Credit Markets

In the United States, when the Federal Reserve increases the prime rate, “tightening” the economy, the move affects individual consumer and business economics. When the “tightening” is severe enough, deflation results. The result can be catastrophic because when consumers do not have enough cash to purchase goods and services, businesses do not profit. Even when the “tightening” of the economy is not as severe, tightening will reduce the amount of credit banks will extend to individuals and businesses. When banks do not generate enough income from interest assessed on loans, which flows from the prime rate, banks will reduce the amount of available credit. Then, when individuals and business owners, franchisees and franchisors, do not have enough capital to repay loans, in turn, they will be loaned less, if anything.

By October 2, 2008, The New York Times was reporting that declines among companies in manufacturing, chemical production, and mining “suggested that the problems of the tight credit market, once mostly contained to Wall Street, were spreading across the broader economy.” Those declines and the related uncertainty affected consumers, and, in turn, franchisees and franchisors. As banks, and individuals, tightened their grip on their cash, virtually all industries were affected. The same New York Times report quoted a “top executive” in the Marriott hotel chain as saying that “the company was forced to borrow $900 million from its credit lines in the face of a weak commercial paper market.”

Individual consumers and small business owners who were not positioned like Marriott did not have that ability. They scrambled to hold onto their cash, spending less. With consumer spending down, franchised businesses suffered from the dual effect of their own inability to borrow in the tight economy and the drop-off in sales as a result of their customers’ inability or unwillingness to spend.

While during a recession interest rates typically decrease, which could be to the advantage of a franchise seller, in a tight credit market, prospective franchisees may not be able to borrow

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16 Id.
enough to pay a franchise fee and start-up costs. Franchise sales are likely to fall with consumer spending. Particularly for small or start-up franchisors, franchise sales are a critical part of cash flow. The decline in franchise sales in a tight credit market could be the third strike for franchisors. Decline in consumer spending – strike one; inability to borrow – strike two; decline in franchise sales – three strikes, you’re out. A tight credit market could mean the ballgame for a small or relatively new franchise concept.

3. **Tight Labor Markets**

A more recent concern among business owners in the United States is the tight labor market. While employees enjoy certain benefits of a tight labor market, like the ability to demand more benefits and higher pay as their labor becomes a more valuable commodity, employers suffer higher turn-over as workers shift into different and higher-paying industries, and face the need to meet the employees’ demands for higher wages. The costs to small businesses, like single-unit franchisees and small franchisors, both in direct dollars and in wasted training time and other more intangible elements, can be significant.

Most of the required employer responses to tight labor markets come at significant tangible cost. These include advertising, using employment agencies, restructuring the type of work and the hours scheduled for employees, increasing overtime or converting part-time to full-time employment, improving conditions for employees, improving benefits, offering bonuses, and, of course, raising wages. For many franchisees, these kinds of changes are cost prohibitive. Converting part-time positions to full-time, in many markets, can be extremely expensive, especially where the law requires certain benefits for full-time employees.

Employers might also offer additional training to build a larger supply of qualified employees. Franchisors might attempt to deal with the tight labor market by increasing their training of their own employees and of their franchisees, but the risk they face is that these people take the benefits of the increased training to another employer or industry. Larger franchisors can attempt to build and maintain the workforce from the ground-up, rather than through more traditional hiring practices. For instance, they may accomplish this through high school or college internships, work-based and school-based learning. Smaller franchisors might not have the “muscle” alone to develop such programs, but if the labor market continues to tighten, they may need to be creative and work with franchisees within communities to develop community-based workforces. Certain industries, like mechanical and automotive concepts, may already be positioned to do so.

Actively seeking non-traditional employees and franchisees is another option for franchisors in any market. In 2013, The Dwyer Group launched its “Women in the Trades” program offering scholarships to women who attend trade or technical schools to go to work in service jobs or own their own businesses. The Women in the Trades program and others like it can actively bring more women into repair businesses as employees and owners.¹⁷

Franchisors and franchisees in a tight labor market should explore changes, but also remember the importance of holding on to the best talent, even at a higher cost. Consider whether the benefit of maintaining the best talent outweighs the cost of being the place the talent wants to work, or the company for whom the talent wants to work. The best employees will have choices in a tight labor market. That means that there should also be prospective employees looking for

opportunities.

4. **Governmental Regulations Affecting System’s Industry**

   a. **Minimum Wage**

   Most governmental regulations affecting a system will be costly, but not enough so to bring the chain to its knees. The consequences of non-compliance are likely much greater than the cost of coming in line with new and changing governmental regulations. The exception may be minimum wage. For franchises, unanticipated external mandates, like governmental regulations of wages, can have profound and complicated results.

   Nearly every business in every industry is affected by federal and state employment and labor laws and regulations. Business owners have to absorb the cost of keeping up with the seemingly constantly changing employment laws. It can be difficult to run a business and keep up with changes to minimum wage requirements, safety and health regulations, entitlement to retirement plans, health care benefits, and privacy laws. On the other hand, the cost of failure to adhere to the regulations can be far greater than the cost of knowing and following the rules.

   Minimum wage hikes are touted by some as a key to thriving economies and a “win for workers.” Others, including many franchisees, argue that in the battle to do business, minimum wage hikes affecting franchisees will be the cost franchisees cannot absorb, and businesses will close. A complete discussion of minimum wages and franchising is beyond the scope of this paper. Still, the effect of governmental regulation of minimum wage, and particularly laws like Seattle’s minimum-wage law, which classifies franchisees as large employers, must be considered. Seattle’s law requires employers with 500 or more employees to raise wages to $15/hour and gives those employers three years to do so. But, the law treats franchisees as a single employer with the franchisor. This includes franchisees with fewer than ten employees. So, a single unit Subway franchise owner, who employs six people, is deemed by the Seattle law to be one with every other Subway in America, and subject to the three-year phase-in $15/hour minimum wage requirement.

   Some franchisees are raising prices in response to the requirement that they pay higher wages. But, if not all franchisees or their competitors raise prices, the risk to those who do is a drop in customers and sales. Other franchisees are cutting employee hours, hiring few or no full-time help. It is hard to see how that is a win for workers. But the city of Seattle argues that the intent of the law is not to target franchisees, but to support workers. The idea behind putting franchisees in the large business category, was that franchisees, like large employers, have the resources to pay more sooner. Franchisees say they lack those resources. They might admit though, that regardless they would have to pay employees $15/hour sooner or later.

   The IFA and five Seattle-area franchisees were not able to convince the U.S. District Court for the Western District of Washington that the city intended to discriminate, and the district court found that there was no credible evidence that the law would cause franchisees to close or reduce operations. Furthermore, the district court found that there was a legitimate purpose of the city

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19 “Here, there is simply no credible evidence in the record that indicates franchisees will close up shop or reduce operations, or that new franchisees will not open up in Seattle.” *International Franchise Ass’n, Inc. v. City of Seattle*,
classifying local franchisees as large employers.\textsuperscript{20} The Ninth Circuit affirmed this decision.\textsuperscript{21} The appeals court also evaluated whether local franchisees would suffer, and concluded, “the chain of events suggested by IFA was speculation that did not rise beyond the mere possibility of harm.”\textsuperscript{22}

Efforts by labor unions to organize employees of franchised businesses continue to increase. During the 2016 Forum on Franchising, Paul Ades and Ruthie Goodboe provided an overview of applicable laws and a comprehensive discussion of franchisor and franchisee responses to union organizing campaigns.\textsuperscript{23} Ades and Goodboe concluded:

“Employers are now faced with extremely tight timeframes and must now navigate through substantially more red tape that will create numerous legal trip wires. These new rules leave no room for error when employers are targeted by union organizing. Because the rules of the game have been so drastically changed to advantage unions, employers must adapt to this new reality. Employers must prepare ahead of time and carefully execute a plan to confront this challenge.”\textsuperscript{24}

\textbf{b. Privacy Regulations}

Regardless of the industry, privacy laws are significant. The Federal Trade Commission regulates and oversees business privacy laws and policies that impact consumers.\textsuperscript{25} As those involved in franchising would expect, the FTC prohibits deceptive practices. Any online business, and any business that utilizes email marketing, or even a website, should have online privacy policies describing how the business will collect, use, share, and protect consumer data. The SBA points to its own privacy policy as an example.\textsuperscript{26} It also recommends business owners “talk to a lawyer who specializes in Internet or online law to determine whether [your] policies are adequate.”\textsuperscript{27}

Privacy laws also appear to be proliferating, both in the United States and internationally.

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\footnotesize\textsuperscript{20} “The Ordinance is, at least putatively, designed to assist low wage workers, to decrease the gender wage gap, and to ensure that workers can better support and care for their families and fully participate in Seattle's civic, cultural and economic life—objectives that are well within the scope of legitimate municipal policymaking. While the court may philosophize about ways that the Ordinance could have been more narrowly tailored to achieve these goals, it is not the court's place to second guess the reasoned judgments of the lawmakers who studied and analyzed this issue as part of an involved legislative process.” \textit{Id.} at 1277.


\footnotesize\textsuperscript{22} Paul Adler and Ruthie L. Goodboe, \textit{In the Trenches: What Every Franchise Lawyer Needs to Know About Labor Unions and Union Organizing Activities}, ABA 39th Annual Forum on Franchising W-23 (2016). The impact of the Trump Administration and its appointments to the National Labor Relations Board on the rules for union organizing remains to be seen.

\footnotesize\textsuperscript{23} \textit{Id}. at 47.


\footnotesize\textsuperscript{26} \textit{Id}..
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Several federal and state laws have provisions for data privacy, including the Americans with Disabilities Act, the Electronic Fund Transfers Act, and the Fair Credit Reporting Act. Laws and regulations like these are creating a growing burden for many companies.

c. Restaurant Regulations

Restaurant regulations affect the operation of every franchised restaurant. The Food and Drug Administration maintains a very useful chart, with links, to state retail and food service codes and regulations. Of course, following the standards is a cost of doing business. But in some instances it may seem as though the regulations are unduly burdensome. Most restaurant owners do not rebuke the sanitary standards imposed by government. Some franchisors’ standards are even more stringent than those of government when it comes to food safety and handling. But many have bristled at the idea of compliance with dietary guidelines and menu labeling.

In 2010, when the Patient Protection and Affordable Care Act became law, federal menu labeling laws went from a fear of many, to a reality. Public health advocates argued that if consumers see calorie counts before buying, they will order healthier options. Critics argued that the rule was too strict. Pizzerias, supermarkets, convenience stores, bakeries, and others argued against the regulations. In April 2016, the FDA released its final guidance for the labeling rule, and enforcement was set to begin in May 2017. But five days before the effective date, the FDA announced a new deadline for restaurants to post calories, extending the deadline one year, to May 7, 2018. An alternative, the Common Sense Nutrition Disclosure Act, passed the House, but as of this writing, has not been voted on in the Senate.

The Telephone Consumer Protection Act of 1991 restricts telemarketing and the use of automated telephone equipment. Its passage changed the way many businesses advertised and solicited customers. Still, the Act was a basis for lawsuits against companies, including franchises, nationwide. These lawsuits can be extremely costly to businesses, including franchisors.

Franchisees and franchisors need to know their industry and be prepared. Governmental regulations are an area where it pays to know what is required and to make every effort to adhere to those requirements. Although meeting governmental regulations is not an issue unique to struggling franchise systems, the costs involved in doing so can put additional stress on a system

28 42 U.S.C. § 12112, et seq.
32 For a comprehensive discussion on menu labeling, see Breton Permely and Suzanne Trigg, Menu Labeling – “Cheese Fries for 700 Calories, Please”, ABA 39th Annual Forum on Franchising W-14 (2016).
that already is struggling financially or operationally.

B. Industry Disruption Issues

1. Online Product/Service Providers Disrupting Brick and Mortar Locations

From 2005 through 2015, Barnes and Noble closed bookstores across the United States. According to a January 3, 2016 report by Michael Kozlowski for Good E-Reader, “The vast majority of them are unprofitable due to sagging print sales and the rise of e-books.”36 Throughout the early months of 2017, Business Insider repeatedly published stories about shopping malls “dying” and closing across America.37 “According to many analysts, the retail apocalypse has been a long time coming in the US, where stores per capita far outnumber that of any other country.”38 “Visits to shopping malls have been declining for years with the rise of e-commerce and titanic shifts in how shoppers spend their money.”39

Traditional brick and mortar retail locations are taking repeated and sharp blows from online shopping and falling foot traffic. The result affects not only retail locations, but the businesses around those locations that also rely on the incoming foot traffic, like fast-food and fast casual restaurant chains.

In some industries, franchisors might be able to adjust to the shifting focus of consumers away from brick and mortar. For example, with the rise in products like Turbo Tax and other tax preparation software programs that allow taxpayers to prepare returns at home, H & R Block launched its own tax preparation software that “lets you file your taxes from the comfort of your home.” The software has basic, deluxe and premium editions, and can be downloaded so that the user never needs to leave home to prepare and file income taxes. Perhaps it is ironic that while many retailers are blaming Amazon for their declining sales, the H & R Block Tax Software is available for purchase on Amazon.com.

However, solutions such as this H & R Block example may not help the franchise system, and may also be in breach of the existing franchise agreement. Franchisors who turn to direct customer sales to boost business risk reaction from franchisees who find their units cannibalized by the direct sales by the franchisor. Relying on its franchise agreement, a franchisee sued its

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39 Id.
franchisor for breach of an in-term non-competition provision in *Armstrong v. HRB Royalty, Inc.* The franchisee claimed that the franchisor sold tax preparation software and provided internet-based tax preparation services within the franchisee’s protected territory. The contractual remedy was fifty-five percent of the franchisor’s gross receipts from the services the franchisor sold in the territory. Disagreement over the amount of damages led to contentious litigation. Following unsuccessful mediation in 1999, the parties were still arguing evidentiary motions in the U.S. District Court for the Southern District of Alabama in late 2005. The plaintiff franchisees demanded payment of a “fair and equitable price” as required by their franchise agreements. The court held that “fair and equitable price” did not “unambiguously mean ‘fair market value.'” After the parties filed proposed jury instructions in early 2006, a settlement conference was held and the case settled.

But, Carvel’s supermarket program is probably the best example of direct sales affecting franchisees. In 1989 Thomas Carvel sold his company to an investment bank. By 1990 Carvel was the third-largest ice cream chain in the U.S. Now, there are about 400 locations in twenty-five states in the United States and five international markets. In contrast, today Dairy Queen is “one of the largest fast food systems in the world, with more than 6,000 restaurants in the U.S., Canada and other countries.” In a case in the New York Court of Appeals involving Carvel, the court noted that until the early 1990’s, Carvel distributed its products exclusively through franchised stores, and repeatedly told franchisees it had no plans to distribute their products through supermarkets. Following a decline in business Carvel then adopted a “supermarket program.” The program provided for sales to supermarkets by Carvel itself “and by those franchisees that chose to participate in the program—which required franchisees to pay substantial license fees and to upgrade their stores. Most franchisees chose not to participate. From 1993 to 2000, the supermarket program grew rapidly, while many franchised stores went out of business.” Franchisees claimed, and juries agreed, that Carvel induced customers not to buy Carvel products from the franchisees. Franchisees also claimed that such inducement amounted to tortious interference under New York law. The Second Circuit certified to the New York Court of Appeals the question: “Under applicable standards for a claim of tortious interference with prospective economic relations, did the evidence of the franchisor’s conduct in each of the three trials on review in these consolidated appeals permit a jury finding in favor of the franchisee?” The answer was “No.” But for franchisees, the damage was done.

In other industries, like the hotel industry, while chains can offer on-line booking, it may become difficult to compete with new lodging alternatives such as Airbnb. The “sharing economy” is being enthusiastically embraced by millennials and offers more personalized products, passing the savings from lower marginal costs down to consumers. In less than ten years, has Airbnb

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42 Id. at *1.
46 3 N.Y. 3d at 189, 818 N.E.2d. at 1102.
47 Id.
48 3 N.Y. 3d at 189, 818 N.E.2d at 1102-1103.
become a serious threat to hotels? Maybe. In a September 2015 Impact Analysis Report to the Hotel Association of New York City, HVS Consulting & Valuation reported on the effects of Airbnb in New York City and estimated that City hotels lose approximately $450 million in direct revenue per year to Airbnb. But, earlier this year, market researcher STR Inc. said it could not find clear effects on hotel industry performance attributed to Airbnb and its study concluded that Airbnb has not harmed the traditional hotel market in most cities.

Franchisees and franchisors whose industries are affected by online, alternative, or sharing options, are wise to be vigilant and keep a watchful eye on non-traditional competitors. It might also make sense to take steps to position traditional locations to take advantage of technological or other advances.

2. **Innovative Competitors Disrupting Industry**

The disruption of an industry by innovative competitors can be sudden, or slow. In the case of fast-food burgers, it was probably the quick growth of a concept long-refined that disrupted the industry. On August 4, 2014, the Huffington Post published a story with the headline, “Americans are Totally Over Fast Food Burgers.” “Some day soon,” the story said, “a burger and fries will no longer be the quintessential American fast-food meal.” But, less than two months earlier, on June 10, 2014, the same publication wrote, “You could actually argue that the cult of the burger has never been stronger.”

On May 17, 2017, the Huffington Post reported, “Surprise! Five Guys is Now America’s Favorite Burger Chain.” The sub-heading for that piece was, “Winner winner, burger dinner!”

Five Guys is considered an innovative competitor in the burger market. Burger King, Checker’s/Rally’s, DQ Grill & Chill, Hardee’s, Jack in the Box, and White Castle did not make the top ten list published by Huffington Post. The article reminded us, “Over the past few years, Five Guys has grown exponentially, which could help explain its familiarity with customers and rise in the rankings.” It also noted In-N-Out’s reluctance to expand, and offered a “Here’s hoping” that the success of Five Guys would pressure In-N-Out to do so.

Of course, Five Guys is not an overnight sensation. It has been over thirty years since the first Five Guys opened in 1986. But the “Five Guys” fresh ground beef burgers and fries cooked in peanut oil continue to develop “a cult-like following” around the world. Five Guys refined its system for more than fifteen years before it offered its first franchise opportunity in 2003. Then, it sold more than 300 units in under eighteen months and now has “almost 1,500

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53 Id.

54 Id.
locations worldwide and another 1,500 units in development.” It is fair to say that fries cooked in peanut oil with a “cult-like” following disrupted the burger chain industry.

3. Relevance of the Concept

Recent news brings steady reports of clothing chains closing many or all storefronts. “Studies show that Americans are increasingly choosing to spend money on technology and experiences like vacations over apparel.” It is also widely reported that shopping malls are troubled and closing throughout North America. Howard Davidowitz, of Davidowitz & Associates, explains, “The shopping that used to be done in the mall is now at Family Dollar, Dollar General, Dollar Tree, TJ Maxx, and Walmart.” The entire trend, which probably peaked in the 1980s, of teenagers hanging out at the mall appears to be over.

Many people report on Twitter and other social media that they cannot go to a mall without having a Mrs. Fields cookie or an Auntie Anne’s pretzel. Without the physical location and the accompanying foot-traffic, concepts centered around mall locations, like certain ice cream, candy, and cookie concepts must adapt to survive. Mrs. Fields, for instance, has a popular on-line gift basket business. But, surviving, and franchising are different. Mrs. Fields notably closed about sixty percent of its stores between 2003 and 2013, but currently its website shows three locations in New York, six in New Jersey, and at least twenty in California. Perhaps it has struck a balance with online sales and still hundreds of physical locations globally. In 2013, taking its concept on the road, Auntie Anne’s introduced a food truck and continued international and nontraditional growth, innovating and adapting to the changing landscape.

Sometimes, though, the concept becomes so completely irrelevant that it cannot be adapted enough. Not only can fads fade in a moment, but technology can simply explode into consumers’ homes and hands. Consider Blockbuster Video, which went through bankruptcy in 2010. As DVD delivery and online streaming became increasingly affordable and convenient, the video rental chain could not overcome its irrelevance to consumers.

4. Shortage of Licensed Employees in Regulated Industries

Not unlike the problems of a tight labor market, in regulated industries franchisees can suffer from a shortage of licensed employees. This issue arises in industries like construction, trucking and hauling, massage, hair care, home health care, child care, and personal fitness.

Franchisors can help franchisees in these industries with wide-spread advertising campaigns, education and training, and economic incentives.

III. DEVELOPING AND IMPLEMENTING POTENTIAL SOLUTIONS IN STRUGGLING SYSTEMS

Just as the problems in a struggling system may arise from many issues, there also are a variety of potential solutions franchise systems can consider to resolve these issues. When faced

55 Id.


57 Id.
with an array of potential solutions, franchisors must carefully and objectively review these solutions to find the best ones for the system. Timely and effective communication and collaboration with franchisees, franchisee associations and advisory councils, and other stakeholders is a critical part of successfully implementing solutions.

A. Communicating with Stakeholders

Support from key elements of the franchise community is nearly always essential in the development and implementation of a successful turnaround in a distressed franchise system. The establishment of strong communication links with the franchise community and other important stakeholders, such as vendors, is important for a franchise system even in good times. But at times when systems face serious obstacles, it is even more important that the system has a credible franchisee association, franchise advisory council or other mechanism in place to communicate with franchisees on the problems facing the system and to seek their input on potential solutions. Lacking such a communication structure, the franchisor might establish an ad hoc group of representative franchisees to provide input and other assistance. Key franchisees will often be the franchisor’s best ambassadors in soliciting support for turnaround efforts, and in many cases can test proposed solutions before they are rolled out to the system.

It may not be enough for franchisors to simply set up the systems and groups. Strong franchisors communicate in as many ways as possible—one on one, in groups (formal and informal), and other means like surveys, conference calls, and webinar town halls. Many franchisors set up quarterly or bi-monthly advisory council or franchisee association board calls. They continually seek feedback on new ideas from franchisees and franchisor field personnel. When franchisors over-communicate, problems are identified earlier and solutions found before the issue becomes a system failure trigger.

Franchisees in a distressed system may well have to take matters into their own hands. That is, officially or unofficially form a franchisee association. The formation of such an association is protected by the laws of at least twelve states with franchise relationship laws. The association can enhance the bargaining power of the franchisee community in circumstances where the franchisor is not listening, is oblivious or incompetent. The wise franchisor will

58 ARK. CODE ANN. § 4-72-206(2) (West 2017); CAL. CORP. CODE § 31220 (West 2017); CONN. GEN. STAT. ANN. § 42-133(f)(2) (West 2017); HAW. REV. STAT. ANN. § 482E-6(2)(A) (West 2017); CH. 815 ILL. COMP. STAT. ANN., § 705/17 (West 2017); IOWA CODE ANN. § 537A10(10) (West 2017); MICH. COMP. LAWS ANN. § 445.1527(a) (West 2017); MINN. R. § 2860.4400; (West 2017); NEB. REV. STAT. ANN. § 87-406(2) (West 2017); N.J. STAT. ANN. § 56:10-7(b) (West 2017); R.I. GEN. LAWS ANN. § 19-28.1-16 (West 2017); WASH. REV. CODE ANN. § 19.100.180(2)(a) (West 2017).

59 Consider the DirectBuy franchise system. DirectBuy was acquired by a PE group. Under the franchise agreement, the franchisor was to buy advertising for the system and charge the cost back to the franchisees. The PE group saw the opportunity to possibly enhance sales by increasing its ad spend, and because the spend would be charged back to the franchisees, the increase would not affect its profit. It also elected not to involve the franchisee community in deciding where and how to make the ad buy. When the franchisees objected that the ads were not effective and that the amount the franchisor could spend (and charge back) was limited by the franchise agreement, and more importantly that the franchisor’s actions were threatening the viability of their businesses, the franchisor ignored them. Franchisees who had invested hundreds of thousands of dollars in their businesses and had been in the system for years were going bankrupt. The PE firm was literally killing the “golden goose” that it had bought. A group of the remaining franchisees formed a franchisee association and made demand on the franchisor to cease its unilateral action. Only after threat of litigation by the newly formed franchisee association did the PE firm agree to bring the franchisees into the ad decisions and cap the ad spending. See Sedaker Group of S. Cal., Inc. v. DirectBuy, Inc., Cause No. 2:15CV198-PPS, 2015 WL 6610212 (N.D. Ind. Oct. 29, 2015) and Arcangelo, Inc. v. DirectBuy, Inc., 3:13CV104-PPS/CAN, 2013 WL 6095678 (N.D. Ind. Nov. 20, 2013). Les Wharton, one of the co-authors of this paper, represented franchisees in the formation of a franchisee association in this matter.
consider the formation or proposed formation of an association an opportunity to work toward an improved system. However, where the franchisor is the problem, the relationship with the franchisee group may well be contentious. The Canadian and U.S. franchisees of the Tim Hortons system have formed franchisee associations in each country. The Canadian franchisees filed a class action suit against the franchisor, claiming the franchisor has breached its obligations to the franchisees. The U.S. franchise association has engaged counsel, who said the stores are lacking in profitability and that the franchisees feel the franchisor is not helping them.60

B. Unit Economic Improvements

Franchisors of retail systems may consider a variety of ideas to improve unit level economics. In many cases the difficulties within the system can be traced back to faltering sales or unsustainable cost structures. Some potential fixes to unit level economic issues involve direct expenditures by the franchisor, but that is not always the case.

1. Sales Enhancement Programs

Improvements in unit level sales can provide much needed additional revenues to enable a system to address its problems. These improvements can come in many forms. New or improved products and services can drive traffic by attracting new customers and strengthening the loyalty of existing customers, generating excitement in the system, and improving franchisee morale. Franchisees’ own innovations can be critical to the development of new products and services. Consider the McDonald’s system, where the Big Mac, the Egg McMuffin, and the Ronald McDonald character all originated with franchisees.61

Marketing can be a crucial component in rolling out new products and services. But as discussed earlier in this paper, the changing media landscape can make it more difficult than ever to communicate with potential customers of new products and services. A well-conceived and well-executed plan, often integrating traditional media and social media, is important to the success of the rollout of a new product or service. Franchisors may need to consider marketing assistance programs, where funds are available to assist in these rollouts, as discussed in Section III.C.2 of this paper.

2. Unit Level Cost Reductions

Along with enhanced sales from new products and services, improvements in unit level cost structures will increase profits. For example, in the food service industry, food and labor costs typically exceed fifty percent of sales. Reducing food costs by several percent can enhance unit level profitability. Suppliers facing the loss of business if a troubled system continues to deteriorate or disappears entirely may be willing to renegotiate supply agreements, particularly if the system commits to a certain volume of business in connection with a new product rollout. As discussed earlier, online shopping is creating a major problem for retail landlords, particularly in shopping malls. Franchisors and franchisees should not ignore the possibility of negotiating temporary or permanent rent reductions.


3. Improved Technology

Ever increasing advances in technology are responsible for some of the disruptions that can present serious obstacles for franchise systems. But on the positive side these technological advances may provide franchise systems with more and better data on their customers and their product and service preferences. Business schools now offer concentrations in fields such as Business Intelligence and Analytics which did not exist even a few years ago. But to obtain and analyze this data requires investment in technology. It is important for franchise systems to spend dollars wisely in this area to purchase technology that targets their industry as specifically as possible.

4. Remodeling Programs

When franchise systems are in distress, one area that can suffer is unit level appearance. Spending scarce dollars to remodel a location, which can involve disruption to the day-to-day business while the remodeling work takes place, for an uncertain return on investment, can be a very hard sell. It is important for franchisors, working with franchisee groups, to develop prototypes for remodeling that can enhance the appearance of locations with the lowest cost and the least disruption to the business while still achieving an upgrade that makes the location more attractive to consumers. This is an area where it can be important for the franchisor to lead by example. It can be very difficult to convince franchisees of the benefit of a remodeling program when the franchisor has not remodeled its own locations, particularly in a market shared with franchisees. To the extent the franchisor has developed data showing the impact of completed remodels on unit level sales and profits at remodeled locations, the franchisor can share this data with franchisees. Franchisors may also want to look at alternate means of funding franchisee remodels, including the use of revenues received from the supply chain for the system.

C. Financial Assistance from Franchisors

In considering turnaround plans for a troubled system, franchisors almost inevitably will face the reality that they may need to provide financial assistance to enable or encourage franchisees to implement turnaround programs or just to stay afloat. In some cases, this may involve reduction or deferral of amounts, such as continuing franchise fees that franchisees are required to pay under franchise agreements. In other instances, it may involve direct payments by franchisors, such as funding of marketing programs for new products and services. Targeting these expenditures at specific programs, geographic areas, or specific franchisees becomes critical to the success of the turnaround program, but can lead to increased legal risks. A careful review of what is permitted under the applicable franchise agreements and a good faith effort to develop reasonable classifications for franchisees eligible for assistance programs can be important in avoiding legal issues related to the implementation of such programs. Common forms of assistance are continuing fee relief, marketing subsidies, and remodel incentive programs.

1. Continuing Fee Relief

Continuing fee relief is a common form of assistance to struggling franchisees. It can involve forgiveness of existing past due fees or reductions in future fees. In some instances a

62 Schools that have data science and analytics programs include American University, Creighton University, Syracuse University, the University of California at Berkeley, and Villanova University.
portion of continuing fees may be deferred and made payable at a later date or under certain conditions. Franchisors must be cautious to provide the least amount of fee reduction and for the shortest period of time possible. Such relief can always be extended, but providing relief over a long or indefinite time period can lead to the relief becoming permanent. At a minimum franchisors might require that franchisees be otherwise in compliance with the terms of the franchise agreement when the fee relief commences and during the entire time the fee relief is provided, and comply with all terms of the assistance agreement. In addition, if the franchisor is rolling out a new product or service, or some other unit level enhancements discussed earlier, the franchisor can require franchisees receiving assistance to participate in these programs.

Systemic issues with unit level economics require an examination to determine the root cause(s), such as those discussed earlier in this paper. Franchisors can assist struggling franchisees where the issues are systemic, with system-wide changes. For example, if food cost is an issue for most of a chain’s franchisees, the menu might be adjusted and system-wide pricing might be adjusted. The franchisor might also start, or encourage and assist franchisees to start, some form of purchasing co-op to take advantage of group pricing advantages. If franchisees are struggling system-wide because of a fall-off in customer visits, a chain-wide couponing program or an app offering incentives might increase traffic, benefitting individual franchisees and the entire system. Before a franchisor offers financial assistance to franchisees, it should identify the root cause of the struggle.

2. Marketing Assistance

In franchise systems with a national or regional marketing fund, the franchisor can provide a reduction in the amounts payable by the franchisee as part of its assistance program. This assistance may be conditioned on the franchisee's agreement to use the reduced amount for specific marketing purposes, to enhance the rollout of new products and services in the franchisee's location. In some cases the franchisor may contribute directly to co-op advertising or other local marketing efforts of the franchisee for the programs being promoted the franchisor.

3. Remodel Incentive Programs

As discussed earlier, remodeling of existing locations can be critical in bringing the customers back to a location. Well-crafted remodeling incentive programs can provide powerful incentives to franchisees to encourage them to participate in such programs. These programs may provide the franchisee fee relief for a specified time period after the remodel is completed, depending on the amount spent by the franchisee on the remodeling.

D. Use of Assistance Agreements

An important component of the assistance program in a distressed system is the consistent use of assistance agreements. Hansen and Lauer's paper on distressed systems provides an excellent discussion of assistant agreements, which counsel would do well to review

63 The franchisor must not be oblivious to the occasional issue that may warrant a permanent change in the fee structure. See David C. Gurnick and Les Wharton, Effective Franchisee Associations, Advisory Boards and Councils, ABA 23rd Annual Forum on Franchising W-7 (2000). As cited in the addendum to that paper, changes caused by competition in the profit margins in the staffing industry in the late 1980s meant that the royalties paid to the franchisor, Norrell Services, were squeezing the unit economics to the point the franchisees were unable to make enough money to make their continued operation worthwhile. A system revolt resulted. Norrell agreed to engage in system discussions, and ultimately agreed to a permanent revision in the royalty structure, one that encouraged unit growth, and enabled the franchisees to continue operations.
before drafting these agreements. As they discuss, the assistance agreement enables the franchisor to describe both the assistance provided in the agreement and the group or groups of franchisees to whom assistance is provided.64 This can be helpful in defending claims by franchisees of discrimination in providing this assistance. Franchisors might also use the assistance agreement to secure a complete release of claims by the franchisee and its owners, when permitted by applicable law. Depending on the nature and extent of the assistance being provided, the franchisor may want to obtain a security interest in certain assets of the franchisee. If the franchisor is deferring the payment of certain amounts, such as franchise fees, rather than foregoing these payments, the assistance agreement may include a promissory note guaranteed by the franchisee’s owners in the event the franchisor is required to take action to collect these amounts.

IV. STRUCTURAL CHANGES IN FRANCHISE SYSTEMS

In some cases the problems facing a franchise system are too large, or the available resources to address them are too small, for unit level enhancements and franchisee assistance programs to work. Some form of substantial structural change in the franchise system may be the only available alternative. These structural changes can include a reduction in the number of units, system consolidation to reduce the number of franchisees, market withdrawals, a sale of the system either to a franchisee or a third party, or a bankruptcy filing by the franchisor.

A. Reduction in Number of Units

In some situations the problems within a system may be too difficult for at least some franchisees to overcome, leading to a closing of some franchise locations. To the extent such closings can be carried out through voluntary termination agreements, which may include forgiveness of amounts owed to the franchisor and releases, this is certainly the preferable approach. But if the franchisor is required to use the termination procedures provided for in the franchise agreement, the franchisor will need to carefully review the termination procedures in the agreements, any applicable state franchise relationship statutes, and any potential counterclaims that may be available to a franchisee based on the covenant of good faith and fair dealing or other theories.65 Although devastating to the franchisee, the elimination of locations where the franchisee was not in compliance with the franchise agreement may free up additional resources for the franchisor to use in implementing turnaround plans for the remainder of the system.

B. System Consolidation

As a less traumatic alternative to reductions in the number of units, franchisors may implement system consolidation plans by acquiring underperforming but economically viable locations or encouraging other franchisees to acquire these locations. In some cases the franchisor can provide fee relief or other forms of consideration to the acquiring franchisee to facilitate the completion of these transactions. As with unit reductions, franchisors must carefully evaluate potential claims by the selling franchisee. If the sale is not voluntary or is for an unfair price, the franchisee may have valid claims against the franchisor. Many franchisors also obtain a release from the selling franchisee and its owners as a part of its process in approving the sale to a third party. In some instances involving system consolidation, particularly where the seller is a multi-unit franchisee, the selling franchisee may want to consider a bankruptcy filing. This may


65 These legal issues are discussed in more detail in part V. of this paper.
make the sale more attractive through the rejection of unfavorable leases or other executory contracts, and may assist the selling franchisee in managing or eliminating the claims of certain other creditors, particularly through the use of sale proceeds.

System consolidation when a competitor buys a franchised system may result in markets where both systems have a franchise presence with units located in close proximity to one another. As a result two locations—now operating under the same brand—may not be profitable, leading to a serious franchise relationship problem. Unless one of the franchisees has committed a material default under the franchise agreement, the franchisor's only recourse in these overlap markets may be to offer a voluntary buyout to one of the franchisees or facilitate the purchase of one franchisee by the other. In the event of a buyout, the franchisor might need to offer the purchased business to the other franchisee or shut it down. In considering to whom to offer a buyout, the franchisor may want to consider factors such as the relative financial and operational strength of the competing units, the remaining terms of the franchise agreements, the location and condition of each unit, and whether one of the franchisees has expressed interest in leaving the combined system.

C. Market Withdrawals

Franchisors that franchise multiple different brands may decide that it makes sense from a business standpoint to discontinue operating certain brands or product lines, at least in some markets. Such decisions can lead to clashes between the franchisor's good faith business decisions to cease doing business under a faltering brand or in underperforming markets, and the applicable franchise agreements and/or state franchise relationship statutes. These issues have been fought over going back at least to the 1980s when Walgreens terminated certain franchise agreements after deciding to discontinue growing through the franchise model in some markets.66 That case, which determined that such market withdrawals did not constitute good cause under the Wisconsin Fair Dealership law, generated a lot of discussion in franchise circles. Later cases under the Wisconsin Fair Dealership Law permitted market withdrawals in certain situations.67 The Hanson and Lauer article, written during the 2008-2009 recession, states that the case law was split on this issue. They noted that the Wisconsin cases permitting market withdrawals required that the changes be "essential, reasonable and non-discriminatory."68 They provide a market withdrawal checklist for franchisor counsel to consult before undertaking random market withdrawal activities.69 However, these types of withdrawals are always going to be fraught with legal risks for franchisors, and should only be considered when less extreme alternatives are not likely to succeed.

66 Kealey Pharmacy & Home Care Svcs., Inc. v. Walgreen Co., 761 F.2d 345, 350 (7th Cir.1985).
67 See Morley-Murphy Co. v. Zenith Electronics Corp., 142 F.3d 373 (7th Cir. 1998); Ziegler Co. v. Rexnord, Inc., 147 Wis.2d 308, 433 N.W.2d 8 (1988).
68 Hansen-Lauer, supra note 10, at 39. There have been few cases on market withdrawal in the past few years, but this split remains. See, for example, Santiago-Sepulveda v. Esso Standard Oil Co. (Puerto Rico), Inc., 860 F. Supp. 2d 131 (D.P.R. 2012) (franchisor established market withdrawal defense to liability in case under the Petroleum Marketing Practices Act) and Girl Scouts of Manitou Council, Inc. v. Girl Scouts of U.S. of America, Inc., 646 F.3d 983 (7th Cir. 2011) (attempt to realign certain Girl Scout councils seeking to increase diversity not good cause under the Wisconsin Fair Dealership Law).
69 Hansen-Lauer, supra note 10, at 43-45.
D. **Sale of the System**

In some situations, the nature and extent of the problems confronting the franchise system may simply be too big or too complex for the current owners of the system to fix. A sale of the system may be the only realistic alternative for maintaining the system intact. Particularly in situations where the problems within the system arise from the kinds of management deficiencies discussed earlier or from the lack of financial resources needed to remediate these issues, a sale may be the only realistic alternative. The nature and extent of the issues in the system will impact the potential buyers. Strategic buyers, who are knowledgeable about the franchisor and its industry, will often be candidates, although that may raise issues when two competing systems combine.70

E. **Franchisor Bankruptcy**

When the other alternatives for resolving the issues facing a troubled franchise system are unavailing, a last resort for the franchisor may be bankruptcy court. The opportunity to reject potentially burdensome executory contracts, including certain leases and franchise agreements, may give the franchisor breathing room to continue to implement its turnaround plan. But the cost of a bankruptcy filing, including professional fees, business distraction, and the inevitable damage to the brand that can accompany a bankruptcy filing makes such filings truly a last resort for franchisors.

V. **LEGAL ISSUES**

Franchisors and franchisees face a variety of legal issues in developing, executing, and responding to plans to address the problems confronting distressed systems. Fortunately, there are several sources that provide guidance to franchisors in these matters.71 Careful planning, active communications between franchisors and franchisees and with other stakeholders, and a healthy realization regarding what is permissible from both a legal and a practical business perspective can help guide franchisors and franchisees through this difficult process.

A. **Potential Claims**

Franchisors seeking to implement remedial plans in a system can face claims based on a number of legal theories. Three of the most common potential sources are breach of contract claims under the franchise agreement or related documents, claims for breach of the covenant of good faith and fair dealing, and claims under state franchise discrimination and relationship statutes.72

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70 See discussion at part I.H., supra.


72 Beyer et al., supra note 71, at 3.
B. Breach of Contract Claims

At the core of many franchisor/franchisee disputes over proposed system changes is a disagreement over whether a franchisor’s proposed changes are permitted by the franchise agreement. That makes it vitally important that franchisors build into their franchise agreements from the beginning the flexibility needed to implement sometimes significant system changes. Preserving the right to change system standards, both in the franchise agreement and in other documents such as the operations manual, can make the difference between a successful and an unsuccessful attempt to implement significant changes to address problems facing the franchised system.

Many franchise agreements contain general language reserving to the franchisor the right to unilaterally modify system standards, including the standards described in operations manuals. Although the presence of this language may have a big legal and practical impact on the franchisor’s ability to implement system changes, one commentator contends that it is important to have more specific language permitting changes to certain aspects of the franchise system when the proposed changes are material to franchisees—i.e. changes likely to have a significant financial impact on franchisees.73

The importance of clear language in the franchise agreement on system changes is illustrated in Bores v. Domino’s Pizza LLC.74 In Bores the franchise agreement stated that Domino’s would provide franchisees with specifications for computer hardware and software, and that franchisees could purchase items meeting Domino’s specifications from any source. Domino’s sought to implement PULSE, described as a proprietary comprehensive computer system. The hardware for PULSE was available only from IBM, and the software was available only from Domino’s. Domino’s required franchisees to implement PULSE by a specified date. Certain franchisees refused, arguing that Dominos was required to provide them with the specifications for the system and permit them to buy the hardware and software from any source that met Domino’s specifications.

The trial court, deciding cross motions for summary judgment, ruled for the franchisees on their breach of contract claim. The court determined that the franchise agreements were clear and unambiguous, and did not permit Domino’s to mandate the installation of PULSE unless Domino’s provided the specifications for PULSE to the franchisees and permitted them to purchase hardware and software meeting these specifications from any source. The court stated that the franchise agreement made it clear that Domino’s could require its franchisees to update their computer system, but could not force them to buy the hardware or software from Domino’s or another source designated by Domino’s. The court concluded that the franchisees were entitled to a declaration that Domino’s must provide them with the specifications if Domino’s continue to insist that they install the PULSE system.

Domino’s appealed and the Eighth Circuit reversed the district court. The appeals court determined that the plain and ordinary meeting of “specification” included both a list of component parts necessary to construct or design an item as well as a single finished product. Under this definition the franchise agreement permitted Domino’s to specify a computer system with comparable capabilities or the PULSE system. The franchise agreement merely allowed

73 Id. at 2.
74 489 F. Supp. 2d 940 (D. Minn. 2007), rev’d, 530 F.3d 671 (8th Cir. 2008).
franchisees to purchase the system from any available source—whether one source or multiple sources.

This case illustrates the importance of franchise agreement provisions that permit the franchisor to make certain system changes, and clearly identify the available sources for the products and services required for these changes. Although neither the district court nor the Eighth Circuit believed the applicable language in the franchise agreement was ambiguous (while reaching different conclusions), this language generated a significant fight between Domino’s and its franchisees who were reluctant to implement the new system. Although it may be difficult to connect this case to today, it is interesting to note that Domino’s is currently a high performing restaurant system, due in no small part to its adept use of new technologies. In a headquarters staff of approximately 800 employees, 400 people work in software analytics, and Domino’s CEO has characterized the company as being as much a technology company as a pizza company.75

In JDS Group, Ltd. v. Metal Supermarkets Franchising America, Inc., the plaintiff was a franchisee of a system of retail locations selling industrial metal components.76 The franchisee alleged that the franchisor breached the Washington Franchise Investment Protection Act (FIPA) and the covenant of good faith and fair dealing in seeking to force the franchisee to implement a new software system. The franchisor contended its software system was outdated and inefficient, and had spent three years and over $1 million to develop a new system. In seeking to avoid installing the new software, the franchisee introduced declarations from six other franchisees describing problems they encountered with the software. The franchisor countered with evidence that seventy-eight of the eighty-six stores in the system had implemented the software and experienced an average sales increase of 7.4 percent.

The court denied the franchisee’s motion for a temporary restraining order and preliminary injunction to prevent the franchisor from requiring installation of the new software. The court noted that the franchisee had been aware of issues concerning the software since at least August 2016, but signed new franchise agreements in January 2017 that gave the franchisor the right to designate software systems and require the franchisee to use them. The court was not persuaded by the franchisee’s argument that it believed it had no choice but to sign the new agreements and that the franchisor would not require installation until the new software was functional.

The court rejected claims under portions of FIPA that required the parties to deal with each other in good faith,77 prohibited a franchisor from requiring franchisees to purchase from approved sources unless the franchisor could show the restriction was “reasonably necessary for a lawful purpose justified on business grounds, and do not substantially affect competition”,78 and from imposing “any standard of conduct unless the person so doing can sustain the burden of proving such to be reasonable and necessary.”79 The court cited cases holding that lack of good faith under the statute was the equivalent of bad faith, which is more than bad judgment and negligence. The court noted that the franchise agreement specifically permitted the franchisor to require a specific software system, and there was no evidence of bad faith by the franchisor.80

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76 17-cv-6293 (MAT), 2017 WL 2643667 (W.D.N.Y. June 20, 2017).
78 Id. § 19.100.180 (2)(a).
79 Id. § 19.100.180 (2)(h).
80 JDS Group, 2017 WL 2643667 at *3.
rejecting the franchisee’s standard of conduct claim, the court stated that “commentators have noted that the franchise system relies in large part on a franchisor’s ability to ensure uniformity and limit franchisee discretion and that § 19.100.180(2)(H) should therefore not be interpreted ‘to undercut a franchisor’s business judgment in establishing standards for its franchise system.”  

In some instances the changes franchisors seek to implement in a system will be costly for franchisees to implement. This fact alone will not necessarily lead to a breach of contract claim, but case law cautions franchisors against situations in which the system changes require the payment of additional fees to the franchisor. In *Bird Hotel Corp. v. Super 8 Motels, Inc.* the franchisor sought to require its franchisees to implement a customer loyalty program. Over 200 Super 8 franchisees sought class action status for their breach of contract claim over the requirement that the franchisees pay an additional mandatory five percent fee on all gross room sales for customers enrolled in a Super 8 customer loyalty program. The court determined that the case could proceed as a class action. In a later ruling the court granted summary judgment to the franchisees on the liability issue, determining that Super 8 breached the franchise agreements by requiring the payment of the additional five percent fee.

This case serves as a good reminder to franchisors to avoid the imposition of additional fees on franchisees when considering system changes, unless these fees are permitted by the franchise agreement and disclosed in Item 6 of the FDD. The court appeared to focus primarily on the fact that the franchise agreement did not provide for the imposition of such a fee, and did not focus on the amount of the fee. It may be that the fee the franchisor attempted to impose here was disproportionate to the benefit the franchisees received from having a customer loyalty program. A significantly smaller fee might have lessened the likelihood of widespread franchisee pushback or might have made the court more receptive to the franchisor’s argument.

C. Covenant of Good Faith and Fair Dealing

Even when the system’s franchise agreements clearly give the franchisor broad discretion in implementing system changes, the franchisor’s actions can be subject to claims that the franchisor’s misuse of that discretion breached the implied covenant of good faith and fair dealing. Some courts conclude there is no issue related to the covenant when the franchisor’s actions comply with the franchise agreement, citing *Clark v. America’s Favorite Chicken Co.* That case arose after the common owner of the Popeye’s and Church’s chicken systems implemented differing marketing strategies for the two systems. Certain franchisees of Popeye’s complained that the marketing strategy for Popeye’s had a detrimental effect on their business. The court noted that it had stated in a prior case that the obligation of good faith usually modifies but does not override or contradict the express terms of the contract. The court concluded that the franchise agreement expressly reserved to the franchisor the right to do what it implemented in this case, and that there was no evidence of bad faith or ill motive of the franchisor.

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84 *110 F.3d 295* (5th Cir. 1997).
85 *110 F.3d at 297*, citing *Domed Stadium Hotel, Inc. v. Holiday Inns, Inc.*, 732 F.2d 480, 485 (5th Cir. 1984).
86 *110 F.3d at 298.*
A franchisor's communications with its franchisees played an important role in a decision made by the franchisor of the Sizzler system to reorient its system marketing strategy away from a buffet approach in favor of a grill concept. In re Sizzler Restaurants Int'l, Inc., 225 B.R. 466 (Bankr. C.D. Cal 1998). The buffet drove traffic into the restaurants, but not profits. Importantly, the franchisor made the decision to focus its marketing on the grill concept with the support of the marketing committee of the board of trustees of the Sizzler franchise organization. In rejecting a covenant of good faith and fair dealing claim against the franchisor, the court noted that in looking at Sizzler’s decision making process it was not looking at or second guessing results but rather considering whether "the decision-making process was honest or was within accepted commercial practices." In re Sizzler Restaurants Int'l, Inc., 225 B.R. 466 (Bankr. C.D. Cal 1998).

In contrast to the result in Sizzler is the result in Loehr v. Hot 'n Now, Inc. The franchisee of six locations alleged that the franchisor had destroyed its business by materially altering the franchised company's fast food concept. The franchisee brought claims against the franchisor based on breach of contract and the covenant of good faith and fair dealing. The franchisor argued that the express language of the franchise agreement gave it the right to make decisions regarding the franchise, while the franchisee contended that the franchisor failed to provide the required assistance and guidance and constructively modified the franchise agreement, causing the franchisee's business to fail.

The reported case does not describe the nature of the changes the franchisor made, and there is no indication that the franchisor reached out to the franchise community before making the changes. The court cited a Seventh Circuit case to the effect that a controlling party must exercise its discretion reasonably and not "in a manner inconsistent with the reasonable expectation of the parties." Beraha v. Baxter Health Care Corp., 956 F.2d 1436, 1443 (7th Cir. 1991). With that backdrop the court determined that whether the franchisor breached the implied covenant was a question of fact, citing Scheck v. Burger King Corp. In determining whether to pursue a claim for a breach of the covenant of good faith and fair dealing, franchisees may want to consider whether the franchise agreement language on standards and specifications changes is limited to the franchisor’s good faith judgment. Such language was litigated in several cases involving the Burger King system and the franchisor's implementation of a menu containing low cost items. The franchisor was successful in two cases related to this issue, both of which discuss whether the Burger King franchisor implemented this menu in its good faith judgment. See Burger King Corp. v. E-Z Eating, 41 Corp., 572 F.3d 1306 (11th Cir. 2009); Nat'l Franchisee Ass'n v. Burger King Corp., No. 09–23435–CIV., 2010 WL 4811912 (S.D. Fla. Nov. 19, 2010); Beyer et al., supra note 71, at 5.

Jade Group, Inc. v. Cottman Transmission Centers, LLC is a case brought by four franchisees against the franchisor of the Cottman Transmission Centers system, its parent company, and another subsidiary of the parent company. The franchisees brought claims of breach of contract, breach of the covenant of good faith and fair dealing, and tortious interference related to the purchase of a system competitor (AAMCO), and a decision by the parent company to focus almost all resources on the AAMCO system. Upon acquiring the AAMCO system in 2006

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88 Id. at 474.
92 See Burger King Corp. v. E-Z Eating, 41 Corp., 572 F.3d 1306 (11th Cir. 2009); Nat’l Franchisee Ass’n v. Burger King Corp., No. 09–23435–CIV., 2010 WL 4811912 (S.D. Fla. Nov. 19, 2010); Beyer et al., supra note 71, at 5.
the parent company stated its intention to phase out the Cottman system. Following significant pushback from Cottman franchisees, the parent company permitted some Cottman franchisees to continue to operate under that name and expressed its intent to grow the Cottman system. In September 2013 the parent company named a new CEO and in May 2014 he said the parent intended to “focus its resources on its AAMCO brand going forward, and that no resources would be invested in growing the Cottman brand.”

In ruling on a motion to dismiss by the defendants, the court said that it could not determine at that stage of the case that the franchisees could not state a claim for breach of contract and permitted that claim to proceed. The court also refused to dismiss the franchisees’ tortious interference claims, their claims for declaratory relief that the licensee agreements should be declared terminated, and their claims for declaratory relief that the post-term noncompete could not be enforced. The court dismissed the franchisees’ claims based on the covenant of good faith and fair dealing, finding that the franchisees could not pursue this claim where an adequate remedy exists for the breach of contract claims.

Although the court dismissed the covenant of good faith and fair dealing claim, its refusal to dismiss the breach of contract, tortious interference, and declaratory relief claims makes this an important case for franchisees to consider in dealing with a struggling franchisor. This case may be particularly applicable when the problems within the system follow the franchisor’s acquisition of a competitive brand.

D. State Franchise Discrimination and Relationship Laws

State franchise discrimination and franchise relationship statutes represent another source of potential claims by franchisees who oppose the remedial plan a franchisor seeks to implement. At least six states have statutes that specifically prohibit discrimination by a franchisor among its franchisees. Perhaps the best known of these statutes is in Indiana.

A case often cited in connection with the Indiana anti-discrimination statute is *Canada Dry Corp. v. Nehi Beverage Co. Inc. of Indianapolis*. That case arose over Canada Dry’s refusal to permit Nehi to begin selling Ginger Ale. Nehi contended that it was the only one of nine bottlers in its area that was offered the right to sell Ginger Ale but then not allowed to exercise that right. Nehi sued and obtained a $200,000 jury verdict for unfair discrimination. The Seventh Circuit reversed, finding as a matter of law that there was insufficient evidence of discrimination. The appeals court said that discrimination in this context meant that there must be two or more similarly situated franchisees where under similar financial and marketing conditions the franchisor provided less favorable treatment to the franchisee alleging discrimination.

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94 *Id.* at *3.
95 *Id.* at *7.
96 *Id.* at *9.
97 HAW. REV. STAT. ANN. § 482E-6(2)(C) (West 2017); 815 ILL. COMP. STAT. ANN. § 705/18 (West 2017); IND. CODE ANN. § 23-2-2.7-5 (West 2017); MICH. COMP. LAWS ANN. § 445.1527(e) (West 2017); MINN. R. 2860.4400 (West 2017); and WASH. REV. CODE ANN. § 19.100.180(2)(c) (West 2017).
98 723 F.2d 512 (7th Cir. 1983).
99 *Id.* at 521.
Although franchisors have prevailed in a number of claims of franchise discrimination, the case of *Andy Mohr Truck Center, Inc. v. Volvo Trucks North America* illustrates the importance to franchisors of treating similarly situated franchisees in a similar manner.\(^\text{100}\) In *Mohr* a Volvo truck dealer sued its franchisor over what it alleged to be discriminatory treatment by the franchisor. Certain types of heavy trucks are sold in competitive bid situations, where buyers solicit bids from competing sellers. Manufacturers provide concessions to their franchisees to assist in the bidding process. These concessions relate to matters such as price, warranty coverage, and trade-in allowance concessions.

Mohr alleged that, between 2010 and 2012, Volvo consistently offered other franchisees better concessions and as a result Mohr lost at least thirteen sales. The parties argued over whether the competing dealers were similarly situated for discrimination purposes. In arguing that the transactions where the alleged discrimination occurred were comparable, Mohr alleged that the dealers all had the same form of dealer agreement, the potential sales all involved the same truck models and same type of customer, and all the dealers operated under Volvo’s national sales and marketing policies. The court agreed with Mohr’s argument, concluding that determining the substantiality of the differences among dealers is what juries are for.\(^\text{101}\) The case went to trial, and a jury rendered a verdict in favor of Mohr for $6.5 million.\(^\text{102}\) As this case illustrates, franchisors should be cautious in determining whether certain franchisees or groups of franchisees are similarly situated for discrimination purposes.

In reviewing discrimination issues, franchisors and franchisees should also be aware of potential concerns under the Robinson-Patman Act.\(^\text{103}\) The Hansen-Lauer article contains a more extensive discussion of these concerns.\(^\text{104}\) Franchisors and franchisees should be aware that the Robinson-Patman Act prohibits sellers from price discrimination between purchasers of goods of like grade or quality where the effect may be to substantially lessen competition or to create a monopoly. According to Hansen and Lauer, this lessening of competition and creation of a monopoly requirement should keep most franchise assistance programs from having Robinson-Patman Act issues; but franchisors need to keep this statute in mind when evaluating potential discrimination concerns. Franchisees can consider the possibility of a Robinson-Patman Act claim if they believe their franchisor is discriminating against them in the development of franchise assistance programs and the effect of such discrimination is a lessening of competition. This may be the case if the inability of a franchisee to participate in franchise assistance programs made available to similarly situated franchisees is a contributing factor in the closing of a franchisee’s business, thereby lessening competition.

### E. General State Franchise Relationship Laws

Franchisors and franchisees also need to be mindful of general state franchise relationship laws when designing or evaluating remedial programs in distressed systems. This is particularly true where franchisees have concerns that the franchisor may be considering terminating or refusing to renew the franchise agreements of franchisees who do not comply with the remedial programs. As illustrated by the Wisconsin Fair Dealership Law, issues that impact remedial

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101 Id. at *5.
programs may be found in both the general good cause definition and in separate provisions within the franchise relationship statute.105

The Wisconsin Fair Dealership Law describes good cause as a failure to comply substantially with requirements that "are not discriminatory as compared with requirements imposed on other similarly situated dealers either by their terms or in the manner of their enforcement."106 The Wisconsin Fair Dealership Law also places limits on changes in competitive circumstances.107 In *East Bay Running Store, Inc. v. NIKE, Inc.*, a shoe manufacturer withstood a claim under the change in competitive circumstances requirement by a Wisconsin running shoe dealer who objected to Nike's policy that a new brand of shoes required interaction with a sales person thereby leading Nike to ban mail order or telephone sales of this product.108

F. **Duty to Support or Police Franchise System**

Franchisees may argue that the franchisor has contributed to the system's problems by failing to properly support or police the franchise system. Efforts by franchisees to argue that the franchisor has an affirmative duty to support the system have met with limited success in the United States, but have fared better in Canada.109

Three cases provide examples of courts rejecting attempts to impose a duty on the franchisor to police the system. In *Cullen v. BMW of North America, Inc.*, a customer of a franchisee sued the franchisor after the president of the franchisee absconded with the customer's money after the customer purchased a vehicle, and the customer did not receive either the vehicle or a refund.110 The U.S. District Court for the Eastern District of New York determined that the franchisor owed the franchisee's customer a duty "to reasonably police the authorized use of the BMW name and supervise the operation of its franchisee."111 The Second Circuit reversed, finding that BMW could not reasonably have foreseen the criminal activity of its franchisee.112

In *Creel Ltd. v. Mr. Gatti's*, a franchisee of a pizza restaurant system alleged that the franchisor damaged its business by failing to require de-identification of two closed locations and to address a bug infestation issue at a third location.113 The court denied the franchisee's claims for breach of contract, third party beneficiary liability, and intentional infliction of emotional distress, determining that an obligation in the franchise agreement to uphold standards does not create a duty to other franchisees to enforce these standards.114

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106 Id. at § 135.02(4)a.
107 Id. at § 135.03.
108 890 F.2d 996 (7th Cir. 1989).
109 Craig Tractenberg, Jean-Philippe Turgeon and Stéphanie Destrempes, *The Franchisor’s Duty to Police the Franchise System*, 36 Franchise L.J. 87 (Summer 2016) (hereinafter Tractenberg et al.).
110 691 F.2d 1097 (2d Cir. 1982).
111 Id. at 1100.
112 Tractenberg et al., supra note 109, at 91.
114 Tractenberg et al., supra note 109, at 91.
In *Kilday v. Econo-Travel Motor Hotel Corp.*, a franchisee alleged that its franchisor breached the franchise agreement by failing to require other franchisees to comply with the franchisor’s standards of quality, maintenance, and cleanliness. The court concluded that the language of the franchise agreements did not support the franchisee’s claim. The court determined that when read in context the language of the franchise agreements did not obligate the franchisor to require all franchisees to conform to the standards to which it held the complaining franchisee.

However, a 2016 decision from the U.S. District Court for the Eastern District of New York provides support for franchisees who contend that their franchisor is required to enforce standards against other franchisees. In *Valley Stream Foreign Cars, Inc. v. American Honda Motor Co., Inc.*, Honda announced that as of a certain date it would strictly enforce its policy requiring dealers not to engage in the wholesaling of Honda vehicles. The plaintiff Honda dealer alleged that other dealers outside of the dealer’s area engaged in wholesaling using intermediaries, and that despite receiving information regarding this wholesaling, Honda failed to control it. In denying Honda’s motion to dismiss the dealer’s claim for a breach of the covenant of good faith and fair dealing, the court said the dealer had stated a plausible claim for a breach of the covenant. The dealer alleged that Honda’s failure to enforce its policy denied the dealer profits from the sale of vehicles. Taking the dealer’s allegations as true in ruling on a motion to dismiss, the court determined that Honda received reports of wholesaling activities by the other dealers, but abandoned its stated intention to enforce its wholesale policy.

The *Honda* case was filed in the same federal district court as the *BMW* case. In *BMW* the Second Circuit reversed the district court’s determination that the franchisor owed a franchisee’s customer a duty to supervise the operation of the franchisee’s business. However, it seems plausible that the Second Circuit may view the *Honda* case differently based on the fact that the claim in *Honda* was brought by a franchisee seeking to require the franchisor to enforce a specific policy: its previously announced policy prohibiting wholesaling by its dealers.

Although there does not appear to be a specific statutory duty to police the franchise system in Canada, the application of duties of good faith may impose obligations on franchisors of struggling systems greater than those of their American counterparts. The six common law jurisdictions in Canada that have franchise statutes all have provisions imposing a duty of fair dealing which includes a duty to act in good faith. In addition, the Supreme Court of Canada has ruled there is a uniform duty for parties to perform contracts honestly. In analyzing the scope of this duty of honesty, the authors of a recent article believe that the mutual cooperation involved in a franchise relationship may lead to the conclusion that the franchisor’s duty of honest performance creates obligations on the franchisor not found in the express terms of the contract.

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116 Id. at 163.
118 Id. at 554.
119 Tractenberg et al., supra note 109, at 93.
121 Tractenberg et al., supra note 109, at 97.
In Quebec, Canada’s sole civil law jurisdiction, the duty of good faith is codified in the Civil Code of Quebec. A volatile mix of this expansive duty of good faith, some broad franchise agreement language, and a franchisor slow to respond to a changing competitive environment led to a $10.9 million verdict against a franchisor in *Dunkin’ Brands Canada Ltd. v Bertico Inc.*  

This case involved the sufficiency of the franchisor’s response when the Tim Hortons system entered Quebec and successfully challenged Dunkin’ Donuts’ leading position in the province, where it had over 200 locations.

In 2000 the franchisor introduced its Strategic Growth Plan, which included a store remodel component, an increased focus on operations and standards compliance, and marketing and franchise development programs. Franchisees were slow to embrace the remodel program, which involved a substantial expenditure by franchisees and required them to sign a release. These attempts by the franchisor to reverse its fortunes in Quebec were unsuccessful, and the number of Dunkin’ Donuts units in Quebec declined from 210 in 1998 to 41 in 2008.

In focusing on the long-term nature of the franchise agreement and the franchisor’s duty of good faith, the Quebec Court of Appeal found that the franchisor had an implied and affirmative obligation to protect the brand. The court noted that the franchisor’s duty to supervise the system could require it to terminate franchisees that failed to meet uniform standards. One commentator has concluded that this result goes beyond what the common law courts in Canada have done, and goes beyond previous decisions of Quebec courts.

In considering potential obligations for franchisors to police their brand or system, U.S. lawyers should be cautious in evaluating Canadian precedents. The common law provinces have statutory and common law duties of good faith that may have been interpreted more expansively that good faith obligations in U.S. jurisdictions. The *Bertico* case, coming from a civil law jurisdiction, may have resulted from a combination of broad language in the applicable franchise agreements, a robust duty of good faith in Quebec, and a slow and tentative response by the franchisor. These factors may lead franchisors to conclude that a similar result could not occur in the United States. Franchisees may view the *Bertico* decision as an opportunity when dealing with a franchisor that has similarly broad franchise agreement language and has been slow to respond to competitive pressures or other systemic issues. Perhaps it is better viewed as a cautionary tale arguing in favor of careful drafting of the franchise agreement, a reasonable exercise of the discretion granted to franchisors when dealing with franchisees in distressed systems, detailed communication and collaboration with franchisees concerning a proposed remedial program, and prompt and carefully crafted responses to the problems facing distressed systems.

G. Releases

When the issues facing unsettled franchise systems lead to legal disputes, as often is the case, it is usually in the best interests of franchisors and franchisees to resolve these disputes as soon as possible. The cost, business distraction, and uncertain outcome that surround legal

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122 2015 QCCA 624, J.E. 2015-692 (leave to appeal to the Supreme Court of Canada was dismissed with cost on Mar. 17, 2016).


124 *Tractenberg et al.*, *supra* note 109, at 100.

125 *Id.*
actions all argue for a prompt resolution of disputes. One of the most important forms of consideration franchisors can receive when resolving these disputes is a strong, enforceable release.

Franchisors and franchisees face a variety of legal issues when negotiating and drafting releases. A recent paper on settlements and releases identifies nine key issues to be considered in connection with the negotiation of settlements and releases.\(^{126}\) We will examine five of these issues: (1) the parties to be bound by restrictive covenants included in releases; (2) restrictions on lawyers’ rights to take future cases; (3) sales of assets by franchisees; (4) statutes dealing with releases; and (5) confidentiality and non-disparagement provisions.

1. **Parties Bound by Restrictive Covenants in Releases**

Questions concerning the parties to be bound by releases typically arise in the negotiation of non-competition and non-solicitation provisions. Although parties are sometimes able to enforce restrictive covenants against non-signatories, a franchisor is better served by having certain parties, such as officers, directors, and family members of owners, sign settlement agreements.\(^{127}\) The parties a franchisor may want to include in a settlement agreement may differ from the parties bound by the restrictive covenants in franchise agreements. Ginsburg et al write that franchisors negotiating a settlement agreement have a better understanding of the parties to include in restrictive covenant provisions, and should take advantage of that knowledge to ensure that all appropriate parties are covered by the restrictive covenants.\(^{128}\)

2. **Restrictions on Lawyers’ Involvement in Future Cases**

Distressed franchise systems are likely to face claims from multiple franchisees. As dissatisfaction spreads within a system, additional franchisees may want to use lawyers who have represented franchisees who pursued earlier claims against the franchisor. Seeking any possible advantage in dealing with claims by multiple franchisees, a franchisor may seek to have certain lawyers for franchisees agree not to take similar cases from other franchisees in the system. These attempts by franchisors raise ethical issues for both franchisor and franchisee counsel. At least one state, Maine, has a statute that prevents lawyers from agreeing to limit future representations as part of a settlement.\(^{129}\) In other states ethical rules limit such agreements.\(^{130}\)

The policy justification for such rules is that they help ensure an adequate supply of lawyers to take plaintiff’s cases. Franchisee lawyers assert that franchisors who seek agreements limiting the involvement of franchise counsel in similar future cases place franchisee lawyers in an untenable position. Agreeing to such limitations may result in a bigger settlement for the lawyer’s current client, to whom the lawyer has a fiduciary duty to obtain the best possible

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\(^{127}\) See Id. at 6-8 for a discussion of enforcing post-term covenants against non-signatories.

\(^{128}\) Id. at 6.

\(^{129}\) 14 ME. REV. STAT. ANN. § 169 (West 2017).

\(^{130}\) See ABA Model Rules of Professional Conduct 5.6(b).
outcome, but it runs afoul of the applicable ethical rules. Franchisee lawyers also have concerns regarding the supply of available franchisee lawyers within an area.

3. Asset Sales by Franchisees

In some situations involving franchisees in a distressed system, the only viable solution is for the franchisee to leave the system. That may be as a result of an uncured default by the franchisee under the franchise agreement or other agreements, or because of a negotiated settlement for the early termination of the franchise agreement with a financially troubled franchisee. Permitting a franchisee to attempt to sell a franchised location may be an integral component in negotiating a mutually satisfactory settlement. The buyer may be the franchisor, often under buy-back rights contained in the franchise agreement, or a third party approved by the franchisor. The franchisee can win in such a resolution by receiving some compensation for its investment in the franchised business. The franchisor can win by keeping a good location in the system.

Although both sides can benefit from an asset sale, problems can arise in completing such sales. Even when a clear valuation process exists in the franchise agreement, differences may arise in determining the value of the business to be sold. Issues also occur when liens on the franchisee’s assets or claims against the franchisee by other creditors make it difficult to confirm that the buyer will receive clear title to the assets. When the proposed sale is to a third party, disputes may occur over the franchisor’s right to approve or disapprove a proposed buyer or the terms of the sale.

Another problem from the franchisee point of view is that the franchisor will often impose a short deadline for the sale, which may be unrealistic. The franchisee is attempting to sell under duress and buyers—particularly those within the system—will be aware of this fact and use it to attempt to secure a lower price.

4. Statutory Restrictions on Franchisee Releases

Many franchise relationship statutes contain limits on releases from franchisees. Most of these statutes focus on prospective releases by franchisees, containing either implicit or explicit carve-outs for releases negotiated in the settlement of disputed claims. These statutes may not prevent releases in negotiated settlements. However, franchisors should be mindful, as a matter of best practices and as a statutory requirement in some states, of the importance of franchisees being represented by independent franchise counsel in negotiating these releases.

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131 Ginsburg et al., supra note 126, at 10.
132 Id.
133 Id. at 15.
134 Id. at 15-17.
135 Id. at 17-20. See also Mark J. Burzych and Michael J. Cole, Franchisor Successor Tax Liability Risk in Terminations, 35 Franchise L.J. 447 (Winter 2016).
136 For a summary of these statutes, see Martin Gilbert and Allan Hillman, Settlements and Releases in Franchise Disputes: How To Make Sure It’s Over When It’s Over, ABA 30th Annual Forum on Franchising W-6 (2007).
137 Ginsburg et al., supra note 126, at 20-21.
138 Id. at 22.

Franchisors who provide fee relief or other consideration to franchisees may seek to include confidentiality and non-disparagement provisions in financial assistance agreements or related documents. Franchisors must be aware of their disclosure obligations related to settlements when preparing their franchise disclosure documents. Franchisors may seek one-sided disclosure obligations, where only the franchisee is required not to disclose settlement terms, or ensure that the franchisor has appropriate carve-outs to enable the franchisor to comply with its disclosure obligations.

Franchisors also may want to avoid including liquidated damages in settlement agreements with franchisees to avoid the problems faced by the franchisor in Caudill v. Keller Williams Realty, Inc. In that case the franchisor disclosed in Item 3 of its franchise disclosure document information from a matter covered by a settlement agreement with confidentiality provisions. The settlement agreement provided for liquidated damages of $10,000 per breach for breaches of the confidentiality provisions, and the franchisee sought damages of nearly $20 million. The Seventh Circuit affirmed the decision from the U. S. District Court for the Northern District of Illinois that there was no basis to conclude that $20 million was a reasonable estimate of the franchisee’s damages when the parties entered into the agreement that contained the liquidated damages provisions. The Seventh Circuit also recognized there may be a conflict between the franchisor’s confidentiality obligations and its disclosure obligations. The court said that for a franchisee to recover it would have to show that the disclosure was not required by federal or state law. Although the Seventh Circuit appeared open to finding in favor of the franchisor on the underlying disclosure issue despite the confidentiality provisions, franchisors and franchisees will be well advised to seek to avoid this dilemma entirely by including appropriate carve-outs for the franchisor’s disclosure obligations in confidentiality provisions in settlement agreements.

Liquidated damages clauses may pose problems for franchisees as well. These provisions can be used against them by the franchisor if the franchisee breaches a confidentiality provision in a settlement agreement. Based on the result in Keller Williams, a court may permit the franchisor to make disclosures required by franchise disclosure laws despite the language in the settlement agreement prohibiting disclosures.

Franchisors sometimes seek to include non-disparagement clauses in settlement agreements to avoid the problem of settling claims with a franchisee, which may include payments to the franchisee, only to find that the franchisee is publicly criticizing or disparaging the franchisor or the franchise system. Franchisees may seek mutual non-disparagement language to avoid negative comments by the franchisor after the resolution of a dispute. Non-disparagement clauses give the party against whom disparaging statements are made a breach of contract claim. But proving the statements made breached the non-disparagement provisions and recovering damages for the alleged harm may not be worth the effort when the franchisor or franchisee have more pressing issues to resolve.

139 Id. at 27.
140 828 F.3d 575 (7th Cir. 2016).
141 Id. at 577.
142 Id. at 578.
Non-disparagement clauses in settlement agreements may raise issues related to state statutes regarding free association rights of franchisees. We have found no cases that have addressed this issue, but with free association provisions in at least twelve state statutes or regulations, this is a claim franchisees may want to consider—particularly if as a part of any settlement with the franchisor the franchisee remains in the system. Franchisors and franchisees should consider this possible argument when drafting non-disparagement provisions. In one case a group of franchisees contended that the class action waiver provisions in their franchise agreement violated their free association rights under a state franchise relationship statute, but the district court rejected their argument. The Eighth Circuit affirmed in part and reversed in part that decision, but did not discuss the freedom of association issue.

Conclusion

The problems faced by struggling franchise systems often arise from a complex mix of internal and external causes. Franchisors must be willing to conduct a careful and candid review of these causes to have a realistic opportunity to correct these problems and move the system forward. As discussed in this paper, franchisors must be willing to engage in extensive communications with their franchise communities and other system stakeholders in examining these problems and in formulating plans to remediate these problems and obtain the support of these stakeholders. Franchisees need to be ready to engage in frank, but constructive, dialogue with their franchisor to provide their perspective on the issues facing the franchise system and to propose possible solutions.

Franchisors certainly will want to obtain as much support as possible for their proposed remediation efforts. Franchisees will want to do everything possible to come to agreement with the franchisor on how to best address the issues confronting the system so that a major franchisee-franchisor confrontation can be avoided and the parties can work together to resolve the issues facing the system. However, the problems confronting the system often will be accompanied by an acrimonious environment that does not always lend itself to a rational discussion of these issues and proposed solutions. Inevitably, some franchisees will leave the system—either voluntarily or involuntarily—and franchisors must navigate through a series of difficult legal issues. Breach of contract claims, claims for breaches of the covenant of good faith and fair dealing, and claims based on state franchise discrimination statutes and general franchise relationship statutes are just some of the legal hurdles franchisors may face, and some of the claims franchisees should consider in a troubled system. Franchise systems with well-drafted franchise agreements, an effective ongoing franchisor-franchisee communications process, franchisors who have made every effort to use this communications process to secure as much franchisee support as possible, and franchisors who have used their best efforts to exercise their discretion under the franchise agreement in a reasonable manner, will be the most likely systems to have franchisees willing to work with them to overcome these sometimes existential problems and emerge as stronger systems.

143 Ginsburg et al., supra note 126, at 30.


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