THE PROS AND CONS OF DEFRANCHISING

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I. INTRODUCTION

Over the last 40 years, franchising has become one of the most ubiquitous business-expansion models in the world economy. The success of the franchise business model is founded upon its ability to match the creative minds that develop brands and business concepts with motivated entrepreneurs who wish to devote their time and financial means to operate franchised businesses. The importance of franchising can be measured by the sheer breadth of business types now being franchised and the massive role franchised businesses play in the U.S. retail economy.1

Franchising, however, is just one model for delivering services and products. There are many highly successful brands that operate primarily on a company-owned basis for a variety of reasons, including among others, financial control and brand protection. The domestic development strategy for the Starbucks® brand is perhaps the best example of this. Why some brands franchise while others remain company-owned depends principally on the specific business and financial circumstances of each brand.

Although members of the franchise bar typically devote their energies to expanding the scope and success of franchising, we recognize that for some brands, franchising might become a less attractive business expansion model as business and financial circumstances change. For those brands that have franchised for many years, but are now considering a shift in focus to a company-owned model, analysis of the risks and benefits of pursuing “defranchising” is essential. Importantly, defranchising is not just about legal issues. It is a topic that blends business and marketing considerations with legal doctrines that have been applied in many contexts in the franchise industry, but rarely specifically to the issue of defranchising. For that reason, this paper focuses on both the business and legal considerations related to defranchising programs and the pitfalls of such programs, especially if they are not carefully and thoughtfully developed and implemented.

This paper first explores various reasons why a franchisor might consider a defranchising program - - whether through termination or repurchase of franchised units or by focusing its development efforts on company-owned locations. We discuss business rationales for buying back franchised units, market development considerations, and taking advantage of the best locations for company-owned development. We address these issues in Section II with examples on how franchisors historically have addressed defranchising. Section II also explores replacing poorly performing franchisees with company-owned locations, including through franchisor use of rights of first refusal, bankruptcy proceedings, settlements, and the franchise termination, expiration, and renewal process. We analyze some of the business challenges posed by expanding company-owned operations, including the need to develop the systems and operational capability to run more company-owned locations. We also urge franchisors to consider how defranchising will be perceived by franchisees. Our objective in

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1 In 2001, franchising was a $624.6 billion industry that directly employed almost 10 million Americans in over 75 different industries. International Franchise Association, Economic Impact of Franchised Businesses, POLICYMAKER DIGEST, 2-3 (2004). In addition, the indirect effects of franchising generated $1.53 trillion in 2001, representing 9.5% of the private sector output in the United States. Id. at 3.
Section II is to provide a franchisor with a roadmap of the critical reasons why it might consider a defranchising program.

Section III provides a summary of various the legal theories available to franchisees seeking to challenge defranchising programs. These challenges are the “cons” of defranchising and include contract-based claims, the implied covenant of good faith and fair dealing, market withdrawal issues, vicarious liability claims, and the potential encroachment consequences of a defranchising program. Section IV then identifies the franchise disclosure implications of a defranchising program.2

In the final analysis, whether a franchisor should pursue a defranchising program depends on a careful analysis of the franchisor’s goals for its brand, its ability to meet those goals under a company-owned model, and its wherewithal to diminish the risks attendant to transitioning from franchised to company-owned locations.

II. THE PROS OF DEFRANCHISING

A strong business case can be made for certain companies to operate through company-owned locations. These companies may pursue defranchising through buying back franchised units or, alternatively, using legal means to assume control over franchised locations. Regardless of the means, defranchising should be approached strategically and with a keen focus on profitable regions, markets and locations. Another strategic approach for the franchisor is to assume control over poorly performing franchised locations, where the brand’s potential is enhanced by assuming such control.

A. Why Buyback Franchised Units?

Any franchisor who has fully embraced franchising as a business expansion vehicle understands that, as a franchisor, it is involved in two separate businesses. The first business is the franchisor’s core business of delivering products and services to customers, whether the hotel business, the quick service restaurant business, the hair care business, the lawn care business, or the myriad of other business categories. The second business is the franchise business itself. Successful franchisors must continuously devote significant attention to the unique aspects of franchising and the franchise relationship. Franchising is not simply about delivering products and services to customers; it also is about providing and nurturing the franchise relationship and opportunities for franchisees to be successful. One of the challenges in this endeavor is that franchisees will have varying, and at times divergent, views on success. Some franchisees will view success as paying off their debt, making a modest profit, and operating the business on a less than full-time basis. These franchisees may resist change or the reinvestment that may be necessary to meet or stay ahead of the competition or respond to

2 This paper focuses on defranchising through the establishment of company-owned locations. Other defranchising options exist beyond the scope of this paper, however, including instances where a franchisor discontinues its franchise program but continues to distribute products or services through a non-franchise model. Examples of this may include different forms of licensing, distributorships or dealerships. Importantly, any franchisor who pursues this option must proceed very carefully in examining whether the alternative format is structured in a way that avoids satisfying: (i) the definition of a franchise under federal and state law; and (ii) the definition of a business opportunity under other federal and state laws, which, if either were satisfied, disclosure or registration requirements potentially would be triggered. Both of these critical issues have been researched and discussed at previous Forums. See e.g., James A. Meaney et al., The Business Opportunity Laws: An Enforcement and Litigation Trap?, AMERICAN BAR ASSOCIATION’S 24TH ANNUAL FORUM ON FRANCHISING (October 10-12, 2001); Rochelle B. Spandorf et al., The Accidental Franchise, AMERICAN BAR ASSOCIATION’S 24TH ANNUAL FORUM ON FRANCHISING (October 10-12, 2001).
the ever-changing customer demands. Another franchising challenge is the time, money, and effort that is necessary to fight battles when franchisees decide to leave the franchise system, but remain in business and challenge their noncompete obligations. When encountering these issues, some franchisors may question whether franchising is really worth its inherent challenges.

With this backdrop, a franchisor likely will consider, from time to time, buying back franchised units.

1. **Understand The Business Rationale**

The business rationale for defranchising can be straightforward or complicated depending on the franchisor and the circumstances. It often includes an analysis of whether company-owned units are profitable or franchised locations unprofitable. For example, unprofitable franchised locations with decreasing top line sales result in dwindling revenue streams to the franchisor and may be the catalyst in the franchisor's decision to defranchise.

The business unit economics of the brand's locations are critical to the defranchising analysis. Generally, the business rationale for franchising is that brand locations are built using the franchisees' initial investment capital. The franchisee also continues to invest working capital in the day-to-day operation of the business. Thus, the investment and operating expense structure of the location is borne by the franchisees. The franchisor also incurs expenses to support the franchise structure and system — franchise management, franchise sales, marketing, research and development, operational support, and product distribution. The franchisor's revenue streams from the franchised locations typically include initial franchise fees, royalty fees, and any revenues that the franchisor may derive in the form of product rebates, commissions, or direct product purchases.

In many franchise systems, the above-described structure is more profitable for franchisors than the franchisor investing in building and operating company locations. There are exceptions, however. In a number of franchise systems, and in particular during robust economic times, well-run company locations where the company captures 100% of the profit (rather than 4-6% of gross revenue through royalty payments) result in higher bottom line numbers for the company. In recent years, several well-run hotel companies, service-based companies, and retail companies have pursued this corporate-owned unit growth strategy. For example, with the post “9/11” economic recovery in full swing and the relatively easy access to capital, many of the major hotel brands in the United States have increased their percentages of corporate or managed locations versus franchised locations, in part because of the higher revenue percentages they retain for those hotels compared to franchised locations. Also, a number of service-based companies with an emphasis on profitable national account customers have pursued the stronger relationship and revenue streams that company-owned locations can maintain with respect to those profitable national accounts.

The presence of unprofitable or complacent franchise locations also may lead to the same decision that company-owned locations are the preferred method of operation. Recent examples include mature franchise systems with early generation franchisees who received large protected territories with inadequate minimum performance standards. In those instances, franchisees often settle into a comfort zone of “doing just enough” rather than maximizing brand penetration and overall system revenue. Even without minimum performance standards, franchisees may have one retail location in a large undeveloped territory that otherwise could be filled profitably by multiple company-owned locations.
The bottom line is that the business rationale is important to any defranchising analysis. Any franchisor that is considering defranchising must analyze carefully the short-term and long-term financial implications of its defranchising decision. When considering a defranchising program, a franchisor should run several financial models with various assumptions on revenues and expenses, as well as forecasting the future direction of the brand. Implementing the business rationale in a manner that produces the desired results is critical and must be handled with utmost care and diligence.

Presumably a number of franchisors have done that analysis and have determined that a focus on company-owned expansion was best for them. For example, franchise systems that have implemented buyback programs recently include Orkin, Texas Roadhouse, and Krispy Kreme. Texas Roadhouse, a franchisor of 196 steak and ribs restaurants as of Spring 2005, determined to focus its growth more on company-owned locations rather than franchising. In addition, Krispy Kreme has a history of buying back franchises and has continued to accelerate its buyback program. Likewise, Terminix, which initially built its brand on franchising, currently is not pursuing any new franchisees. Starting in the late 1970s, Terminix decided to buyback many of its larger franchisees with the goal of converting them into company-owned offices in an effort to better control its own destiny. In addition, Terminix determined that its profitability could be increased by operating company-owned locations instead of collecting franchise fees.

2. Opportunity To Control Key Profitable Markets/Locations Through Company Operations

Location. Location. Location. Real estate professionals proclaim the importance of location when analyzing the success of unit-level businesses. As an example, many hotel franchisors have determined that they want to control key locations in profitable markets like New York City, Washington, D.C., Chicago, southern Florida, Orlando, San Francisco and southern California. Another example is a franchisor’s decision to control key sites from a branding perspective – sites like transportation terminals, sports stadiums, key shopping malls, or other high density locations where the brand will receive more exposure than typical locations.

Other franchisors follow similar paths by identifying entire markets as company markets or franchised markets with a view towards retaining key markets as company-owned. Franchisors expanding into new markets often will analyze a market’s demographics in determining whether to pursue company-owned or franchised locations. A franchisor who has operated company-owned locations successfully in a number of existing markets likely will pursue company-owned development in new markets that possess similar demographics to its existing locations. This approach is consistent with many franchisors' beliefs that “mixed” markets with a combination of company-owned and franchised locations can present problems regarding uniformity and responding to market change that otherwise do not exist if the market is filled only by company-owned locations.

A strategy of designating markets as company-owned or franchised does not mean all key markets should be company-owned, nor does it mean that if a company develops a key market for its own account, profitability is guaranteed. Further, if a company does not have the capital or operational resources to develop a key market profitably, it should grant the development rights to highly qualified franchisees who will capitalize on the opportunity to drive the brand to its full potential. The brand overall is better served in key markets or locations with highly motivated and successful franchisees than mediocre company operations. Nonetheless,
3. Option To Eliminate Poorly Performing Multi-Unit Franchisees Or Area Developers

Defranchising opportunities come in many shapes and sizes. The opportunities exist not only where a franchisor can operate company-owned locations profitably, but also where franchisees have performed poorly.

During the early stages of system expansion, many franchisors look to expand by granting multi-unit or area development rights. Despite both parties’ best intentions, best efforts, and hard work, some multi-unit franchisees or area developers fail. Their failure may leave large territories or markets undeveloped. Further, many franchise systems experience instances where the multi-unit franchisees or area developers have performed so poorly that customers are left with a negative perception about the brand. In these instances, franchisors often take far too long to decide whether defranchising is the right solution. Franchisors may believe or hope that under-performing franchisees miraculously will turn everything around, but hope is not a strategy. Rather, highly successful franchisors understand that they need a strategy to address poor or under-performing multi-unit franchisees or area developers. These highly successful franchisors must have a team of experienced operations people who can move into an area on relatively short notice and assess the necessary steps toward making a positive difference for the brand and outlet performance. In many instances, the franchisor may decide to assume direct management or operation of the locations through a buyback or other means. This operational strategy can be coupled with a move towards company ownership of the locations. The key is the franchisor’s ability to address proactively those instances where the franchisor concludes that defranchising and company ownership is necessary to protect and enhance the brand.

Defranchising a poorly performing multi-unit franchisee or area developer and converting existing franchised units to company-owned locations can require significant franchisor capital. Unfortunately, these costs usually increase over time as too many franchisors allow poorly performing franchisees to linger with sub-standard performance and under-developed territories. The franchisor is then faced with defranchising more units rather than fewer units, in lieu of proactively addressing the issues early with a defranchising option at a less substantial cost.

A franchisor who has the operational and financial ability to run company-owned locations has different opportunities to eliminate poorly performing franchised locations. The opportunities include rights of first refusal upon franchisee transfers, franchisee bankruptcies, settlements in franchisee litigation, and franchise agreement expirations. Before pursuing any defranchising strategy under these circumstances, the franchisor must understand the relevant pressure points in each situation.

a. Exercise Right Of First Refusal Upon Franchisee Transfer

An easy avenue for defranchising on an isolated basis occurs when a franchisor exercises a right of first refusal upon a franchise transfer.

A poorly performing franchisee often will have a business for sale at a relatively low price. A franchisor with the ability to improve the financial performance of a business seriously should consider exercising a right of first refusal if it believes the business is undervalued due to
franchisee performance, rather than location or other reasons unrelated to franchisee performance. The right of first refusal also is a key tool for franchisors to gain control of high performance locations. Franchisors with a significant number of successful company-owned locations and the financial resources to acquire additional locations will pursue this strategy actively and defranchise locations through exercising rights of first refusal. To do so, the franchisor must have a process to make certain it (i) follows the contractual requirements under the franchise agreement for exercising its right of first refusal, (ii) has a checklist of information necessary to assess the opportunity, (iii) has a team assembled to assess and decide on the opportunity, and (iv) then timely communicates and executes on the decision. If a franchisor is serious about defranchising, it will have this “best practice” process in place and be ready to go, rather than addressing it on an ad hoc or informal basis.

Many prospective franchisees attempt to delete the franchisor’s right of first refusal during pre-sale negotiations, often citing the chilling effect it may have on any sale where the franchisor can step in and acquire the business by exercising its right of first refusal. Despite those requests and despite franchisors at times believing they are not in the business of owning company-owned locations, franchisors are well served by retaining a right of first refusal. This is especially important for multi-unit franchisees or area developers with rights that impact a market or territory, particularly when one considers how the competitive and economic landscapes in an area may change over the life of a ten or twenty-year franchise agreement.

One final point regarding the right of first refusal: Prudent franchisors recognize that any potential buyer of a franchise system may consider the right of first refusal as valuable when considering an acquisition. A franchisor that frequently deletes its right of first refusal must realize the potential limitations it places on any buyer of the franchise system, especially if the buyer is considering defranchising options in its assessment of the system’s overall value.

b. Rescue Franchisees From Bankruptcy

Bankruptcy is another method for moving units from franchised to company-owned. Businesses, whether franchised or not, sometimes fail and avail themselves of the protections of the United States Bankruptcy Code. For many franchisee principals, bankruptcy is an unattractive business option as many brands require that principals personally guarantee the franchisee’s obligations to the franchisor. As a result, a franchisee principal who is contemplating bankruptcy for the franchisee also must consider declaring personal bankruptcy. The difficult decision to declare personal bankruptcy may create an incentive for the financially underperforming franchisee to seek other options for relinquishing ownership of a franchised business.

The reticence to filing bankruptcy that the owner of a franchise might experience may create significant opportunities for a franchisor seeking to acquire a troubled franchised business. Obviously, whether a franchisor wishes to acquire a failing franchised business on the brink of bankruptcy will depend heavily on whether the franchisor believes it can operate the location profitably as a company-owned unit. If the franchisee is failing in the market because of weakness in the brand or weakness in the market itself, then the franchisor has little incentive to negotiate a purchase of the franchised location. Conversely, if the franchised business is failing because of poor operational or marketing performance by the franchisee, or other factors that

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could be addressed and reversed by good management, then plenty of incentive exists for the franchisor to attempt to repurchase the business.

An added benefit of using a pending bankruptcy filing as a means to acquire franchised businesses is that the franchisor likely will have increased bargaining power, especially if the franchisee is seeking to avoid a personal bankruptcy filing. This advantage in bargaining power can allow a franchisor to purchase franchised businesses facing bankruptcy at a considerable discount. The ability to purchase such businesses at a discount enhances the ability to implement a defranchising program and increases the chances that the franchisor will experience financial success operating the location as a company-owned business, given that its investment in that business was made at a discount. The franchisor also keeps the units operating at full capacity, rather than having units close or operating with lower levels of inventory or staffing, which can have a negative impact on the brand.

Beyond the general business strategies that may apply in the context of a franchisee bankruptcy, there are a number of specific legal tools under the Bankruptcy Code that allow a franchisor to buyback a franchised business.

As a matter of background, the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure control the rights and obligations of the parties in interest to an insolvency proceeding. The purpose of the Bankruptcy Code is to permit reorganization or liquidation by a debtor in a manner that protects and maximizes the legitimate rights to recovery by creditors. A bankruptcy petition may be filed voluntarily by the franchisee or involuntarily by creditors of the franchisee (which could include the franchisor).

Under the Bankruptcy Code, a debtor has the right to assume, assign, or reject any executory contracts to which it is a party, including contracts such as leases and franchise agreements. Pending assumption or rejection, the franchisee technically is not required to perform obligations under the executory contracts. However, the Bankruptcy Code requires the debtor to assume, assign, or reject executory contracts within specific time periods.

This assumption or rejection process offers a franchisor opportunities to pursue a defranchising program because a bankrupt franchisee who rejects an executory contract will be leaving the franchise system, thus opening up that territory for company-owned operations. A bankrupt franchisee who wants to assume its franchise agreement must cure any breaches or provide adequate assurance of cure, compensate other parties to the contract for pecuniary

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4 See 11 U.S.C. §§ 301 and 303. Upon the filing of the petition, a bankruptcy estate is created consisting of all the property and property rights of the franchisee. See 11 U.S.C. § 541(a). Once the property is put into the bankruptcy estate, that property is protected from creditor action by what is known as the automatic stay. See 11 U.S.C. § 362(a).


7 For Chapter 7 liquidation cases, executory contracts will be deemed rejected if the trustee does not assume or reject the contract within sixty days of the petition filing date. For Chapter 11 reorganization cases, the debtor may assume or reject executory contracts anytime prior to confirmation of a reorganization plan. See 11 U.S.C. § 365 (d)(1), § 365(d)(2) and § 1123 (b)(2).
loss, and provide adequate assurance of future performance.\textsuperscript{8} Absent meeting these standards, a bankruptcy court will not allow a bankrupt franchisee to assume its franchise agreement. This results in the loss of franchised status, which could further a defranchising program if the franchisor wishes to have that particular franchisee out of the system. The Bankruptcy Code also allows creditors to file motions to compel assumption or rejection, especially in instances where the creditor can show severe defaults by the debtor sufficient to support a request to accelerate the process for assumption or rejection of executory contracts.\textsuperscript{9} Again, a franchisor could use the opportunity for filing such a motion to put pressure on a bankrupt franchisee in the hope that might it lead to a rejection of a franchise agreement.

Additionally, Rule 9019 of the Federal Rules of Bankruptcy Procedure allows the bankruptcy court to approve compromises or settlements with creditors in bankruptcy proceedings.\textsuperscript{10} Settlements will be approved if they are fair and equitable and in the best interest of the bankruptcy estate.\textsuperscript{11} In general, settlements and compromises in bankruptcy proceedings are favored because they minimize litigation and expedite the administration of the estate.\textsuperscript{12} Like the assumption and rejection process for executory contracts, the ability to enter into enforceable settlement agreements with the bankrupt debtor provides significant opportunities to a franchisor pursuing a defranchising program. In connection with this bankruptcy settlement process, a franchisor may be able to negotiate with the bankrupt franchisee to obtain certain assets of the franchised business at a considerable discount, with the franchisee being willing to enter into this type of arrangement because of the other protections provided by the bankruptcy process, including the general discharge of debts. This is especially so in situations where the franchisor is a secured creditor of the bankrupt franchisee. Thus, the bankruptcy settlement process allows additional opportunities for franchisors seeking to move a bankrupt franchisee out of the franchise system and expand company-owned operations.

In short, a franchisee entering the bankruptcy process offers significant opportunities for a franchisor pursuing a defranchising program. The ability to force a franchisee to assume or reject the franchise agreement as an executory contract and to negotiate a settlement in the context of a Rule 9019 bankruptcy compromise increases the franchisor’s leverage to move a franchised business out of the system. A franchisor considering defranchising first should take a careful look at any franchisees who may be on the brink of bankruptcy to see if those territories or businesses are of interest to it for company-owned development, and then employ the tools afforded by the Bankruptcy Code to establish company-owned operations in those territories.

c. Settlement Option In Franchisee Litigation And Terminations

A wide range of potential disputes may arise between franchisors and franchisees, including issues involving product pricing, advertising funds, compliance with operating requirements, termination and renewal issues, and non-compete obligations. As in most

\begin{itemize}
\item \textsuperscript{8} See 11 U.S.C. § 365 (b)(1).
\item \textsuperscript{10} See Fed. R. Bankr. P. 9019.
\item \textsuperscript{12} See In re Coram Health Care Corp, 315 B.R. 321, 329 (Bankr. D. Del. 2004).
\end{itemize}
litigation, very few suits between franchisors and franchisees go to trial. More typically, the

disputes are resolved on motions or through settlement negotiations. For the franchisor

considering defranchising, disputes with franchisees offer the opportunity to use the settlement

process to convert franchised businesses to company-owned operations.

Using the settlement process to further a defranchising program takes advantage of

what is often a cost of doing business in franchising (namely, litigation), and converting it into an

opportunity to advance the franchisor’s long term goal of moving away from a franchise model. Thus, the franchisor gets the dual benefit of resolving disputes in a manner that furthers the system’s long term defranchising objective. As with any settlement situation, successfully using the litigation settlement scenario to further defranchising involves negotiation and compromise with the franchisee. To a large degree, the nature of the dispute will determine the extent to which the settlement negotiation process can be used to further a defranchising program.

Certain types of litigation disputes lend themselves to settlements involving buyouts of franchisees more than others. For example, franchise sales fraud litigation -- where a franchisee is asserting that it was fraudulently induced into purchasing the franchise by a misrepresentation by the franchisor -- is a perfect example of an instance where a settlement can be used to further a defranchising program. In this type of litigation, the franchisee is much more likely to have an interest in leaving the system altogether. If the franchisee’s business has some value and the franchisor is pursuing the defranchising program, a natural resolution might involve the franchisor purchasing the franchised business. The business then can be converted into a company-owned operation and the litigation can be resolved. As with all settlement situations, however, the success of this strategy will depend on the ability of the parties to reach agreement on the terms of sale. In the situation where a franchisor is pursuing a defranchising program, the franchisor presumably has determined that company-owned operations can be run more profitably than a franchise. That determination might aid in the settlement options by allowing a better valuation of the business by the franchisor and a more attractive settlement offer to the franchisee.

Other litigation scenarios likewise can lend themselves to franchise buyouts through the settlement process. For example, termination suits against franchisees for noncompliance with the franchise agreement arise when the franchisee is not operating the business properly or in conformity with the system. That, combined with a franchisor who believes that a defranchising program provides financial benefits, naturally leads to the result that the franchisor may want to purchase the franchised business to resolve the lawsuit.

In other litigation scenarios, the franchise buyout scenario might be a less likely result of the settlement process. For example, franchisors often litigate with franchisees over violations of non-compete issues. In litigation involving a post-termination non-compete, a settlement option involving a buyout scenario is less likely because the franchisor has already terminated the franchisee and could establish a company-owned operation without the need of a buyout. Similarly, litigation relating to product supplier or advertising fund issues does not lend itself naturally to franchise buyout scenarios, but even in that instance, if a franchisee is willing to consider ceasing its operations as part of a settlement outcome, the franchise buyout program could apply as well.

Additionally, a franchisor who has valid grounds to do so under the terms of the franchise agreement can further a defranchising program by getting more aggressive in terminating franchisees who have not complied with their franchise agreements, thus using the termination process to close franchised locations. Clearly, in pursuing a termination program as
part of an overall defranchising effort, the franchisor must ensure both that the terminated franchisee has in fact breached the franchise agreement and also that the franchisor is complying with all notice and cure obligations placed on it by the franchise agreement and any applicable state franchise termination statutes. Otherwise, the franchisor could be subject to franchisee claims of breach of contract, unfair practices or lack of good faith. So long as the franchisee clearly is in breach and the franchisor complies with all its legal obligations, the added fact that a termination might be motivated in part by a defranchising objective should not create added exposure for the franchisor. But, any franchisor who tries to use a termination program to pursue a defranchising program without having valid grounds to assert a breach risks significant litigation with its franchisees, as further explored in Section III below. Assuming there is a valid basis to terminate a franchisee, the next issue a franchisor must consider is the termination provision in its franchise agreement.

Most franchise agreements have termination provisions that fall into two categories – immediate termination clauses and notice-and-cure clauses. The grounds for immediate termination typically focus on issues such as material misrepresentations by the franchisee, insolvency of the franchisee, unauthorized transfers or assignments of the franchise rights, or issues of illegal conduct by the franchisee. Notice-and-cure clauses include failures to meet monetary and operational obligations under the franchise agreement. Both types of termination may require some sort of notice to the franchisee. Strict compliance with these provisions is necessary for any franchisor attempting to use a termination program to further defranchising.

A franchisor cannot rely solely on its compliance with the termination clause in its franchise agreement. Sixteen states, Puerto Rico and the Virgin Islands have franchise termination statutes that may override the termination provisions in a franchise agreement and create (i) different standards for what constitutes good cause for termination, and (ii) different required periods for notice and cure. The majority of the statutes require certain minimum notice and opportunity to cure periods and many define what constitutes good cause for termination and non-renewal of a franchise agreement.

Statutory definitions for what constitutes good cause for termination vary by state, but typically focus on material breaches by the franchisee of provisions in the franchise agreement relating to operational or monetary obligations. Poor financial performance by the franchisee alone is not typically a ground for terminating a franchise agreement. Furthermore, assuming the good cause requirement is met, many states require that the franchisor give the franchisee an opportunity to cure the breach prior to termination. These specified cure periods can range from 30 to 90 days. Moreover, as a general rule, the franchise agreement cannot be used to

13 See generally McDonald’s Corp. v. Robertson, 147 F.3d 1301 (11th Cir. 1998).
15 See e.g., Minn. Stat. § 80 C-14 (B) (2005).
16 See Id.
waive the applicability of these franchise termination statutes if there are grounds for those statutes to apply based on personal and subject matter jurisdiction.  

Due to the regulated nature of the termination process, a franchisor attempting to use a termination procedure to pursue defranchising must move with extreme caution. The best practice is to focus only on franchisees who clearly are in breach of highly material provisions in the franchise agreement and use those breaches as a good faith basis to terminate those franchisees. Any franchisor who attempts to manufacture termination grounds to convert franchised locations into company-owned operations risks not only violation of the termination provisions and termination statutes, but also claims based on the implied covenant of good faith and fair dealing. For this reason, using a termination program to pursue defranchising is a less attractive option.

Using the settlement or termination process to further a defranchising program allows a franchisor to use each process (which otherwise are annoying diversions and expenses for franchisors) as an avenue of achieving a long term business goal. It is an opportunity to turn a negative into a potential positive. In specific regard to settlements, and as with any adversary process, ultimate success will depend on the ability of the parties to reach agreement on the financial and business terms. If the franchisor has a business interest in buying back units, there is at least a greater potential common ground for discussion between the settling parties.

d. Franchise Agreement Expirations And Renewals

Another avenue for implementing a defranchising program is the franchise agreement expiration and renewal process. Typically, with the exception of early agreements for certain systems, franchise agreements set forth a specific term. Franchise agreements typically also contain provisions relating to rights to renew the agreement. Franchisors seeking to pursue a defranchising program can use the franchise agreement’s expiration and renewal process as a means of furthering such a program. Obviously, a franchisor can easily convert a franchised unit to company-owned if the franchise agreement expires and the franchisee has no interest in renewing that agreement.

A more difficult situation arises when a franchisee wishes to renew the expired franchise agreement. In that situation, a franchisor can take advantage of the renewal process to try to move franchised businesses into the company-owned category through contract drafting and negotiation. To understand the opportunities and limitations on this strategy, we first must explore various statutes and judicial decisions that place certain limitations on franchisor conduct in the renewal context.

i. Legal Standards Pertaining To Franchise Expiration And Renewal Process

The rights of franchisees and franchisors in the expiration/renewal process are governed primarily by the terms of the franchise agreement. Most franchise agreements have provisions that first establish a specific term for the agreement and then set forth certain requirements that the franchisee must meet to renew that agreement for an additional term. A franchisor seeking to further a defranchising program has two options. First, in connection with the long term goals

of the defranchising program, the franchisor could insert provisions into the renewal section that encourage franchisees not to renew their franchise agreements or provide certain rights to franchisors that will allow them to more easily deny a renewal. For example, a franchise agreement renewal provision could provide that upon expiration a franchisee has a right to renew, but the franchisor first has an opportunity to purchase the location for bona fide price upon expiration. Practically, this gives the franchisor a right to repurchase franchised businesses upon each franchise agreement expiration. This contract drafting approach can be an effective tool in many, but not all, jurisdictions, as further discussed below. However, revising a franchise agreement’s renewal provisions will have an impact only on new franchisees entering the system. Thus, depending on the term of the franchise agreement in any particular system, revising these provisions might have no impact on a defranchising program for 5, 10 or 15 years. This strategy has an advantage for long term progress towards a defranchising program, but no immediate impact.

A second option for a franchisor is taking advantage of the provisions already contained in the renewal section of its franchise agreement to try to limit the number of renewals, with the result of moving more franchise locations into the company-owned category. This approach primarily relies on the strict enforcement of whatever franchise renewal requirements are set forth in the franchise agreement. Typically, for a franchisee to have a right to renew, franchise agreements require that the franchisee be in full compliance with all operational requirements. Thus, if the franchisor strictly enforces this requirement, it can be used to deny renewals to franchisees with less than stellar operational performance. Likewise, most renewal provisions require that the franchisee be in full monetary compliance. Again, strict enforcement of this type of provision could limit the number of renewals. Most renewal provisions also require the franchisee to sign the then current form franchise agreement. If franchisees are unwilling to sign the current form franchise agreement, this also could be used to limit the number of renewals.

Franchisors must be very careful when using strict enforcement of renewal requirements to further defranchising programs. As discussed in detail below, many states have regulations that limit the franchisor’s right to deny renewal. Further, and as discussed later in this paper, the implied covenant of good faith and fair dealing could limit a franchisor’s ability to use strict enforcement of renewal provisions to try to reduce the number of franchise businesses.

ii. Legal Limitations On A Franchisor’s Right To Deny Renewals

At common law, the duration of a franchise agreement is determined by the bargain struck between the parties. A franchise agreement that disclaims any right to renew is enforceable because at common law there is no right to renew unless such rights are provided for in the franchise agreement. Some franchisees have challenged the common law rule, arguing that the doctrines of promissory estoppel or the implied covenant of good faith and fair dealing could limit a franchisor’s ability to use strict enforcement of renewal provisions to try to reduce the number of franchise businesses.

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18 See infra note 22 for an explanation of those states that have evergreen renewal rights.
Most of the efforts to create a judicial limitation on the common law right not to renew a franchise agreement have been rejected. However, some jurisdictions, including Minnesota, have doctrines that state that the franchisee should have some opportunity to recoup its investment if denied an opportunity to renew.\(^{21}\)

In many jurisdictions, however, the rights of a franchisor to deny renewal are governed by more than simply the terms of the contract and common law. Sixteen states and three U.S. territories have statutes that address the franchise renewal issue. As noted above, many of the states that have laws that address renewal rights require some form of good cause by the franchisor before a right of renewal can be denied.\(^{22}\)

There are various standards under state statutes for what constitutes a material breach providing good cause to deny a renewal. These include voluntary abandonment by the franchisee, the franchisee’s conviction of a crime, insolvency, failure to pay money due to the franchisor, and failure to act in good faith or in a commercially reasonable manner.\(^{23}\)

States that require good cause for denial of a renewal right predicate those requirements on some right to renew in the franchise agreement. However, there are three jurisdictions whose franchise statutes have been interpreted to provide unlimited renewal rights to

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franchisees absent a material breach, thus creating a continuing franchise agreement. Those jurisdictions are New Jersey, Puerto Rico and Wisconsin.24

iii. Franchisor Impact

Most state laws that regulate renewal decisions focus on the conduct of the franchisee. However, there are a few jurisdictions that expressly consider the impact the renewal decision has on the franchisor. For example, in Morley-Murphy Co. v. Zenith Electronics Corp.,25 the Seventh Circuit analyzed whether a distributor’s refusal to assent to changes in the system constituted good cause for termination or nonrenewal. The court held that system changes imposed in a nondiscriminatory manner and that were not focused solely on increasing profits could meet the good cause test for nonrenewal. Likewise, under the Connecticut Franchise Act, the Second Circuit in Petereit v. S.B. Thomas, Inc.26 held that good cause to refuse renewal is not limited to the franchisee’s compliance with the franchise agreement, but can also take into account the franchisor’s economic and brand interests.

Moreover, a number of statutes and cases have addressed whether market withdrawal by the franchisor is sufficient good cause to deny a renewal. New Jersey and Puerto Rico appear to view market withdrawal as insufficient “good cause” to deny a renewal.27 In the Freedman Truck Center v. General Motors and the Consumers Oil Corp. v. Phillips Petroleum Company cases, courts have criticized New Jersey’s prohibition of market withdrawal as a good cause for nonrenewal both on constitutional and policy grounds, saying it could constitute a taking and that good cause might be inapplicable if the franchisor is not exploiting its position over other franchisees.28

Likewise, Puerto Rico’s prohibition on market withdrawal as good cause has been criticized by a judicial decision focusing on whether the franchisor’s withdrawal from the market is total and not designed to take advantage of good will built by the franchisee.29 It is also important to note that two jurisdictions specifically permit market withdrawal as a good cause for

24 See Ark. Code Ann. § 4-72-202(7); Cal. Bus. & Prof. Code § 20021(b); Minn. Stat. § 80C(3)(b)(3); N.J. Rev. Stat. § 56:10-5. On the criminal conviction element, California requires a felony conviction or criminal misconduct relevant to the operation of the franchise. Cal. Bus. & Prof. Code § 20021(i). Minnesota has a more lenient standard, including a plea of no contest or of guilt of “an offense directly related to the business conducted pursuant to the franchise.” Minn. Stat. § 80C.14 Subd. 3(2). New Jersey requires conviction of an “indictable offense.” N.J. Stat. Ann. § 56:10-5; See also Ark. Code Ann. § 4-72-202(7)(D); Cal. Bus. & Prof. Code § 20021(a); Minn. Stat. § 80C.14 Subd. 3(b). Good cause for nonrenewal in California can be found where amounts due to the franchisor are not paid within five days after notice of default. Cal. Bus. & Prof. Code § 20021(j). The franchise statute in California also lists some additional potential grounds for denying a renewal, including conduct by the franchisee that reflects poorly on the brand, operational noncompliance, seizure of assets by creditors, and danger to the public health or safety. Cal. Bus. & Prof. Code § 20021(d); Id. § 20021(f); Id. § 20021(g); Id. § 20021(h); Id. § 20021(k).

25 142 F.3d 373, 377 (7th Cir. 1998).

26 63 F.3d 1169 (2d Cir. 1995).

27 See Caribe Indus. Sys., Inc. v. Nat’l Starch and Chem. Co., 212 F.3d 26 (1st Cir. 2000); Gen. Motors Corp. v. Gallo GMC Truck Sales, Inc., 711 F.Supp. 810 (D.N.J. 1989) (partial withdrawal of truck line from market is not good cause for nonrenewal as good cause requires franchisee’s material breach). However, there have been some decisions that have questioned those statutes’ provisions.


nonrenewal, so long as the franchisor does not seek to enforce covenants against competition and does not try to benefit from the good will supposedly built by the franchisee.30

iv. Notice Requirements

With respect to jurisdictions that require good cause for nonrenewal, most require the franchisor to provide advance notice of the decision not to renew the franchise agreement. The only jurisdictions that do not require notice are Hawaii and Puerto Rico.31 Apart from the good cause and notice requirements, a number of jurisdictions have anti-discrimination statutes that require a franchisor to apply fairly decisions in the renewal context in a nondiscriminatory manner.32

v. Impact Of The Law On Renewals In The Defranchising Context

In view of the above summary of the statutes and cases governing renewal decisions, a number of limitations on a franchisor’s ability to further a defranchising program through nonrenewal become apparent. Initially, for those states that neither have franchise statutes nor case law limiting the franchisor’s discretion on renewals, a franchisor can use the terms in the franchise agreement to limit renewals and further a defranchising program. However, as noted above, there are many jurisdictions that place limitations on the franchisor’s rights to deny renewals. Jurisdictions requiring nondiscriminatory conduct and/or good cause for nonrenewals pose substantial hurdles to using the nonrenewal process in furtherance of a defranchising program. Unless a franchisor is prepared to move all franchise operations into company-owned hands, an argument could be made that trying to use the renewal process to force some franchisees out of the system is discriminatory.33 Also, if a franchisor has determined for business reasons that it is better to operate locations on a company-owned basis, it will be vulnerable to arguments that the franchisor is trying to take advantage of the “good will” built by the franchisees. Underlying all these concerns are not only the statutory limitations, but also the implied covenant of good faith and fair dealing (as discussed below in Section III.B.1.b), because even where a franchisor might have a right to use the nonrenewal process in furtherance of a defranchising program (either under the contract terms or under applicable state law), if those rights are used in a manner that could be viewed by a court as unfair to franchisees or inconsistent with the parties’ bargain, then the franchisor’s efforts to use this strategy could be limited.

30 See CAL. BUS. & PROF. CODE § 20025(e); IOWA CODE § 523H.8.
31 See generally, Craig R. Tractenberg et al., Legal Considerations in Franchise Renewals, 23 FRANCHISE L.J. 198 (Spring 2004).
32 Id.
33 States that have laws prohibiting discrimination towards franchisees on renewal include Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Michigan, Minnesota, Nebraska, New Jersey, Tennessee, Washington and Wisconsin.
4. Franchisors Who Lack The Ability Or Desire Necessary To Develop A Successful Franchise System May Better Serve The Brand By Operating Company Locations

Many franchisors fully embrace and understand that they will not succeed unless their franchisees are successful. Franchisors and franchisees need each other to survive and prosper in any competitive business environment. This interdependence is one of franchising’s greatest strengths. It is also be one of franchising’s most difficult challenges, however.

The interdependence of the franchisor-franchisee relationship has a number of unique and interesting features, several of which do not exist in the company-owned location context. Some franchisors incorrectly believe that franchisees simply will “do what they are told” without understanding why they must operate in a certain manner or without regard to the resources it takes to operate in that manner. Managers of company-owned locations are far more likely to do their jobs quietly and operate the company-owned location precisely as directed. The “do what you are told” approach often does not work with franchisees. A successful company-operated system does not guarantee that its franchisees using the same system with the same trademarks will be successful. Successful franchisors understand that they must empower franchisees with a trust-based franchise system and a culture of frank and open communication, in which franchisees feel empowered to participate actively in the present and future direction of the system.

Franchisors who do not or cannot commit passionately to that type of culture may encounter franchisee unrest and dissatisfaction as both the franchisees and the system mature. Other forces also may dictate that a franchisor operate in a more rigid environment. Where a franchisor has successful company locations and franchisees challenge and fight their lack of power, a franchisor should have a defranchising program available as a way to convert franchise locations to company locations. The availability of a defranchising program does not mean that a franchisor must utilize it in every instance when a franchisee fails or the franchisor is frustrated with certain franchisees. Defranchising, however, is a tool that a successful franchisor can exercise under the right circumstances.

5. Company Locations May Adapt And Change Quicker Than Franchise Locations In Response To Economic Or Competitive Forces

Most franchisors face customer competition from non-franchise companies. Franchisors believe that franchisee ownership presents a competitive advantage over non-franchise businesses due to the franchisee’s willingness to work harder and longer and go the extra mile on customer service, more so than the corporate store manager. While that view may have merit, franchisors also must understand that non-franchise businesses may be able to more quickly adapt and change than franchised locations. The flexibility and speed in implementing change is driven by the nature of control at the operating unit. For example, if the chief executive officer or chief operating officer of a company-owned system decides to change pricing at the unit level, those pricing changes can be implemented the next day. In a franchise system, pricing decisions are subject to antitrust restraints and likely cannot be changed on a decision by the chief executive officer or chief operating office of a franchisor.

Even when change is implemented in a franchise system, it often is implemented at a more deliberate pace than a non-franchised system with company-owned locations. Deliberate
change may be appropriate in certain industries. In other industries, where speed and reaction to the marketplace and market forces is critical, deliberate change is like no change at all.

Although these competitive change factors are not likely the single overriding factor in analyzing a defranchising program, for certain companies these factors will be important to consider, especially when coupled with some of the other potential reasons to defranchise in some manner or in some markets.

B. Issues To Consider With A Defranchise/Buyback Program

A franchisor with a successful defranchising program will have prepared adequately for the critical issues and challenges it will encounter. The franchisor must understand that it is necessary to have the financial resources to execute a defranchising program with minimal disruption to either its other franchisees or company-owned locations. It also must understand that any defranchising initiative will require more franchisor employees to operate the company-owned location than was necessary to provide operational support to that same location when it was operated by a franchisee. Finally, the franchisor must understand that the franchise network’s perception of the franchisor’s motives, execution and strategic direction for the future of the brand and system will be scrutinized widely, and the franchisor must appropriately address those concerns.

1. Structuring The Financial Terms Of A Defranchise/Buyback Program

The alternative financial structures that are available for a defranchise/buyback program largely depend on the circumstances of the defranchising event. In many instances, the defranchise event may require a relatively small financial payout from the franchisor. Examples include the franchise termination and expiration opportunities described above, where the franchisor has no contractual obligation to pay for the goodwill of the business, and all that remains to be purchased is the fair market value of any remaining assets usable in the operation of the business as a company-owned location. Conversely, a franchisor who launches a major defranchising/buyback program for multiple units or geographic areas will require significant internal financial resources or outside funding to accomplish the objectives in an effective and efficient manner. Franchisors engaged in the latter type of defranchising program must have adequate resources in place before pursuing any defranchising program. In certain instances, funding can be arranged with outside sources for the express purpose of a defranchising program.

Some franchisors with defranchising programs focusing on regions or markets have pursued their strategies by way of exchanging a franchise or territory with the participating franchisee(s). An example might be where a franchisor believes that consolidation of company-owned units in one market or territory is better than “mixed” markets of both company-owned and franchised locations. In effect, the franchisor takes control of one market and the franchisee controls another through this exchange. This can result in a deal with significant value to all parties, but with relatively little money exchanged.

Any franchisee who voluntarily participates in a buyback likely will want to be paid the full value for its unit at the time of closing. Some franchisees will accept payment terms under circumstances where the likelihood of being paid in the future is high, but only with a promissory note and some form of security behind the note. The past operating success or failure of the franchised business also will play a factor in how the parties assess this part of the transaction.
Poorly performing franchisees are in a much weaker negotiating position than franchisees with successful units.

Finally, regardless of the specific financial structure, franchisors must consult with their financial and tax advisors as they consider the financial implications of the various defranchising options.

2. A Franchisor Must Have The Human Resources And Operational Systems To Run The Units To Ensure That The Transition To Company-Owned Units Is Seamless To Customers

Section II.A, above, addresses the opportunities that exist for franchisors to defranchise locations and convert those locations to company-owned businesses. Most of the discussion thus far has focused on a franchisor’s business rationale for pursuing defranchising and the various legal means a franchisor may utilize in its defranchising efforts. The impact on the customer is equally important, if not of far greater importance, than the franchisor’s rationale.

The transition from a franchise location to a company-owned location must be seamless. Customers must not observe or experience any drop in service (and hopefully will see a noticeable improvement in service and overall performance at the location). Too many franchisors make inadequate arrangements for the defranchising event and rely on hope: (i) hope that the franchisee’s key employees will stay through the transition, (ii) hope that what has worked before in these defranchising situations will work again, and (iii) hope that customers will understand that some drop-off in service should be expected in the transitions. As mentioned before, however, hope is not a strategy.

The successful franchisor with an effective defranchising program spends hours of preparation before the transition, with the understanding that any preparation will pay off multifold when the transition occurs. This preparation includes unit management and having employees identified and in place at the time of the transition (with appropriate training if needed). It also includes having operational systems and local marketing efforts ready to launch, with the understanding that the effectiveness of these systems and efforts at the local unit level may be different from the standard procedures of the franchisor. The final component ensures a seamless transition is attitude. Every member of the franchisor’s team must be armed with the attitude that they will do whatever it takes to ensure that customer service and attention is at the highest possible level.

3. How Will Defranchising Be Perceived By Franchisees? Strategic Planning And Appropriate Communication With Franchisees Are Critical.

Franchisee perception is, in many respects, the most challenging aspect of defranchising. Initially, many franchisors forget that the franchisees’ perceptions are their reality. Too many franchisors get caught up in justifying their position on a particular matter by stating that the franchisee perception was not the franchisor’s intent or that the franchisee’s perception is wrong because it is different than the franchisor’s position. In reality, from the franchisees’ standpoint, it does not matter what the franchisor believes or intends. The critical point is how the franchisees perceived something or some action or event.

This distinction is critical in defranchising. Although instances may exist where legitimate legal and business reasons require silence (such as specific terms in a settlement
agreement resolving litigation), franchisors must recognize when appropriate and straightforward communication to the franchise system will assist in its defranchising efforts. For example, a franchisor whose development strategy is to keep key markets for company-owned locations is better off communicating this strategy to franchisees rather than, for example, turning down the efforts of qualified franchisees who want to develop those key markets. If the franchisees’ perception regarding a franchisor’s defranchising actions is that the franchisor is focusing solely on company-owned locations and has given up on franchising and franchisees, the franchisor will face difficult challenges in maintaining its franchise system and will confront many of the “cons” of defranchising, as noted in Section III below.

III. THE CONS OF DEFRANCHISING

Section II of this paper addresses the pros of defranchising – the business and legal pressure points that provide franchisors with opportunities to effectively and efficiently defranchise locations or territories. Defranchising, however, is fraught with potential pitfalls. Those pitfalls are business and legal challenges, which must be properly considered to avoid devastating consequences on any defranchising effort. We discuss those challenges below.

A. Business Challenges

Business challenges that qualify as a “con” of defranchising are best characterized as a franchisor’s failure to prepare and execute properly on the key issues identified in Section II. Does the franchisor have sufficient capital to repurchase franchised locations? Has the franchisor communicated with franchisees clearly and with integrity regarding any defranchising initiatives or related concerns raised by franchisees? Does the franchisor have the human resources and operational capabilities necessary to defranchise successfully and assume control over former franchised locations? If the answers to even some of these questions are negative, then the franchisor’s defranchising efforts likely will fail.

B. Legal Challenges

Many of the cons of defranchising relate to legal challenges that a company may face as it shifts its focus away from franchising. Franchisees who feel unwanted or believe they have received a reduced level of support and commitment from their franchisors may resort to the courts or other means to voice their concerns. Many franchisors mistakenly become too focused on company operations at the expense of their franchisees; however, franchisees will not sit silently if they believe that a franchisor is shifting its focus away from franchising. A shift in a franchisor’s focus also can result in weaker financial performance for franchisees. Failing franchisees look elsewhere if they believe the franchisor has lost focus. This lack of franchisor focus and attention is a reason that franchisees in many systems form independent associations to attempt collectively to influence the direction of the franchise system. If a franchisee association or any other group of franchisees believes that a franchisor is losing interest in franchising, or is defranchising at the expense of franchisees, legal challenges to the franchisor are soon to follow.

1. Claims Of Franchise Brand Abandonment

A franchisor who elects to defranchise must not forget the emotional reaction that franchisees might experience. These franchisees invested in the franchise opportunity based on a belief that they would be part of a system that would thrive and grow over the years. If they believe the franchisor is moving away from franchising, they likely will feel abandoned. A
franchisor must prepare and manage that reaction properly and address franchisee expectations.

a. **Contract Drafting**

One potential legal challenge to any defranchising program is the presence in the franchise agreement of clauses that appear to be inconsistent with defranchising. Typically, well-drafted franchise agreements are careful to give the franchisor the right to maintain, manage, and expand the brand. Most often, franchisors find troublesome provisions concerning defranchising programs in those sections of the franchise agreement that generally describe the brand or the franchising program. Sometimes those sections discuss the brand solely in terms of franchising or imply that the franchisor would continue to franchise perpetually. For example, many older form franchise agreements include recitals that “the franchisor is in the business of franchising its brand,” or the franchisor is in “the business of expanding its brand.” Although these general descriptive provisions are designed merely to give context to the overall relationship by describing the system and brand, that language can be used against the franchisor in a defranchising context to try and create contractual obligations to continue franchising. Therefore, it is important for a franchisor to review its franchise agreement thoroughly and assess the extent to which its forms of agreement could provide arguments to franchisees opposing a defranchising program.

To mitigate the legal risks incident to a defranchising program, a franchisor should review its franchise agreement and eliminate provisions that could be read to: (i) imply some obligation on the franchisor to continue franchising indefinitely; or (ii) prevent the franchisor from pursuing defranchising through buyback programs, rights of first refusals, and other similar avenues.

As part of that same due diligence, the franchisor should review and note the provisions in the franchise agreement that can support a defranchising program. Those provisions are found most frequently in sections describing the franchisor’s rights over the brand and the limitations on a franchisee’s protected territory. Well-drafted franchise agreements generally contain provisions specifying that the franchisor owns the marks, system, and brand, and retains the right to modify all of those elements in the future. These provisions are important because they give the franchisor the right to make changes to the system and also put the franchisee on notice of the potential for change, highlighting that such changes were contemplated by the parties at the time of contract execution.

Another important provision to review in assessing contract issues relevant to defranchising is that dealing with the franchisee’s protected territory. Many franchise systems provide protected territories to franchisees, which state that the franchisor will not place other franchises in that protected territory. Well-drafted franchise agreements also contain provisions allowing the franchisor to operate direct sales activities and businesses under different marks (even if the products and services are similar) in the protected territory. These protected territory provisions are important in the defranchising context because defranchising, by definition, includes a relative expansion in company-owned operations. Likewise, a franchisor needs to be conscious of the size of territories granted to franchisees and the rights it has to operate businesses in those territories. If the franchise system grants very large protected territories to franchisees with limited rights for the franchisor to operate in those territories, the franchisor’s ability to effectively pursue a defranchising program may be limited. This is because large territories may be “off limits” to company-owned operations so long as those franchisees are in business. Moreover, if the franchise agreement does not provide adequate
rights to the franchisor to operate direct distribution or to run similar businesses under different marks in that territory, then a franchisor pursuing a defranchising program could find itself subject to claims that the program is a breach of the protected territory granted to the franchisee. As discussed below, this could also lead to encroachment claims.

Likewise, it is important to review the franchise agreement to ensure that it grants rights to the franchisee only with regard to the franchisee’s own unit, and not for the franchise system as a whole. This is crucial because if the franchise agreement is clear on this issue, then a defranchising program affecting other franchisees under different agreements is less likely to be deemed to breach the agreement of a franchisee not subject to that program.

Review of the brand description, brand change, and protected territory provisions in the franchise agreement is essential to assessing any risks in pursuing a defranchising program. There are also certain proactive steps a franchisor can take to increase the chances of success of a defranchising program in the future. For example, there are a number of express rights that a franchisor can add to a franchise agreement to solidify its ability to defranchise, including: (1) providing for franchisor’s right to (a) establish and operate, and license others to establish and operate a business similar to or the same as the franchised business under the same or different proprietary marks at any location; and (b) sell or distribute, directly or indirectly, or license others to sell or distribute similar products or services as those offered by the franchisee and any other products or services, including, without limitation, sales made at supermarkets, convenience stores, grocery stores, machines, variety stores and the Internet, at any location (notwithstanding its proximity to the franchised business) under the same or different proprietary marks at any locations as the franchisor or its affiliates deem appropriate; or (2) providing for franchisor’s right to change, improve and further develop its franchised system. Placing these provisions in a franchise agreement will provide substantial additional protection to the franchisor in terms of its ability to defranchise under the contract. Obviously, these provisions will not provide protection as to current franchisees operating under different forms of agreement, but as the franchisor sells new franchises or as franchisees renew their agreements (which typically requires them to execute the current form franchise agreement), adding new provisions to the franchise agreement will impact any future defranchising program.

The most important provision that a franchisor should consider adding to its agreements is an express clause stating that it is not obligated to continue franchising its brand, and that the franchisor has the right to cease franchising and seek to buyback the franchised units under such terms and conditions as are provided in the franchise agreement. Such terms and conditions can include franchisee bankruptcy, rights of first refusal, termination and renewals. Expressly stating in the franchise agreement that the franchisor has no obligation to continue franchising puts the franchisee on notice of the potential for a defranchising program and rebuts any effort of the franchisee to use the implied covenant of good faith and fair dealing to create an obligation to continue franchising. This is because, as discussed below, the implied covenant of good faith and fair dealing generally cannot be used to contradict an express provision in a contract. Thus, if a franchisor expressly states that it may stop franchising, it rebuts a substantial legal claim that could be raised by franchisees. However, such disclosure may discourage prospects from joining the franchise system in the first instance due to concerns that, after investing in a franchise, the franchisor may discontinue franchising and focus on company-owned locations.

Another provision to add to the franchise agreement to strengthen defranchising rights relates to grants of protected territories. Many franchise systems with protected territories do not provide an exception for company-owned operations within the franchisee’s territory. If a
franchisor who grants significant protected territories wants to pursue defranchising, the franchisor should put an exception in the protected territory provision providing it with the right to place company-owned operations in the protected territory. This type of provision generally limits the value of the protected territory to the franchisee, so it may be necessary for business reasons to limit the franchisor’s rights to operating company-owned businesses under different marks or slightly different systems; but, in general, the franchisor’s reservation of rights to operate company-owned units in protected territories will increase contractual leverage to pursue defranchising programs significantly.

b. **Implied Covenant Of Good Faith**

One key legal issue facing any defranchising program is the implied covenant of good faith and fair dealing. Even the most well-drafted franchise agreement, which provides the franchisor with the right to buyback franchised stores or to expand company-owned operations, will be subject to the implied covenant of good faith and fair dealing given that the covenant is read into every contract in virtually all jurisdictions. Its purpose is to ensure that the parties’ mutual intent is reflected in the contract. However, there are many limitations on the application of the implied covenant of good faith. Those limitations can be used by a franchisor pursuing a defranchising program to minimize its potential legal risks.

The central claim arising under the implied covenant of good faith and fair dealing in a defranchising context is that the franchisee relied on a certain size or scope of the franchise program when it bought the franchise. The franchisee’s theory is that, by focusing on the growth of company-owned units as opposed to franchised locations, the franchisor is denying the franchisee the benefit of its bargain. As noted above, the best way to combat this argument is through careful drafting of the franchise agreement. This is because the implied covenant of good faith and fair dealing has been interpreted rather consistently as limited to implied duties, such as where the contract is silent or where it accords discretion to one party. The implied covenant of good faith and fair dealing cannot be used to override express contractual provisions. For that reason, a properly drafted franchise agreement will help protect a defranchising program from implied covenant claims.

i. **The Implied Covenant And The Exercise Of Discretion**

The implied covenant often is used to curb the exercise of one party’s discretion over a significant aspect of the contract and otherwise may be invoked to prevent abuses of discretion. As one court stated, “the implied covenant of good faith and fair dealing essentially serves to supply limits on the parties’ conduct when their contract defers decision on a particular term, omits terms or provides ambiguous terms, … [or] where a party to a contract makes the manner of its performance a matter of its own discretion.” 34

Where one party to the contract truly is given unfettered discretion concerning its performance, the result may be a failure of the contract. In such a situation, the extent of the discretion may constitute a failure of consideration, rendering the contract illusory. This is one reason the implied covenant is read into contracts. This problem may be avoided by (i) eliminating the use of the word “discretion” in a franchise agreement and reserving for the franchisor rights to make decisions or take actions, or (ii) defining clearly the scope of the promisor’s discretion. Discretion may also be defined explicitly as being absolute. Courts will

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sometimes recognize - and enforce - a contract provision that clearly and unambiguously vests absolute discretion in one party without reference to any good faith duties. It is thus possible to draw a contract so as to leave decisions absolutely to the uncontrolled discretion of one of the parties and in such a case the issue of good faith could be viewed as irrelevant. However, just as often, the covenant of good faith will be employed. For example, according to Restatement (Second) of Contracts, § 34, comment b, “discretionary power granted by a commercial contract must be exercised in good faith and in accordance with fair dealing.”

A leading decision regarding the application of the implied covenant to contractual discretion is Carvel Corp. v. Diversified Management Group, Inc. In Carvel, defendant Diversified Management Group (DMG), a Carvel distributor and subfranchisor, was responsible for developing Carvel franchisees in mid-Atlantic states. A dispute arose in which DMG alleged “that Carvel had demonstrated bad faith in its dealings with DMG,” when Carvel arbitrarily rejected proposed store locations, refused to allow changes in store blueprints to accommodate local laws, and made unreasonable changes in wholesale sales and advertising policies. The Second Circuit held that “the contract gave Carvel considerable discretion with regard to matters like advertising campaigns, store location and wholesale sales.” However, Carvel could not avoid a breach merely “because it had near absolute control over these matters ... [E]ven if it acted within the bounds of its discretion, Carvel would be in breach if it acted unreasonably.”

In Dayan v. McDonald’s Corp., the court also assessed a party’s reasonable exercise of contractual discretion. The court described the duty of good faith as follows: “[A] party vested with contractual discretion must exercise that discretion reasonably and with proper motive, and may not do so arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties.” The court held that the expectations of a McDonald’s franchisee had not been frustrated unreasonably by the franchisor’s termination of the franchisee for good cause (based on a failure to maintain quality and service standards), because “where a franchisee is in substantial breach of the franchising agreement ... no legitimate expectations of the franchisee are violated by termination regardless of what other motives the franchisor might have.”

This standard is similar to the Restatement (Second) of Contracts, which states that where a party retains discretionary contractual rights, those rights must be exercised within the parameters of the duty of good faith; good faith, in turn, requires each party to act reasonably in

35 See also U.C.C. §§ 1-203, 2-103(1)(b).
36 930 F.2d 228 (2d Cir. 1991).
37 930 F.2d at 232.
38 Id.
39 Id.
41 Dayan, 466 N.E. 2d at 991. (emphasis added).
42 466 N.E.2 at 993. See also Burger King Corp. v. Austin, 805 F. Supp. 1007 (S.D. Fla. 1992) (franchisor’s exercise of discretion in requiring franchisee to make investments in new equipment may have been unreasonable); Beraha v. Baxter Health Care Corp., 956 F.2d 1436, 1443-45 (7th Cir. 1992) (while the implied covenant does not create “an enforceable duty to be nice or behave decent in a general way,” it does require exercise of discretion “in a manner consistent with the reasonable expectations of the parties”).
light of the justified expectations of the other. In the context of defranchising, this means that the implied covenant can be used by a franchisee arguing that the franchisor is abusing its exercise of discretion to cease franchising. This illustrates the importance for a franchise agreement to expressly state that the franchisor has the right to cease franchising.

ii. The Implied Covenant As A Rule Of Construction

Courts use the implied covenant as a rule of contract interpretation to avoid "unreasonable" constructions of contract terms. A court acts in its equitable capacity when it uses the implied covenant as an interpretation tool to avoid unjust results. Thus, the implied covenant can be employed by a court to interpret whether the franchise agreement supports or prevents defranchising.

iii. The Implied Covenant As A Prohibition On Bad Faith

Another well-accepted application of the implied covenant of good faith is as a bar to intentional bad faith conduct. Like the cases in which courts have found a general duty of good faith, these cases tend not to rely on specific contractual provisions, but look to the party’s conduct and the motivations behind it. As noted above, this application of the implied covenant can be relevant to defranchising if a franchisee argues that the franchisor is terminating or refusing to renew franchisees in bad faith.

iv. The Doctrine Should Not Override Express Terms

As the guiding rule of contract law is to honor the parties’ intentions, courts routinely caution that the implied covenant of good faith cannot trump an express contract provision: “[I]t is axiomatic that an implied covenant cannot override the express provisions of a contract.”

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43 Restatement (Second) of Contracts § 205, comment a (1981).

44 The theoretical foundation for this application of the implied covenant is found in the Restatement (Second) of Contracts § 203(a) (1981):

An interpretation which gives a reasonable, lawful, and effective meaning to all the terms is preferred to an interpretation which leaves a part unreasonable, unlawful, or of no effect.

The Restatement’s comments provide the following example of an unreasonable construction of a contract that should be judicially corrected:

A licenses B to manufacture pipes under A’s patents, and B agrees to pay “a royalty of 50 cents per 1,000 feet for an output of 5,000,000 or less feet per year, and for an output of over 5,000,000 feet per year at the rate of 30 cents per thousand feet.” The 50 cent rate is payable on the first 5,000,000 feet, the 30 cent rate only on the excess. The more literal reading is unreasonable, since it would involve a smaller payment for 6,000,000 feet than for 4,000,000 feet.

Restatement (Second) of Contracts § 203, comment c (1981).

Courts generally have enforced this exception to the implied duty of good faith and fair dealing.

This long-standing principle of contract law rests on sound policy considerations. As the New York Court of Appeals wisely cautioned: "[I]t is not the function of the courts to remake a contract agreed to by the parties, but rather to enforce it as it exists." Each time a court relies on the implied covenant to rewrite a contract, it "make[s] it impossible for parties to rely on the written expressions of their duties and responsibilities ... and place[s] the court at the negotiation table with the parties." For these reasons, a party who seeks to invoke the implied covenant "bears a heavy burden." Thus, if a franchise agreement expressly provides that a franchisor has the right to cease franchising, the risk of a claim under the implied covenant will be reduced greatly.

v. The Implied Covenant Should Be Limited To Core Issues

The implied covenant of good faith recognizes two types of contractual intent: actual intent and "constructive intent." Constructive intent refers not to the express intent of the parties, but to the intent that they would have had if they had considered the issue. For example, in Dalton, the New York Court of Appeals held that had the parties addressed the issue, they would have agreed that the defendant should be required to consider the documentation submitted by the plaintiff. The principle that the implied covenant should not trump express contract terms relates to the parties' expressed intent. The principle discussed in this section - that the implied covenant should be used to enforce the parties' unexpressed intent - is designed to ensure that the parties' "constructive intent" is honored. Obviously, the implied covenant should not be employed where it is impossible for a court to determine that constructive intent.

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46 CIBC Bank and Trust Co. v. Banco Cent. do Brasil, 886 F. Supp. 1105, 1116 (S.D.N.Y. 1995); accord Murphy v. Am. Home Products Corp., 58 N.Y.2d 293, 304 (N.Y. 1983) ("[n]o obligation can be implied [from the implied obligation of good faith] which would be inconsistent with other terms of the contractual relationship"); Hertzog, Calamari & Gleason v. Prudential Ins. Co., 93 Civ. 6395 (CSH), 1996 U.S. Dist. LEXIS 5821, at *5 (S.D.N.Y. May 1, 1996) ("implied covenant cannot controvert contractual language"); Dalton v. Educ. Testing Serv., 87 N.Y.2d 384, 396 (N.Y. 1995) ("[n]o obligation can be implied, however, that would be inconsistent with other terms of the contractual relationship"). See also, Domed Stadium Hotel, Inc. v. Holiday Inns, Inc., 732 F.2d 480, 485 (5th Cir. 1984) (finding that "[t]he Superdome Hotel's argument that Holiday Inns breached the implied general obligation of good faith that permeates every contractual relationship must fail with our holding that the terms of the franchise agreement do not grant the Superdome Hotel a territorial license. The implied obligation to execute a contract in good faith usually modifies the express terms of the contract and should not be used to override or contradict them."); L.L.C. Corp. v. Baskin-Robbins Ice Cream Co., CA No. 03A01-9207-CV-242, CA No. 03A01-9207-243, 1993 Tenn. App. Lexis 4 (Tenn. Ct. App. Jan. 8, 1993), overruled on other grounds, 18 S.W.3d 626 (Tenn. 2000) ("the express terms are controlling and an implied covenant of good faith and fair dealing will not be read into a contract so as to alter or override the clear and unambiguous terms of the agreement").

48 Rothe v. Revco D.S., Inc., 148 F.3d 672, 675 (7th Cir. 1978).
49 Rowe, 46 N.Y.2d at 69.
50 Dalton, 87 N.Y.2d at 396.
51 The Second Circuit for example has recognized that the implied obligation of good faith should be limited to these instances where it is possible to determine the parties' constructive intent:
Limiting the implied covenant to the preservation of a contract’s essential purpose makes sense because a court may assume that contracting parties would agree that neither party should be allowed to frustrate the contract’s central purpose. For the same reason, courts sometimes caution (appropriately) that the implied covenant should not be used at the other end of the spectrum of contractual disappointment (i.e., where a contracting party has suffered only an “incidental lessening” of the anticipated benefit of the contract). In these instances, it is extremely difficult for a court to determine how the parties would have resolved such a peripheral issue had they considered it.

This issue of constructive intent is highly relevant because it raises the question of whether a franchisee would have entered into the agreement had it known that the franchisor might cease franchising. How this question is answered depends heavily on how the balance of the franchise agreement reads. If the agreement does not expressly imply continued franchising, or if it makes clear that the franchisee only has rights in its unit, then the franchisor is in a better position to rebut a constructive intent argument.

vi. The Implied Covenant Should Not Be Used To Create New Rights

Courts frequently state that they will not use the implied covenant to create new rights that only one of the parties wishes it had included in the contract. For example, in Perez v. McDonald’s Corp., the franchise agreement prohibited McDonald’s from arbitrarily withholding its consent to a franchisee transfer. However, it gave McDonald’s the right, in considering the transfer request, to require that prospective transferees meet the same criteria that applied to the transferee.

(Footnote continuation)

“A promise by the defendant should be implied only if the court may rightfully assume that the parties would have included it in their written agreement had their attention been called to it.”

Neuman v. Pike, 591 F. 2d 191, 195 (2d Cir. 1979). That principle should limit application of the implied covenant to those instances where it is necessary to preserve core contract benefits (the “fruits” of the contract), that were so essential to the bargain that the parties would not have entered into the bargain absent those benefits:

The covenant is to be recognized only if it is clear that a reasonable … [party] would not have entered into the … [contract] without such an understanding, since only in such a situation can it be said with the requisite certainty that to refuse to recognize such a covenant would be to deprive the … [party] of the fruits of his bargain.

Rowe, supra 46 N.Y.2d at 70.


53 Although under New York law, every contract contains an implied duty of good faith and fair dealing, such duty cannot be invoked to imply new or inconsistent terms into the contract. Bibeault v. Advanced Health Corp., 97 Civ. 6026, 1999 U.S. Dist. Lexis 7173, *23 (S.D.N.Y. May 12, 1999). See also Domed Stadium Hotel, Inc., 732 F.2d at 485 (“The implied obligation to execute a contract in good faith usually modifies the express terms of the contract and should not be used to override or contradict them.”); Coca-Cola Bottling of Elizabethtown v. Coca-Cola Co., 668 F. Supp. 906, 918-21 (D. Del. 1987) (analyzing the covenant of good faith and express contractual terms). Accord Metropolitan Life Ins. Co. v. RJR Nabisco Inc., 716 F. Supp. 1504, 1519 (S.D.N.Y. 1989) (“while the court stands ready to employ an implied covenant of good faith to ensure that bargained-for rights are performed and upheld, it will not, however, permit an implied covenant to shoehorn into a contract additional terms plaintiffs now wish had been included”). See also Chang v. McDonald’s Corp., 105 F.3d at *2 (“In Illinois, the covenant of good faith and fair dealing is not an independent source of duties, but instead `guides the construction of explicit terms in an agreement.’”) (quoting Behara v. Baxter Health Care Corp., 956 F.2d 1436 (7th Cir. 1992)).

applicants for a new franchise, including completion of the preliminary applicant training program. McDonald's refused to consent to the franchisee's four proposed sales because the prospective purchasers had not taken the McDonald's training program, in which McDonald's refused to permit them to enroll. Plaintiff's franchise agreement provided that McDonald's would not unreasonably withhold consent to a proposed transfer; it was silent regarding any obligations to enroll prospective transferees in the training. Plaintiff contended that McDonald's violated the implied covenant by refusing to enroll the prospective purchasers in its training program. The court refused to find an obligation under the implied covenant of good faith to require McDonald's to enroll the prospective purchasers in the training program. The court ruled that it would not impute such an obligation because "the covenant is not an independent source of duties" and, therefore, could not limit McDonald's discretion on a subject that was not part of the franchise agreement. The reasoning and holdings from this case may be used to combat any effort to obligate the franchisor to continue franchising.

vii. **Waiver**

Section 1-102(3) of the UCC prohibits any party from waiving the obligation of good faith. Some, but not all, courts have agreed that the covenant cannot be waived. A disclaimer clause stating that the covenant is inapplicable likely would not be enforced where the conduct at issue violates the covenant and is contrary to the contract's core purpose. When, instead of a disclaimer of the covenant, the contract provides that a party will have absolute discretion to engage in any conduct not prohibited by the terms of the contract, that provision may be equally unenforceable for the same policy reasons.

When the contract's terms afford one party absolute discretion with regard to a specified aspect of performance, such as absolute discretion to open new franchises, relocate lessee operations under a percentage lease, or terminate the contract, that specific grant of rights should be given effect. If, for instance, a defendant retained absolute discretion to terminate a plaintiff's distributorship, such a termination would not constitute a violation of the covenant irrespective of the injury it caused. In that case, the plaintiff cannot argue reasonably that its contractual purpose or expectations were undermined by the defendant's exercise of discretion because the plaintiff is unable to contend reasonably that its purpose was to have the contract continue indefinitely. The plaintiff's purpose was to reap contractual benefits until defendant decided, in its absolute discretion, to terminate the plaintiff's continued receipt of those benefits.

Even in these instances, however, the covenant would remain applicable to conduct not encompassed within the defined area of absolute discretion. If a defendant accompanied the termination with a concentrated effort to destroy a plaintiff's reputation for the purpose of

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55 Id.
56 U.C.C. § 1-102(3).
57 See Rhode Island Hospital Trust v. Martin Trust, No. 700674, 1992 Conn. Super. LEXIS 420, *11-12 (Conn. Super. Ct. Feb. 3, 1992) ("The implied covenant of good faith and fair dealing cannot be waived."); Cox v. CSX Intermodal, Inc., 732 So.2d 1092, 1098, n.2 (Fla. Dist. Ct. App. 1999) ("The duty to perform the contract in good faith cannot, by definition, be waived by either party to the agreement [citation omitted]"); First Texas Service Corp. v. Rouiler, 750 F. Supp. 1056, 1062 (D. Colo. 1990) (strongly suggesting that public policy may prohibit waiver of the implied covenant); Chemical Bank v. Paul, 614 N.E.2d 436, 442 (Ill. App. Ct. 1993) ("It must be recognized that the implied covenant of good faith reflects a strong public policy judgment: Parties with unfettered contractual discretion cannot be allowed to exercise that discretion in bad faith."). Other courts, without direct citation to the UCC, have held that the implied covenant of good faith can be waived explicitly or implicitly. FDIC v. Rayman, 117 F.3d 994, 998-999 (7th Cir. 1997); Cox, 732 So.2d at 1098, n.2.
inducing customers to cease dealing with the plaintiff, that effort would not be encompassed within the grant of discretion and, instead, would be subject to the covenant of good faith. Although applicable in any contract setting, the implied covenant is particularly popular as a litigation tool in the franchise context. This is due, in part, to the doctrine’s flexibility since the extreme complexity of the franchise relationship begets a variety of disputes that could not be anticipated or expressly provided for by contract.58 Thus, giving a franchisor the absolute discretion to cease franchising might limit the chances of a successful implied covenant claim, but it will not eliminate the risk completely.

viii. Encroachment Issues

Claims involving the implied covenant are also applicable to encroachment situations. One common dispute between franchisors and franchisees are “encroachment” claims -- the placement of a competing unit, whether company-owned or franchised, in close proximity to an existing franchisee’s business, as well as claims relating to the distribution of the franchisor’s product(s) through alternative methods. Often such claims are brought when a franchisee’s business suffers or faces decreased profitability. For a franchisor considering defranchising, it is necessary to assess the potential encroachment claims because a defranchising program could result in more company-owned units being in close proximity to the franchised locations.

a. Encroachment Claims

The starting point for any encroachment analysis is the franchise agreement. If a franchise agreement grants a franchisee exclusivity or territorial rights beyond the location of the franchisee’s business, then the franchisor’s opening of additional stores in the franchisee’s area could constitute a breach of the franchise agreement.59 However, if a franchise agreement explicitly gives the franchisor the right to grant new locations or does not provide for protected territories, then the franchisee has a much higher burden of proving encroachment.

b. Implied Covenant Claims for Expanded Company Operations

As noted above, the implied covenant of good faith and fair dealing protects the reasonable expectations of the parties involved in a contractual relationship when there are no express contractual provisions to the contrary. It imposes a duty of good faith and fair dealing on the performance and enforcement of a contract. As a result, the implied covenant often is used to support encroachment claims. However, the covenant cannot be used to rewrite or override the express terms of the contract.60 Thus, if a franchise agreement does not provide for a protected territory or reserves the right to develop company-owned units near franchisees, it will be difficult to state an encroachment claim. Further, many courts treat the implied covenant as a supplement to the written contract to protect the reasonable expectations of the


parties when one party is granted discretion in the contract. Thus, if a franchise agreement does not expressly provide a franchisee with an exclusive territory, the franchisor has no contractual duty to refrain from establishing company-owned units near a franchisee’s business and such action is not a breach of the implied covenant of good faith and fair dealing. In Weaver, the franchisee entered into two franchise agreements with Burger King. Under the first agreement, the franchisee was allowed to operate a Burger King® restaurant at a designated location in Great Falls, Montana. The second agreement specifically stated that the “franchise [was] only for the specified location and [did] not in any way grant or imply any area, market, or territorial rights proprietary to FRANCHISEEE.” Neither agreement placed any limitations on the location of future Burger King® franchises.

Burger King subsequently sought to open a Burger King® restaurant at Malmstrom Air Force Base in Great Falls. The franchisee viewed such activity as encroaching on the business of the franchisee’s existing restaurants, a breach of Burger King’s obligations under the franchise agreements, and a breach of the implied covenant of good faith and fair dealing. The court found that no breach of the implied covenant of good faith occurred because: (i) the franchisor in good faith performed all of the express contractual provisions; and (ii) using the implied duty of good faith would vary the express terms of the contract. The court held that the rights and duties of the parties to a franchise agreement were created by the agreement itself, and that neither party had a duty to perform nor a right against the other if not stated in the agreement. Consequently, since the franchise agreement failed to grant the franchisee an exclusive territory, Burger King had no duty to refrain from licensing new franchises in the area. The Weaver court held that, where a franchise agreement clearly does not grant a franchisee an exclusive territory, the franchisor has no duty to refrain from licensing new franchises. Consequently, the court denied the franchisee’s claim for breach of the implied covenant as there was no evidence of any breach of an express provision of the franchise agreement.

A showing of bad faith or ill motive by a franchisor is necessary to state a claim for breach of the implied covenant of good faith and fair dealing. In Clark v. America’s Favorite Chicken Co., the franchise agreement expressly provided the franchisor with the right to open competing franchises under a different set of proprietary marks within the franchisee’s designated territory. The franchisees argued that the franchisor violated the implied covenant of good faith and fair dealing due to its merger with a company that owned competing fried chicken restaurants. The court found for the franchisor because the franchisees failed to demonstrate any bad faith or ill motive on the franchisor’s part with respect to implementing a marketing plan that affected two competing brand franchisees.

Likewise, where a franchise agreement expressly provides the franchisor with the right to franchise other parties to develop locations outside of the protected geographic area or the

62 Burger King Corp., v. Weaver, 169 F.3d 1310 (11th Cir. 1999).
63 Weaver, 169 F. 3d at 1313.
64 Id.
65 Id. at 1316-1317.
66 Id. at 1317.
67 110 F.3d 295, 297-99 (5th Cir. 1997).
right to develop new locations, the implied covenant of good faith cannot be used to nullify or contradict the express terms of the contract or to add substantive terms into the parties' agreement.\textsuperscript{68} A franchisor can circumvent the implied covenant of good faith through contracts that specifically authorize actions that otherwise might violate the covenant. If a franchise agreement grants the franchisor discretion to establish new franchises or company-owned stores at any location, courts generally will refuse to apply the implied covenant of good faith even if the new location significantly harms the existing franchisee's profit margin.\textsuperscript{69} For example, in Hoffman \textit{v. Midas International Corp.},\textsuperscript{70} the court refused to apply the implied covenant of good faith and fair dealing to an encroachment claim brought by 5 franchisees against the franchisor, Midas, after Midas opened a new location in proximity to the plaintiffs' shops. The court ruled for the franchisor because the franchise agreement specifically provided Midas with a contractual right to open shops "at any other location whatsoever".\textsuperscript{71} Additionally, the franchise agreement did not provide the franchisees with a contractual right to be free from competition from another Midas\textsuperscript{®} shop. Consequently, the court refused to limit Midas' right to open a new location based on the implied covenant of good faith and fair dealing. Thus, where the franchise agreement explicitly defines the franchisee's territorial rights, the franchisee has the burden of proof to show that the encroachment violates the franchisor's duty of good faith. However, where the franchise agreement is silent or ambiguous, the franchisor has the burden of proving that the placement of additional franchise locations is within the reasonable expectation of the parties.

Defranchising can lead to increased encroachment claims by franchisees because defranchising involves the development of more company-owned units which will compete with franchised units. If the franchisee can establish that the encroachment significantly impacts its profitability, the franchisor can refute the franchisee's claims by showing that the decrease in gross sales was due to market conditions, not the encroachment. However, system-wide and system-enhancing franchisor actions that are not directed toward specific franchises are not likely to be viewed as encroachment, even if such actions may negatively impact some franchisees, so long as the franchisor's actions are justified and are not applied in a discriminatory fashion. Franchisor actions to increase the overall market share will also not be viewed as encroachment if they are permitted expressly by the contract.

\textbf{ix. Brand Preference Cases}

Sometimes, a franchisor may have more than one franchise system and thereby operate multiple brands. Not all of a franchisor's brands may be profitable or successful as a franchise concept, resulting in the franchisor possibly favoring the expansion of one of its brands over another. A franchisor may also show preference for one brand over another by defranchising one brand, not both. The franchisor should confirm that the franchise agreement does not prevent it from franchising any brand concept in the protected territory granted to existing franchisees, defranchising one of its brand concepts, or expanding one of its brands.

\begin{itemize}
\item \textsuperscript{68} Cohn \textit{v. Taco Bell Corp.}, 1993 U.S. Dist. LEXIS 1732 (N.D. Ill. 1993).
\item \textsuperscript{70} Bus. Franchise Guide (CCH) ¶ 11,554 (Ill. Cir. Ct., Law Div. 1997).
\item \textsuperscript{71} Id.
\end{itemize}
Although we have found no case that directly addresses this issue, several cases from similar contexts are instructive. In Karl Wendt Farm Equipment Co. v. International Harvester Co., the court found that the manufacturer’s right to make shifts in its product lines through “additions to and elimination from” the product list did not authorize a complete discontinuation of the product lines; however, the manufacturer was not held liable for withdrawing its products from the market through its sale to a third party.

As previously discussed, in Clark v. America’s Favorite Chicken Co., a franchisee sued the franchisor for favoring a competing system. The franchisees operated Church’s Chicken® franchises. The Popeyes® and Church’s Chicken® systems subsequently came under common ownership of Al Copeland Enterprises, which implemented a marketing plan impacting both Popeyes® and Church’s® franchisees. Church’s advertisements stressed value, while Popeyes advertisements stressed quality. Consequently, the plaintiff felt that the marketing plan placed him at a competitive disadvantage compared to franchisees of the other brand. Since the franchise agreement expressly provided the franchisor with the right to open competing franchises under a different set of proprietary marks within the franchisee’s designated territory, and the plaintiff failed to demonstrate bad faith or ill motive on the part of the franchisor, the court found in favor of the franchisor. Consequently, if a franchisor has a good faith motive for preferring one brand over another, a court likely will support the franchisor’s actions.

Typically, if a non-discriminatory system-wide change is implemented, such change is not deemed to be a substantial change in the competitive circumstances of a dealership agreement. In East Bay Running Store, Inc. v. Nike, Inc., a court upheld an athletic apparel supplier’s new policy prohibiting the sale of certain shoes by mail or telephone to all of its retailers nationwide. The new policy was not an attempt to drive particular dealers out of business. Consequently, in the context of defranchising, so long as defranchising is not applied in a discriminatory manner, a franchisor likely will prevail in franchisees’ claims to stop defranchising.

In Crest Cadillac Oldsmobile, Inc. v. General Motors Corp., a plaintiff automobile dealership brought a claim against an automobile manufacturer for discontinuing a line-make of automobiles. The dealership claimed that at all times prior to the manufacturer’s written notice of discontinuance of the Oldsmobile® line, the manufacturer represented the longevity of the Oldsmobile® line. The dealership continued to invest in the franchise based on such representation. The court found that the contractual integration clause barred all claims of alleged promises by the defendant or understandings between the parties. Similarly, in Freedman Truck Center, Inc., the court found no basis for breach of contract and other common law claims where a franchisor cancelled an addendum relating to the sale of discontinued trucks with a franchisee. Under the Motor Vehicle Addendum, the franchisee sold General Motors Corp.’s (“GM’s”) heavy duty trucks. GM subsequently terminated the franchisee’s heavy duty truck

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72 931 F.2d 1112, 1120-21 (6th Cir. 1991).
73 110 F.3d at 296.
74 890 F.2d 996, 1000-1 (7th Cir. 1989).
76 Crest Cadillac Oldsmobile, Inc., 2005 WL 3591871 at *3.
77 Freedman Truck Center, Inc., 784 F. Supp. at 178.
franchise due to a business decision to discontinue four truck models on a nationwide basis, all of which were heavy duty trucks. The court found that the failing product prompted market withdrawal, and market withdrawal did not violate the New Jersey Franchise Practices Act.\(^\text{78}\) In addition, the plaintiffs failed to demonstrate that the elimination of the heavy duty truck business would result in substantial curtailment of GM’s product offerings so as to cancel the entire dealer agreement. Consequently, the court granted GM’s motion to dismiss the dealer’s breach of contract claim.\(^\text{79}\)

Similarly, in Central GMC, Inc. v. General Motors Corp. \textit{et al.},\(^\text{80}\) the court found that the franchise of a Maryland dealership, Central GMC, was not terminated when GM discontinued a line of trucks that comprised only part of the franchise. Central GMC and GM entered into a GMC Truck Dealer Sales and Service Agreement, which provided Central with the right to service GMC trucks and to identify itself as an authorized GMC Truck dealer. Central had a “non-exclusive right to buy the new GMC Truck motor vehicles identified in the Motor Vehicle Addendum” attached to the Truck Dealer Agreement. The Addendum was effective unless canceled or until superseded by a new Motor Vehicle Addendum. In addition, the Truck Dealer Agreement provided GM with the right to discontinue any line of product and stated that GM would not be liable for delay in delivering products due to discontinuance of manufacture or sale. GM subsequently decided to discontinue manufacturing heavy duty trucks due to substantial losses from the production of the trucks and after realizing only a small share of the market. GM then transferred assets used in its American operations to a new corporation formed with AB Volvo, a Swedish motor vehicle manufacturer, and two of Volvo’s subsidiaries (“Volvo”). Dealers were subsequently informed that GM would discontinue offering heavy duty trucks for sale and that the heavy duty truck addendum would expire.

After the plaintiff’s heavy duty truck addendum expired, plaintiff retained only the right to sell and service GMC light and medium trucks. The plaintiff also later entered into an agreement enabling it to continue servicing GMC heavy duty trucks as well as to work on Volvo GM trucks. Nevertheless, the plaintiff sued defendants for wrongfully terminating its franchise in heavy trucks due to the cancellation of the heavy duty truck addendum. The court held that GM’s withdrawal of the heavy duty truck line was not a termination because the “general purpose of protecting dealers against abuses of superior bargaining power was not intended to insulate them from every adverse turn in a market economy”, and further cautioned that characterizing the discontinuance of a product line as a franchise termination would raise significant commerce clause concerns.\(^\text{81}\) Additionally, GM did not exploit any disparities in bargaining power with the plaintiff. It simply withdrew from the heavy duty truck market in a non-discriminatory manner by canceling all preexisting heavy duty truck addenda in a good faith effort to address losses from a heavy duty truck market. Consequently, the court sided with the manufacturers.

In \textit{Harter Equipment, Inc. v. Volvo Construction Equipment North America, Inc.},\(^\text{82}\) the parties entered into an agreement authorizing Harter to sell and service Samsung equipment as

\(^{78}\) Id. at 173.

\(^{79}\) Id. at 177.

\(^{80}\) 946 F.2d 327 (4th Cir. 1991).

\(^{81}\) Central GMC, Inc., 946 F.2d at 332.

a Samsung dealer. Subsequently, the dealer agreement was assigned to Volvo Construction Equipment North America, Inc. (“Volvo”). Volvo eventually stopped production of the Samsung line of excavators and other equipment explicitly named in the Samsung line of excavators and other equipment. The dealer refused to execute a contractual amendment, which confirmed the removal of Samsung heavy equipment from the product schedule. Consequently, Volvo refused to renew the dealer agreement after its expiration. The court found that Volvo’s decision to discontinue the Samsung product line was a non-discriminatory market withdrawal that constituted good cause for non-renewal of the dealer’s franchise under the New Jersey Franchise Practices Act. It appears that so long as a franchisor does not behave in a discriminatory manner, a court likely will deem acceptable the franchisor’s implementation of a system change, including defranchising, even though such change may involve only one of the franchisor’s brands. However, a franchisor should be aware that defranchising one brand over another may result in increased claims by franchisees whose franchised businesses include the brand that is being defranchised.

c. Market Withdrawal Cases

One issue that has been persistently litigated in the franchise context is whether the franchisor may terminate the franchise agreement based on economic necessity. In essence, the issue is whether a franchisor has an obligation to remain in a financially unprofitable relationship absent a franchisee’s breach of some provision in the franchise agreement. These disputes often arise in the context of a franchisor withdrawing certain products from the market generally or withdrawing from certain geographic areas. These market withdrawal cases are related closely to the termination and renewal issues discussed earlier in this article, in that the market withdrawal question focuses mainly on whether economic or business issues constitute grounds to terminate or deny renewal of a franchise agreement. As discussed below, because of the special circumstances relating to defranchising, these market withdrawal cases could pose a problem for a defranchising program.

Much debate exists within the franchise bar as to whether market withdrawal is a valid ground to terminate a franchise agreement. Some commentators take the position that case law supports various franchisee claims challenging market withdrawal, including breach of the implied covenant of good faith and fair dealing, punitive damages claims and fraudulent franchise sales practices. In response, a number of other commentators have noted that most franchisee claims relating to market withdrawal issues have failed and that, for the most part, it is very difficult for a franchisee to state a cause of action if the franchise relationship is terminated for economic necessity.

What the case law appears to show is that the defense of economic necessity, in most jurisdictions, will protect a franchisor’s decision to terminate franchisees. For example, in Morley-Murphy Co. v. Zenith Electronics Corp., the court held that the Wisconsin franchise statute did not prohibit terminations for economic necessity so long as certain conditions were

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85 142 F.3d 373, 376 (7th Cir. 1998),
met. For purposes of this paper, it is not necessary to detail all of the points and counterpoints in the debate about the market withdrawal cases, since those issues have been examined thoroughly in the cited references. What is more pertinent here is how the themes of the market withdrawal cases might apply in the context of a defranchising program.

Franchisors tend to prevail in market withdrawal cases are two key reasons. First, if the franchisor can show an economic necessity for a market withdrawal, i.e., that it is losing money in a market or on a product line, courts are very reluctant to force that franchisor to stay in an unprofitable business venture. Second, in those instances where franchisors are withdrawing from a market or product line entirely, it is hard to argue that the franchisor is acting in an anti-competitive fashion, so courts have shown more sympathy towards the franchisor’s position. These two rationales, which underlie the rulings favoring franchisors in many market withdrawal cases, do not apply so well in the context of defranchising programs. This is because in many instances, a defranchising program is focused on profit maximization as opposed to averting economic loss. Although there are certainly some franchise systems that are unprofitable and some franchise arrangements that do not generate positive revenues for franchisors, in many instances a defranchising program focuses mostly on brand control and profit maximization. For that reason, unlike the market withdrawal cases, courts may not show as much sympathy when a franchisee asserts causes of action such as breach of the implied covenant of good faith, breach of contract and constructive termination and seeks damages against the franchisor because of defranchising. Put simply, the argument of economic necessity might not apply so well in this context.

The element of “complete market withdrawal” also poses issues for any franchisor considering defranchising. As noted above, in instances where franchisors have withdrawn a product line entirely or left a market completely, courts have shown sympathy towards the franchisor because of any lack of evidence of anticompetitive conduct. The reality in a defranchising context is just the opposite. In the defranchising context, a franchisor wants to takeover franchised units and then run them as company-owned operations. The franchisor is not leaving the market; it is assuming the market. This again raises the specter of the theory behind the market withdrawal cases working in favor of the franchisee challenging defranchising. A good example of this is the decision in Kealy Promisy & Home Care Service, Inc. v. Walgreen Company, where a franchisor terminated several independently owned pharmacy dealers across the nation in favor of maintaining and increasing the number of company-owned stores. The court held that this program was not a market withdrawal situation and that the franchisor violated Wisconsin’s franchise relationship law because the terminations did not constitute good cause as that term is defined under the Wisconsin statute. Although the Kealy decision is more than 20 years old, it provides a warning to franchisors who pursue a termination strategy relating to the franchising program. That warning is that a franchisor should not rely on the rationale of the market withdrawal cases for protecting a defranchising program.

d. Constructive Termination Cases

As discussed above, one potential avenue for implementing a defranchising program is through the termination process. However, that approach creates a number of unattractive risks

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86 Most other jurisdictions also hold this view. See e.g., Corp. v. Atlantic Richfield Company, 860 P.2d 1015 (Wash. 1993); Central GMC Inc., 946 F.2d at 333.

87 539 F. Supp. 1357 (W.D. Wash. 1982).
for the franchisor. Ironically, in certain circumstances, franchisors who opt for other methods to pursue defranchising programs still might find themselves on the receiving end of an allegation that they are terminating franchise relationships to pursue defranchising. This is due to constructive termination - a legal theory that has been recognized in certain jurisdictions and that could be used by franchisees opposing a defranchising program.

Most agree that the genesis of the constructive termination theory is in case law interpreting the Petroleum Marketing Practices Act (the “PMPA”), a federal statutory scheme regulating the termination and nonrenewal of petroleum franchise relationships. For many years, courts have recognized a cause of action for constructive termination under the PMPA in instances where the petroleum franchisor has taken business actions that have undermined the core benefits to the franchisee of the franchise relationship. Recently, in Abrams Shell v. Shell Oil Company, the Fifth Circuit addressed the scope of constructive termination claims under the PMPA. Under the Fifth Circuit’s analysis, a claim for constructive termination only lies under the PMPA if the franchisor allegedly has breached one of three components constituting the franchise, namely the trademark license, the supply of motor fuel to the franchisee, and the lease for the premises. Absent a bona fide claim that the franchisor has breached one of those core rights, the court held that there was no claim for constructive termination under the PMPA.

Obviously, the PMPA is a special industry law applicable only to petroleum franchisees. However, the doctrine of constructive termination has been applied in other franchising contexts. Most notably, the Second Circuit in the Petereit case, set forth the well known standard for constructive termination claims in the franchise context generally. There the court held that these could constitute a cause of action for constructive termination, but any negative impact on the franchisee’s income, which results from a franchisor’s business decision, is insufficient to constitute a termination. A franchisee must demonstrate greater than a de minimis loss of revenue, but less than driving a franchisee out of business.

The Petereit case involved a franchisor’s realignment of territories, and the franchisee’s reliance on that realignment to assert a cause of action for constructive termination. The Second Circuit upheld the ability to state the cause of action for constructive termination. In a similar context, a court held that when Oldsmobile discontinued a particular automobile model,

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89 See generally, Deborah S. Caldwell et al., Annual Survey of Texas Law, 57 SMU L. REV. 1035 (Summer 2004).
90 No. 02-21028, Bus. Franchise Guide (CCH), ¶ 12, 632 (5th Cir. Aug. 18, 2003).
91 Id.
92 Interpreting the Connecticut Franchise Law, the Second Circuit held as follows:
We agree that total derogation of franchise is not required to trigger the protection, but cannot agree that any negative impact on the franchisee’s income resulting from the franchisor’s realignment of territory is alone sufficient to be deemed a termination. We note initially that while some plaintiffs are parties to certain agreements allowing alterations to their territories, such agreements do not preclude a finding of constructive termination. The act contains a non-waiver provision that prevents parties from contracting all of its protections. … Where a realignment of territory has had such a substantial effect as to the amount to a constructive termination of contractual reservation of how to realign territories cannot displace a statutory scheme.

Petereit, 63 F.3d at 1182.
93 Id. at 1183.
that conduct might constitute a constructive termination for franchisees who had a heavy financial dependency on that particular model.\textsuperscript{94}

Both of these constructive termination cases show that, in instances where a franchisor makes significant changes to its system or brand, franchisees have asserted that those changes constituted a constructive termination of the franchise relationship. The franchisees then argued that the franchisor failed to meet the termination requirements in the franchise agreement or in any applicable state franchise termination statutes. Thus, franchisors find themselves fighting lawsuits for improper termination based on business decisions, where the franchisor did not expressly seek to terminate the franchise relationships.

The application of the constructive termination doctrine to a defranchising program is readily apparent. For example, if a franchise agreement contains provisions implying that a brand will continue to be franchised, a franchisee might argue under the implied covenant of good faith and fair dealing that the franchisor has some contractual obligation to continue franchise expansion. As a result, a defranchising program could give rise to an argument that a franchisee has been deprived of a core benefit under its agreement. Having established such a premise, it would not be difficult for a franchisee to argue that the defranchising program constituted a constructive termination of the franchise relationship, and that part of the consideration the franchisee paid to join the system with the belief that it was part of a growing franchise brand.

A franchisor can counter such arguments in a number of ways. First, if the franchisor can argue credibly that there is no contractual obligation to continue franchised brand expansion, the franchisee will have a difficult time proving that there has been a constructive termination because absent a material breach by the franchisor, the theory is very difficult to pursue. Second, most courts that have applied the constructive termination doctrine have done so where the franchisee has been deprived of some benefit, either express or implied, in the franchise agreement. If the franchise agreement provides certain express rights to the franchisor to cease franchise brand expansion, it will be very difficult to pursue a successful constructive termination theory.

Third, most courts that have allowed constructive termination claims to survive have construed the claims narrowly, focusing them on core benefits of the franchise relationship.\textsuperscript{95} Of the many rights and obligations granted to parties under a franchise agreement, franchisors can argue that continued franchise expansion solely relates to the franchisor’s interactions with other third party franchisees and does not implicate any of the core benefits under the franchise agreement with a franchisee not subject to the program. Thus, the franchisor has a significant argument that no core benefit has been undermined, so as to warrant the application of the constructive termination doctrine. Finally, a franchisor that is careful to continue fulfilling all of its obligations to existing franchisees, while simultaneously pursuing a defranchising program, greatly reduces the risk of a constructive termination claim by depriving franchisees of the opportunity to point to obvious breaches by the franchisor.

For a franchisee to successfully use the constructive termination theory, a number of factors must be present. However, for the franchisor that does not pursue defranchising

\textsuperscript{94} See Crest Cadillac Oldsmobile, Inc., 2005 WL 3591871 at *2.

\textsuperscript{95} See Abrams Shell, Bus. Fran. Guide (CCH) ¶ 12,632.
carefully, it could easily find itself subject to a constructive termination claim. For that reason, franchisors are wise to adopt the suggestions in this paper on techniques to avoid various legal risks involved with defranchising.

e. Franchise Sales Fraud Claims

Franchise sales fraud claims should not pose a risk for most franchisors in the context of defranchising programs, as along as those franchisors are adhering carefully to the rules and regulations that apply to franchise sales activities. The franchise sales process is regulated by the FTC Franchise Rule and by 17 state franchise sales laws. These laws require the franchisor to provide certain information to prospective franchisees before any agreements are signed or money paid. That information comes in the form of prospectus called a Uniform Franchise Offering Circular (“UFOC”). Most franchisors are careful to comply with all the requirements of the federal regulation and state laws to avoid franchise sales issues.

Franchise sales issues can arise in the context of defranchising if the franchise agreement or the UFOC contains language that implies that the franchisor is making a commitment to continue franchising its brand. As noted previously in Section III.B.1.a, some sections of a franchise agreement (especially general descriptive sections) may contain general statements about the franchise system that could imply that the franchisor intends to continue franchised expansion indefinitely. If those clauses appear in franchise agreements and are replicated in the UFOC, then a franchisee confronted with a defranchising program could attempt to assert a claim that the franchisor made a material misrepresentation in connection with the sale of its franchise.

Franchise sales fraud claims typically come in two forms: Common law fraud and fraud claims under state franchise sales laws. The requirements for common law fraud claims vary by state, but generally, a franchisee must show an intentional, material misrepresentation or omission of fact upon which the franchisee relied to its detriment and which caused the franchisee injury. This common law standard for franchise sales fraud is not easy to meet, but it is a cause of action asserted by franchisees on a fairly frequent basis. Likewise, most franchise sales laws contain antifraud provisions that prohibit a franchisor from making material misstatements or omissions of fact.

Claims under the antifraud provisions of state franchise sales laws tend to track the requirements of common law fraud claims, although it is not always clear from the statutory language whether all the elements of common law fraud must be met to establish such claims. For purposes of defranchising, the issue is not so much the elements or case law for franchise sales fraud issues, but whether a franchisor’s documents, i.e., the UFOC and franchise agreement, contain language that could be used by a franchisee to argue that the franchisor


98 See, e.g., N.Y. GEN. BUS. LAW § 687(1)-(2) (2006).
represented that it would continue franchising. Likewise, in connection with franchise sales techniques, a franchisor must ensure that its franchise sales personnel do not make any statements in connection with the franchise sales process that imply that the franchisor intends to continue franchising indefinitely. In fact, one way to deal with both of these issues, as noted above, may be to insert a specific provision in franchise agreements noting that the franchisor has the right to cease franchising at any time and by instructing franchise sales personnel to refer franchisees to that provision.

If the franchisor's documents do not imply that it will continue franchising and its sales staff is careful not to make such representations, franchise sales fraud claims are unlikely in the defranchising context. However, the issue needs to be considered as another element of basic due diligence. It is not enough for a franchisor to ensure that its agreements do not create an obligation to continue franchising. The franchisor must also ensure that no such representations were made to franchisees in connection with the franchise sales process.

2. **Expanded Third Party Liability**

A franchisor considering a defranchising program must realize that moving away from a franchise model by increasing the number of company-owned locations will result in increased potential exposure to lawsuits in a broad range of areas. For example, a franchisor's liability for general tort claims could be increased significantly by a defranchising program. This is due to the fact that, when a franchisor owns more company locations and operates those locations directly, the franchisor will have an increased liability profile for tort claims relating to the operations at those locations.

As is well known, a broad variety of tort claims can arise in connection with the operation of any business. An obvious example is personal injury liability for accidents that occur at the business. Any franchise business that operates on a service location model experiences the potential for injuries to occur to customers and employees. For example, customers who frequent a food service franchise could be injured in the parking lot while entering the business, claim food poisoning, slip on the floor, be burned by coffee, or claim they contracted some sort of illness from unsanitary conditions in the dining area, kitchen or bathroom. The range of potential tort claims is almost limitless.

The structure of a business itself has a huge impact on potential liability for these types of claims. Under tort laws as they have evolved in the United States, it is much more difficult to hold a franchisor liable for an injury that occurs at a franchised location than it would be to hold that franchisor liable for the same injury when it occurs at a company-owned location. This reality is due to the law of vicarious liability. The law of vicarious liability serves to protect franchisors by limiting the situations in which a plaintiff can hold a franchisor liable for injuries that occurred at a franchised business. The protections that spring from the law of vicarious liability cease to apply in circumstances where the alleged tort occurs at a company-owned location, however. In those circumstances, the franchisor's defenses are narrower. To fully understand the protection the franchisor relinquishes when it moves from a franchised business model to a company-owned store model, one needs to examine the law of vicarious liability.
Many articles have summarized the law of vicarious liability in the franchise context, so below we provide only a basic summary of some of the general principles.99

a. Summary Of The Law Of Vicarious Liability And The Importance Of Control

Liability based on actual agency is a common theory of recovery in the franchising context. For a franchisor to be vicariously liable for injuries that occurred at a franchised business, the franchisor must have exercised control over the specific cause of the injury.100 Control is crucial because it shows an agency relationship where there is “manifest consent that one [party] shall act on behalf of the other and subject to his control.”101 Torts caused in an agency relationship can result in liability to both the agent and the principal.

The theory regarding liability in the agency relationship is not complicated, but the level of control required is very fact specific. Factors suggesting the level of control necessary for an agency relationship include “a principal’s beneficial interest in the agent’s undertaking, written agreements between the parties, and instructions given to the agent by the principal relating to how to conduct business.”102 The level of the franchisor’s control over the day-to-day operations of the franchisee’s business is often the key factor in a court’s decision to find vicarious liability. For example, some courts have found an agency relationship between a franchisor and a franchisee where the franchise agreement did not simply set forth “standards” for conducting business but, rather, established “precise methods” that were enforced through regular inspections and the right to cancel the franchise agreement.103

b. Defranchising Endangers Vicarious Liability Protection

The law of vicarious liability teaches us that whether a franchisor is liable for injuries that occur on the premises of a franchised business is determined by the level of franchisor control over the franchisee’s operation. If the injury was caused by an activity that the franchisor did not control directly on a daily basis, franchisors generally are not liable for those injuries. Conversely, where the franchisor exercises a high degree of regular control over the activity that caused the alleged injury, the plaintiff has a much better opportunity to establish franchisor liability under a vicarious liability theory.

This creates a natural tension in the operation of any franchised business. To protect the value of the brand, the franchisor must maintain control and direction over the key functions for the franchised business. However, the greater the control, the greater potential for liability against the franchisor. The same tension applies in the defranchising context. When a franchisor focuses more on company-owned operations rather than on franchised businesses,

99 Many of the cases cited below reflect the analysis in Scott M roster and Arthur Pressman, Effective Measures To Limited Vicarious Liability Risks For Franchisors, 37th INTERNATIONAL FRANCHISE ASSOCIATION LEGAL SYMPOSIUM (May 23-24 2004).
100 Wu v. Dunkin’ Donuts, Inc., No. 00-7923 (L), 00-9213 (CON), 2001 U.S. App. LEXIS 2544 (2d Cir. February 20, 2001).
103 Butler, 110 F. Supp.2d at 67 (citing Miller v. McDonald’s Corp., 945 P.2d 1107, 1111 (Or. Ct. App. 1997)).
that franchisor has decided, for a variety of reasons, that it will benefit greater by operating company-owned locations. The reasons for that decision vary widely, but one of them certainly involves control and brand protection. Franchising, at its core, is a licensing relationship where the brand owner licenses the concept and trademarks to third parties. Under a company-owned model, the company directly controls operations under its trademark and presumably has a higher degree of control, which results in better brand protection and service to customers. Just as in the franchising context where the level of control increases the liability profile for the franchisor, so in the defranchising context does the franchisor’s decision to own company-owned units bring increased risks of liability for injuries related to business operations.

One of the great benefits of franchising is that, when a company has developed a good business concept and trademark, it can license that intellectual property out to third parties who will pay for the privilege of using the concept and the mark to operate the business. In that way, the franchisor can expand the brand using the efforts and capital of third party franchisees. In addition, given the law of vicarious liability, those third party franchisees who are paying the franchisor for the privilege of using the concept take on the lion’s share of the liability for any torts committed in connection with the operation of the franchised business. This provides a double benefit to the franchisor: The franchisor gets paid for its concept and its franchisees have to pay for torts that might occur during the operation of their business. This model is very appealing from a liability standpoint. It is not foolproof and there are certainly situations when franchisors can be liable for injuries at franchised businesses, depending on the level of control management of the activity causing the injury; compared to other businesses, however, franchising provides a considerable tort liability benefit. All of these benefits are lost in the defranchising context. By defranchising, the franchisor assumes all the risk not only of business success (or failure), but also the risks relating to injuries that may occur in connection with the operation of the business.

IV. UFOC DISCLOSURE ISSUES

Full and complete disclosure is one of the best ways to minimize legal liability when defranchising. Although neither the UFOC Guidelines nor the Federal Trade Commission’s Rule on Franchising require a franchisor to specifically disclose defranchising activities, a franchisor must disclose its operation of company-owned locations. Prudent franchisors understand that flexibility in building and expanding a brand and a system are both critical and appropriate disclosures to include in the UFOC, as such disclosures will provide the franchisor with the right to operate company-owned locations in certain circumstances. As noted in Section III, UFOC disclosures also can minimize the franchisor’s potential exposure to franchisees claiming that they were unaware of the company’s defranchising plans when they invested in the franchise system.

105 16 C.F.R. § 436, Bus. Franchise Guide (CCH) ¶ 6,090.
A. **When And How A Franchisor Should Disclose Its Defranchising Plans Or Activities In The UFOC**

1. **Item 1**

A franchisor must disclose the business experience of the franchisor and its affiliates, as well as the length of time the franchisor or affiliate has conducted a business of the type to be operated by the franchisee. Although this disclosure generally is not more than a few sentences, the information should provide a prospective franchisee with a fairly accurate picture of whether the franchisor has the capacity and financial wherewithal to operate company-owned locations. Even if a franchisor currently does not operate company-owned locations, it should disclose whether it has done so in the past and whether it may do so in the future. This disclosure puts all prospective franchisees on notice that the franchisor may pursue a defranchising strategy through company-owned locations.  

2. **Item 12**

The Item 12 disclosures regarding the franchisor’s ability to develop, operate and eventually purchase company locations are critical to pursuing a defranchising strategy. Item 12 requires that a franchisor describe (i) whether the franchisor has or may establish company locations and restrictions on the franchisor’s future development of company-owned locations; and (ii) whether the franchisor or its affiliates have established or may establish company-owned outlets selling or leasing similar products or services under a different trademark. The following is an example of Item 12 language:

You are granted a license to operate an ABC Restaurant at a single Authorized Location. Your license is limited to the right to operate the Business only at the Authorized Location and, unless authorized by us in writing, may not be used elsewhere or at any other location by you. Your right to operate your ABC Restaurant is not exclusive. You are not granted a territory or any protected area, and we, our affiliate and any franchisee we authorize may operate an ABC Restaurant at any location. You may not exclude, control or impose conditions on our development of future franchised, company or affiliate-owned Restaurants at any time or at any location.

We have the right at any location near your Authorized Location, and without compensation to any franchisee: (i) to establish company-owned or franchised businesses; (ii) to distribute products or services through alternative channels of distribution using the Marks or any other trademarks; and (iii) to establish, and offer services in connection with, a national accounts program. For example, we may establish company-owned or franchised Restaurants that sell goods or services similar to those you offer at the Authorized Location, or that directly compete with your Restaurant.

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106 Item 1 information concerning the franchisor’s (or its affiliate’s) experience operating company-owned locations sheds light on whether the franchisor can effectively operate the locations (i.e., turning on the lights every morning and off every night, as well as all the detailed operational, customer service and marketing issues that arise in between).
As noted above in the Item 1 discussion, prudent franchisors will reserve the right to operate company-owned locations even though their current growth strategy focuses on franchising.

3. **Item 20**

Prospective franchisees can refer to the Item 20 store status summary and obtain valuable information about the company’s focus and attitude on franchising, company-owned locations and any defranchising activities, including specific locations that the franchisor has reacquired from its franchisees. A prospect should analyze the three-year history of company-owned locations, paying close attention to any trends over that three-year period, and then ask questions to obtain an accurate picture of how the franchisor has balanced corporate versus franchised locations on a state-by-state (or even market-by-market) basis.

4. **Item 21**

A franchisor should consider reviewing whether the buyback/repurchase of franchised units results in any material change to the audited financial statements included in the UFOC. Any purchase of units may result in significant debt, which may constitute a material change and require an amendment filing, including updated unaudited financial statements to reflect the changes in the financial statements.

**B. How A Franchisor Can Control What Is Said Outside Of The UFOC?**

UFOC and franchise agreement provisions that describe a franchisor’s defranchising options and right to operate company-owned locations may have a chilling effect on franchise sales. As noted in Section III.B.1.a, prospective franchisees may be reluctant to join the franchise system if the franchisor states in its UFOC and franchise agreement that it may cease franchising or that it has the right to buyback franchises at a pre-determined time and value. Franchise salespersons may be inclined to provide their interpretation of those to close a franchise sale. Interpretations may include some variation of “we really don’t mean that we will stop franchising completely, it is just something the lawyers make us include,” or “we have not bought back franchised units in the six years that I have been with the company, and I am not aware of any plans to do so.”

The franchisor’s field staff and marketing personnel also may feel inclined to make similar statements when asked by existing franchisees to respond to inquiries regarding a franchisor’s defranchising activities. In many instances, franchisees make these inquiries in response to system-wide rumors. Too often, franchisor personnel feel the need to respond immediately to these inquiries in a manner that fosters good relationships with the franchisees without understanding the potential legal implications of their statements.

To control what is communicated to prospective franchisees and existing franchisees, the franchisor should require that: (i) any salespersons, brokers or management engaged in discussions with prospective franchisees attend training on their understanding of the UFOC; and (ii) those same people understand the legal significance of their communications (written and verbal) with prospective and existing franchisees. Franchisors should incorporate regular discussion of these issues in their ongoing internal training for all personnel, not just new hires. These best practices cannot be overemphasized as any dispute challenging a franchisor’s defranchising activities may turn on the statements made to existing franchisees at the beginning and during the franchise relationship.
Additionally, the franchise agreement should provide that a franchisee comply with confidentiality covenants prohibiting the franchisee from disclosing any information that the franchisor deems confidential. A franchisor also should require that a franchisee sign an acknowledgement indicating that he or she cannot rely on statements made by individuals which are inconsistent with UFOC and franchise agreement, unless verified by the franchisor.

V. CONCLUSION

Any franchisor who considers defranchising must understand the pros and cons of the strategy and the interplay between the many business and legal issues impacting defranchising decisions. In all cases, the franchisor’s decision to defranchise units or territories must be an outgrowth of sound business rationale. The business rationale may include franchisee buybacks or other means of reacquiring franchisee businesses with the attainable goal of operating these businesses profitably; it must also include a thorough plan to develop and implement the financial and operational capability to run more company-owned locations, as well as a realistic appreciation of the differences between operating company-owned locations and providing franchisor support to franchised locations. Often a franchisor will face business and legal challenges from franchisees who object to the franchisor’s focus on company-owned locations at the expense of the franchisees and their bottom lines. In the right circumstances, however, and with proper business and legal planning, a franchisor can overcome these challenges and successfully pursue a defranchising strategy.
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