TRANSFORMING AND MODIFYING THE MATURE FRANCHISE SYSTEM

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I. INTRODUCTION

“Nothing endures but change”.

As franchise systems mature, issues arise that trigger a need for change. These issues can range from the routine need to modernize stores to reflect the times or the more complex such as the need to implement wholesale changes to the products or services offered by the franchise system, integration of two systems through merger or acquisition, and the sale of products or services through alternative channels of distribution. But the ability to effect change in the franchise system becomes more difficult due to longstanding practices within the system, the sheer size of the system and customer trends and preferences. A constant source of tension between mature franchisors and their franchisees is the periodic need to modify the network’s concept and system to keep up with (or ahead of) the competition; to incorporate new technologies; to respond to changed consumer demographics, preferences and trends; to introduce new products or services and delete from the system older products and services; to modify existing trademarks/service marks, or abandon them altogether in favor of new marks; to require computerization and integration of new technologies; to compel franchisees to undergo additional training; and to keep the mature franchise network’s image and offerings fresh, competitive and responsive.

This paper will examine seven occurrences that trigger the need for change: (i) shifting consumer preferences; (ii) availability of customers who transcend franchised territories and markets and alternative channels of distribution; (iii) increased competition; (iv) merger and acquisition activity; (v) the need for system expansion through the establishment of additional franchised or company-owned units; (vi) regulatory changes; and (vii) changes in internal practices. For each occurrence, the authors will address the legal and practical restraints that franchisors encounter when attempting to implement change. Antiquated franchise agreements with provisions that do not afford the franchisor the requisite flexibility to implement system-wide changes and outdated system standards that have been in place for decades are the two primary impediments to change. Throughout the paper, the authors will offer practical solutions for the successful management of system change.

There are common causes of action that franchisees assert in attempts to defeat a franchisor’s efforts to implement change, including breach of contract; breach of the implied covenant of good faith and fair dealing; alleged violations of state relationship and disclosure laws; and common law claims for misrepresentation and fraud. But a franchisor’s liability is not just limited to claims in court. Even if a franchisor has the legal right to implement a change to its system, it still must consider the effect of the change on its franchisees because a failure to do so can result in widespread franchisee dissatisfaction that will be detrimental to the franchise system.

II. SEVEN KEY ISSUES/OCCURRENCES THAT TRIGGER A NEED FOR CHANGE

A. Shifting Consumer Preferences

Consumers’ preferences for goods and services change over time, especially so within the past ten years. Changes in demographics and the technology available to deliver goods and services have caused a shift in consumers’ preferences. These changes have caused franchisors to change their systems. For example, the popularity of low and no-carbohydrates diets caused a significant, rapid shift in restaurant menus. In what seems like no time at all, however, demand for these products faded, so restaurants changed their offerings again.
This section will focus on how demographics and technological changes affect consumer preferences and cause franchise systems to change their product and service offerings.

1. Changes in Demographics

Widespread changes in demographics have had a significant effect on consumers' purchasing preferences resulting in a demand for different products and services, but also the need to change how information, training and marketing is provided to consumer and employees.

“Baby Boomers” Becoming Seniors. Now that “Baby Boomers” are becoming seniors, they have started to have a significant effect on healthcare, housing, dining, and other products that franchise systems sell. The National Association of Realtors® reported on March 1, 2005 that one of the major reasons for the boom in real estate during 2004 was the number of investment and vacation homes sold to purchasers over 55 years old. This indicates that a shift in the population will occur, as Baby Boomers become permanent residents of their former vacation or investment homes. This will affect the site selection criteria for franchisors. Baby Boomers’ impact on healthcare will grow significantly in the next ten years as they become eligible for Social Security and Medicare benefits. This will cause a shift of Baby Boomer purchasing dollars towards healthcare, and may spawn new franchise concepts that seek to capitalize on this trend.

Professors O’Rand and Hughes of Duke University published a study called "The Lives and Times of the Baby Boomers," which used census data to compare the Baby Boomer generation at midlife with four preceding generations. Their findings were that Baby Boomers are ethnically diverse, diversity has not led to equality, and many Boomers live in poverty.

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1 A baby boomer is someone who was born during the period of increased birth rates when economic prosperity arose in many countries following World War II. In the United States, the term is commonly applied to people with birth years from the span 1945 to 1964, which may comprise more than one generation. See http://en.wikipedia.org/wiki/Baby_boomer.

2 The National Association of Realtors® study reported that second homes made up more than one-third of residential transactions. The study reported that in 2003, the typical vacation-home buyer was 55 years old and earned $71,000, investment-property buyers’ median age was 47 and they earned $85,700, and nearly 20% of second homes will become primary residences after retirement. Second homes were purchased to diversify investments; for rental income, personal or family retreat, or vacations, and because they had extra money to spend. See http://www.realtor.org/PublicAffairsWeb.nsf/Pages/SecongHomeMktSurges05?OpenDocument.

3 A study by the National Center for Policy Analysis Project reported on March 19, 2005 that in 2011, the first group of baby boomers will reach the age of 65. By then, 77 million of them will have ceased working and paying taxes and will have begun receiving taxpayer-funded health care and pension benefits. The study reported that in 2010, the federal government will need $127 billion in additional funds to pay promised benefits. Five years later, the size of the annual deficit will double. Five years beyond that, it will double again. In just 15 years, the federal government will have to raise taxes, reduce other spending or borrow $761 billion to keep its promises to America’s senior citizens. As the years pass, the size of the deficits will continue to grow. According to the study, without changes in worker payroll tax rates or senior citizen benefits, the shortfall in Social Security and Medicare revenues compared to promised benefits will top more than $2 trillion in 2030, $4 trillion in 2040 and $7 trillion in 2050! See http://www.teamncpa.org/main/news.php?ItemsID=165.


5 About twelve percent of the early boomers (born between 1946 and 1955) are foreign-born, compared to fifteen percent of late boomers (born between 1956 and 1964.) The percentage of African Americans has not changed a great deal over time, but the percentage of Hispanic and Asian Americans has increased dramatically.

6 Baby boomers are the first generation to come of age after the Civil Rights era. Yet, differences in income according to race, ethnicity and country of birth are so entrenched that, in effect, they are ethnic classes. Blacks in the boomer
Purchasing Power of Teenagers. Teenagers today are a major force in the economy. According to Forbes magazine and Marketresearch.com, 12 to 19 year olds will possess $192 billion in purchasing power during 2006. They also report that teens visit stores in greater numbers than any other age group and have increased their control over buying decisions. Therefore, many merchants depend heavily on purchases by teenagers for their profitability and as a result, direct their marketing and advertising programs at teenagers.

The challenge for franchisors is to make sure that their products, services, marketing and advertising programs reach this significant segment of the economy. Simply watching MTV, VH-1 and sports TV channels will show how franchisors have established themselves as major advertisers. These are expensive outlets for advertising and require a commitment from the entire franchise system to support these efforts.

Ethnic Changes. The number of persons who identify themselves as members of ethnic groups is growing rapidly. According to the 2000 Census, 25% of persons in the United States report that they belong to a race group other than “white”. For a significant number of these persons, English is not their primary language. This phenomenon affects franchise systems in two primary areas: the products and services they offer and the methods they use to train employees. Many restaurants and other retailers are printing menus and advertisements in Spanish and other languages to attract non-English speaking consumers. In addition, employers are modifying their training programs to train employees who may not speak English primarily.

Changes In Area Population. According to the 2000 Census, the U.S. continues to become a more urban and suburban society, while rural areas continue to lose population. In addition, many metropolitan areas are seeing significant suburban sprawl, with people moving farther and farther away from the center cities. This sprawl is driven primarily by two factors – the availability of lower cost housing and the movement of business away from center cities to the suburbs. Like the shift in population of Baby Boomers to other areas of the country, these changes will affect franchisor’s site selection criteria as they seek to acquire prime locations in newly developing areas.

2. Changes in Technology

The growth of e-commerce has changed how we research and purchase goods and services. No longer do we need to visit retail locations to buy products. Now, we can make purchases anywhere we have access to the Internet with portable computers, hand-held computer devices and mobile telephones. This form of marketing directs consumers to a single
point – the retailer’s website – to make their purchases. Franchisors, historically, have done the opposite – they have directed consumers to the retail locations. To compete with the online services, franchisors have created their own websites. Today, most all franchise systems have websites that allow consumers to find information about the franchise system and the location of units, make purchases directly from the franchisor or facilitate purchases from franchisees. Hotel system websites have become an effective way to allow consumers to book rooms in franchisees’ hotels.\textsuperscript{11}

When consumers can use the Internet to purchase products and services wherever they are located instead of where the seller is located, traditional concepts of site selection change dramatically. Despite the efforts of franchisees to market and advertise the franchisor’s brand if consumers can make online purchases, the franchisee may see no economic benefit from those purchases. This runs counter to franchisees’ traditional expectations that they will profit from developing their markets. Franchisors, however, may claim that websites with online purchasing features are necessary to compete with non-franchised competitors and provide additional marketing opportunities that will drive consumers into the franchised stores.

3. **Legal and Practical Restraints**

Faced with this rapidly changing economy, franchisors, like their non-franchised competition, must change to maintain and grow their market shares. Effecting change in a franchise system requires a different approach.

a. **Contractual Limitations**

The starting point for any franchisor desiring to respond to or create changes in consumer preferences is to determine if the franchise agreement allows the system to introduce new products and services. An agreement that lists the products or services that the franchisee must offer, without the ability to modify those products or services by the franchisor or, where appropriate, the franchisee, may be too rigid to deal with today’s rapidly changing marketplace. There may be certain signature products that the system will always offer, like McDonald’s® Big Mac Sandwich or Burger King’s Whopper®. Nevertheless, McDonald’s frequently changes other products in its restaurants to appeal to changing preferences.

A franchise agreement that sets a limit on the capital expenditures the franchisee must make during the term of the agreement presents a significant impediment to the introduction of new products or services, especially if the franchisee must purchase additional equipment or remodel the franchise premises. Similarly, if training requirements are not matched with the ability to change products or services, the franchisees may not be obligated to participate in the training necessary to provide the new products and services. This can dramatically slow the introduction of new offerings. Finally, if contract provisions governing franchisees’ participation in national or regional cooperative programs and individual franchisee advertising expenditures generate insufficient funds for a successful new product launch, the new product may not be profitable for the franchisor or the franchisees.

Here is one sample franchise agreement provision that addresses these concerns:

**Modification of the System.** Franchisor reserves the right to change, improve, or further develop the System, or any part of the System at any time. Franchisee must promptly accept and comply with any change to the System and

\textsuperscript{11} See \url{http://www.hilton.com}; \url{http://marriott.com}; \url{http://www.starwoodhotels.com}; and \url{http://www.wyndham.com}. 

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make any reasonable expenditure as necessary to comply. Any modifications to the System developed by Franchisee in whole or in part shall be proprietary to and owned by Franchisor or its affiliates and may not be used or transferred by Franchisee other than as provided in this Agreement.

b. Franchise Registration and Disclosure Laws

The ability of a franchise system to respond to changes can be affected by UFOC disclosures. The disclosure document that existing franchisees received before signing their franchise agreements should have adequately explained the consequences of the franchisor making changes to the system, such as the ability to introduce new products and require the franchisee to purchase new equipment to produce new products. If it did, then recalcitrant franchisees will not be able to claim that they were unaware of the need to modify their products or make the needed expenditures. Even if the prior versions of a UFOC do not adequately address the need to make changes, then the franchisor should modify the current UFOC to do so. Prospective franchisees should also inquire about the past experience of the franchisor in making changes, especially those that require the franchisee to make additional investments in the business.

c. Franchise Relationship Laws

Franchise relationship laws do not affect the ability of a franchise system to implement changes, as much as they restrict the ability of a franchisor to deal with franchisees that refuse to implement the changes needed to respond to changing consumer preferences. Many relationship laws impose good faith requirements to terminate or fail to renew a franchise. In Volvo Trademark Holding Aktiebolaget v. Ais Construction Equipment Corporation, Volvo wanted to re-brand the product lines of an acquired manufacturer under a single trademark and utilize only dealers willing and able to offer its entire product line. Terminated franchisees claimed that Volvo violated the Arkansas Franchise Practices Act by terminating them dealers without “good cause”. Volvo argued that its reasons for the termination, although not expressly stated in the Act, also constituted good cause for termination. The court, granting summary judgment for the franchisees, concluded that good cause for termination was limited to the eight events specifically enumerated in the Act, which did not include Volvo’s reason for terminating the plaintiffs.

d. Implied Covenant

Franchisees frequently use the implied covenant of good faith and fair dealing as a defense to termination. In many situations, the application of the implied covenant depends upon whether the franchise agreement is vague or ambiguous with regard to the introduction of new products or services. Sometimes, however, the implied covenant is used as a “good faith” test on the franchisor, irrespective of the clarity of the franchise agreement.

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14 In Bishop v. GNC Franchising LLC, Bus. Franchise Guide (CCH) ¶13,241, (W.D. Pa., 2005), the court dismissed the franchisees’ claims against their franchisor for breach of the implied covenant of good faith and fair dealing. The franchisees alleged that GNC violated the implied covenant of good faith by “utilizing unconscionable provisions in the agreement.” Applying Pennsylvania law, the court said that the implied covenant of good faith, however, cannot modify or override express contractual terms, and the franchisees, therefore, were barred from raising this claim in
e. **Encroachment**

As customer preferences and expectations change, franchisors are forced to change the way they advertise and sell their products and services. For example, mattresses are now sold over the telephone or via the Internet. These changes can lead to encroachment claims by franchisees alleging that the franchisor’s advertising and sales tactics encroach in their territory.16

4. **Practical Solutions**

Franchisors have become quite resourceful at developing responses to changing consumer preferences. We have mentioned several already and review some others below.

a. **Establish New Marketing Programs**

To develop new products and services to respond to changing consumer preferences is not enough – franchisors and franchisees also need to understand which advertising media reach their target markets. This may require the system to employ marketing programs they had not previously used, such as coupon or discount programs, or to develop e-commerce websites and co-ops.

The Internet has become one of the most popular media for advertising the sale of goods and services. It can be very effective to reach teens, but not necessarily certain ethnic groups who are not regular computer users. The Internet will likely become even more powerful as Baby Boomers, who currently use computers in their work and other aspects of their daily lives, age. A presence on the Internet has become virtually expected for most sellers of products or services. For many people, the Internet has replaced the Yellow Pages as a tool to get information about sellers. Whether a franchise system offers e-commerce features, a

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15 In **C.K.H., L.L.C. v. The Quizno’s Master, L.L.C.,** Bus. Franchise Guide (CCH) ¶13,027, (D. Co., 2005), the court granted the franchisor’s motion to dismiss, in part, and motion for summary judgment because the franchisees failed to state valid claims for breach of contract or breach of the implied covenant of good faith and fair dealing under Colorado law. The franchisees claimed that the franchisor breached their agreements by allowing other franchises to open too close to their restaurants. The franchise agreements granted the franchisees the right to operate a franchise at a specific address and expressly disclaimed any intention to create an exclusive territory. The court observed that under Colorado law, “the implied covenant of good faith and fair dealing is used to effectuate the intentions of the parties or to honor their reasonable expectations in entering into the contract.” (citing **Bayou Land Co. v. Talley,** 924 P.2d 136, 154 (Colo. 1996)). The court also stated that the doctrine applies when one party has discretion in executing its obligations under the contract. (See id.; Amoco Oil Co. v. Ervin, 908 P.2d 493, 498 (Colo. 1995)). The court went on to explain that the duty of good faith and fair dealing does not obligate a party to accept a material change in the terms of the contract or to assume obligations that vary or contradict the contract’s express provisions; nor does the duty of good faith and fair dealing inject substantive terms into the parties’ contract. Rather, it requires only that the parties perform in good faith the obligations imposed by their agreement (citations omitted). The court concluded that the franchisees sought to impose a duty on the franchisor that was absolutely at odds with the terms of the franchise agreements.

16 See Section II.D for further discussion of encroachment claims resulting from distribution through alternative channels.
website simply offering information about the franchise system’s products and services is a necessity. If the franchisor wants to offer more than just information on its website, it can develop a store locator system where the customer can provide zip code or other information about the desired location and find where stores are located. Many of these sites also include features allowing the customer to get a map showing driving directions from the customer’s location to the store, along with distance and driving time. Whether e-commerce is offered is a more complicated issue. The franchisor will need to take a close look at the nature of its products and services to see if selling them over the Internet is appropriate. For example, selling prepared food over the Internet requires a delivery system. The traditional delivery services, such as UPS and FedEx, cannot deliver food for immediate consumption, other than canned, frozen or other preserved foods. Therefore, the system must have its own delivery service. Many of the pizza chains have done just that, which makes it easier to set up ordering services using the Internet. This also resolves another problem with Internet sales – who gets credit for the sale – because consumers can pick the location themselves.

Despite the growth of the Internet, more magazines and television channels exist today than before the Internet became available for consumer use. Magazines and television or cable channels are becoming more and more targeted to specific segments of the population, including ethnic, age, sex and race groups. A franchise system that understands its customers can use these media to great advantage. In many cases, they can make marketing programs not only more effective, but also more economical.

In addition to using different media, establishing advertising co-ops can be effective tools to allow a franchise system to tailor its marketing and advertising to local community characteristics.

b. Change Products and Services Offered to Consumers

Of course, perhaps the most important way that franchisors can deal with shifting customer preferences is to change the products and services they offer. We have already cited several examples of restaurant systems modifying their menus to address new consumer preferences. Other systems have added ethnic foods to reach groups who may not have traditionally purchased their products. The addition of delivery services is another way that systems have been able to reach consumers who may not be able to travel to their locations, such as seniors, or teenagers, some of whom are below driving age.

c. Establish Alternate Sources for Products and Services

Some franchise systems have created alternate outlets for their products. The question is whether this helps to create additional demand for the products in the franchised units or siphons sales away from franchisees. Other ways to create alternate sources to sell products are to establish franchised or company-owned outlets in non-traditional locations, such as food courts and airports.

d. Change Procedures for Selecting Franchisees

In the past, many franchise systems selected franchisees unit by unit. Franchisees were allowed to open one unit and if they proved themselves successful operators and had the desire and capital, they were allowed to open additional units. One of the problems with this approach is that a successful single unit operator is not necessarily a good multi-unit operator. The ability to grow a market presence is vitally important to a franchise system. In most areas, a single

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17 For a discussion of alternative channels of distribution, see Section II.B.
franchised unit does not have the ability to compete with multi-unit locations for name recognition, because it does not have the physical presence or the capital to market effectively. Therefore, many franchisors today are looking for franchisees who can be multi-unit operators and will only grant franchises to franchisees that have, at the start, the demonstrated desire, capital and ability to do so. Franchisors also target certain ethnic groups to be franchisees, because they may be more likely to be successful in ethnic neighborhoods.\(^{18}\)

e. **Change Procedures for Training Franchisees and their Staffs**

Training procedures for franchisees and their staffs must also be responsive to changing consumer preferences. The franchisees must be able to be trained to operate the franchise system, but also to adapt to and learn new products, services and ways to provide these to customers. This may require franchisors to provide training materials in languages and comprehension levels appropriate for their markets.

**B. Customers Who Transcend Franchised Territories and Markets - Alternative Channels of Distribution**

Mature franchise systems must be creative to maximize retail opportunities by offering their products/services any place where the consumer may look. There may be an opportunity to sell a product or service in a venue or through an alternate channel of distribution separate and apart from a free-standing unit. A mature franchise system must be able to anticipate and capitalize on these opportunities. In this section, we will examine three examples of alternative channels of distribution: (i) dual distribution of products through alternative channels such as supermarkets or over the Internet; (ii) national and institutional accounts; and (iii) sale of products at non-traditional locations.

1. **Dual Distribution**

Dual distribution occurs when a franchisor sells its products or services not just through franchised outlets, but also through alternative channels such as supermarkets or over the Internet. A prime example of dual distribution is Nathan’s selling its famous hot dogs, not only at its free-standing restaurants but also in supermarkets. Yet another example is the ice cream industry, where Haagen-Dazs and Carvel have for many years sold their products from free-standing locations and in supermarkets and convenience stores. Why? Because consumer purchasing habits have changed, and it is no longer enough for a franchise to sell ice cream exclusively from a free-standing facility; the consumer expects to be able to purchase the same product at a local supermarket – often, a more convenient venue.

a. **Practical and Legal Restraints**

A franchisor engaged in dual distribution of its product must recognize the very real possibility that this will spark claims by franchisees for breach of contract, fraud, and violation of the covenant of good faith and fair dealing.

**Internet Sales (E-Commerce)**

This section will focus on three e-commerce cases – *Drug Emporium*, *H&R Block* and *Pro Golf* – where franchisors had established Internet e-commerce websites to sell products and services directly to customers, including those who resided in “protected” areas granted to franchisees.

\(^{18}\) See Section II.D.4 for a discussion of diversity and ethnic programs.
In 1997, Drug Emporium faced declining franchise store numbers and flat comparable store sales due to increased competition from other discount chains.\textsuperscript{19} It viewed the website as a means to increase its sales and compete with other discounters. Initially, Drug Emporium created a voluntary program, sharing a percentage of the Internet-based sales from customers in the franchisees’ protected territories. Some franchisees did not participate in the program because they believed that the revenue-sharing percentage was too low. In August 1999, Drug Emporium launched www.drugemporium.com, which accepted orders inside and outside of franchisee protected territories.

Although Drug Emporium offered to share a higher percentage of the revenue based on Internet sales, sixteen franchisees brought claims for breach of the implied covenant of good faith and fair dealing through Internet encroachment.\textsuperscript{20} The case proceeded to arbitration before the American Arbitration Association. In a consolidated arbitration, the panel preliminarily enjoined Drug Emporium and its “e-commerce” subsidiary from selling products over the Internet to customers located within complaining franchisees’ territories. The arbitrators determined that the franchisees were likely to succeed on claims that the Internet sales violated the exclusivity provisions of their franchise agreements and diluted the trademark licenses. The franchisor argued that the exclusivity provisions applied only to “brick and mortar” franchises, not “virtual” stores, and that the Internet site was an alternative means of distribution permitted under a limited grant in the franchise agreements. The arbitrators did not attempt to determine whether an Internet website had a real or virtual existence. Instead, they relied on evidence of the franchisor’s marketing efforts and public statements to determine that the website was a drugstore. The evidence showed that the franchisor promoted the website as a full service drugstore and certified the “e-commerce” subsidiary as a “drugstore” in SEC filings. The arbitrators also examined the franchise agreements and the previous conduct of the franchisor in honoring the franchisees’ territories, which included an offer of compensation during the test period for the website. The arbitrators determined that the franchisees had a reasonable expectation that they would not be forced to compete with direct drugstore sales by the franchisor or its subsidiary and issued a preliminary injunction prohibiting Internet sales to customers located in the franchisees' territories, requiring the franchisor and its subsidiary to place a clear notice on the website stating that the subsidiary was unable to ship orders to the identified territories, and directing customers in those territories to the nearest franchised outlet.\textsuperscript{21}

The arbitrators in \textit{H&R Block} reached a different and distinct decision.\textsuperscript{22} The panel concluded that the panel concluded that the franchisor did not violate a franchise agreement by

\textsuperscript{19} Knack and Bloodhart, \textit{Drug Emporium: The Reality Of The Virtual Do Franchisors Need To Rechart The Course To Internet Success?}, 20 Franchise L.J. 101 at 134 (Winter, 2001)

\textsuperscript{20} Emporium Drug Mart, Inc. of Shreveport aka Gibson Drug, Inc. of Shreveport; Emporium Drug Mart, Inc. of Longview; Emporium Drug Mart, Inc. of Tyler; Gibson Retail Group, L.P.; Gibson Merchandise Group, Inc.; Emporium Drug Mart, Inc. of LaFayette; Emporium Drug Mart, Inc. of Amarillo; Emporium Drug Mart, Inc. of Little Rock; Emporium Drug Mart, Inc. of Abilene; Emporium Drug Mart, Inc. of Lubbock; Emporium Drug Mart, Inc. of Waco; Discount Emporium, Inc. of Wichita; Discount Emporium, Inc. of Denton; Nortex Drug Distributors, Inc.; Mann Drug Inc. of Victoria; and Mann Drug Inc. of Brownsville, Claimants v. Drug Emporium, Inc. and Drugemporium.Com, Inc., Respondents, American Arbitration Association, Dallas, Texas, Case No. 71 1140012600 (September 2, 2000); Bus. Franchise Guide (CCH) ¶ 11,966.

\textsuperscript{21} On September 12, 2003, Drug Emporium, and its affiliates, F&M and VIIX stores, filed for protection under Chapter 11 of the U.S. Bankruptcy Code. The company sold or closed the 77 corporately owned and operated Drug Emporium stores. The franchised Drug Emporium stores in Texas and West Virginia were not affected.

\textsuperscript{22} In the Matter of Arbitration Between Franklin 1989 Revocable Family Trust, Claimant, and H&R Block, Inc., Respondent (AAA, Minneapolis, Minnesota, Case No. 16114005401, 2002), Bus. Franchise Guide (CCH) ¶ 12,473.
offering tax preparation services over the Internet even though some customers were within the claimant franchisee’s exclusive territory. The franchisee asserted that under its franchise agreement H&R Block was prohibited from “operating from a location” in the franchisee’s exclusive territory. The panel interpreted that provision to mean that H&R Block’s Internet services could not “unreasonably intrude on the franchisee’s operations.” According to CCH’s summary of the opinion, “so long as the franchisor’s Internet services did not unreasonably intrude on the franchisee’s brick-and-mortar operations, the franchisor was not operating in violation of the franchisee’s territorial exclusivity.” The panel held that H&R Block did not violate its franchisee’s exclusive territory and found that H&R Block’s Internet marketing and sales efforts were directed to a different market. The panel observed that during the alleged encroachment period, the franchisee’s customer count and overall revenues actually increased, and there was some evidence that the franchisee also gained additional customers from the franchisor’s Internet sales efforts.

In *Pro Golf of Florida v. Pro Golf of America*, a Michigan federal court denied a franchisee’s request to reconsider its denial of a motion for summary judgment on the issue whether the golf store franchisor breached its agreements by selling golf merchandise through its website within the franchisees’ exclusive territories. The court ruled that where the sale took place was a question of fact that could not be determined from the available evidence. The franchise agreements were silent with respect to the specific issue of Internet sales, but the court found that the agreements unambiguously reserved the franchisor’s right to sell golf equipment from outside the franchisees’ territories. Since the franchisees had not presented any evidence to determine where title to the golf equipment sold by the franchisor passed, the court refused to assume that this happened within the franchisees’ territories. The court also refused to interpret the franchise agreements as granting the franchisees the exclusive right to solicit business within their territories, because that would create a breach of the franchise agreement every time a person residing in the franchisees’ territories purchased golf equipment from a Pro Golf franchisee in another territory.

It was not evident from any of these cases that the franchisors actually shared any revenue from the Internet sales with their franchisees. *Drug Emporium* and *Pro Golf* each considered whether the franchisor was operating within the franchisee’s protected territories. In both cases, customer orders were taken from websites and filled outside of the franchisees’ territories. The only distinguishing fact seems to be that Drug Emporium originally acted like it was obligated to compensate its franchisees for Internet sales in their territories, but Pro Golf did not.

**Non-Internet Dual Distribution Programs**

Other forms of dual distribution can also lead to franchisee discontent and litigation. The *Carvel* cases are instructive. Carvel was embroiled in numerous cases with its franchisees over its supermarket program. The franchisees alleged that Carvel breached their franchise agreements by selling products in supermarkets. They also alleged that the supermarket program violated the covenant of good faith and fair dealing and amounted to tortious interference with the franchisees’ contractual relations.

The dispute began in 1992, when Carvel began to sell its products in supermarkets. That decision, which marked a significant deviation from prior marketing and sales efforts, did

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not sit well with certain Carvel franchisees who claimed that they had previously received assurances from the company's President and Chief Executive Officer that Carvel had no plans to distribute through supermarkets.

In the preceding decade, Carvel had seen sales in its franchised stores steadily decline as a result of competition from other frozen dessert providers who were selling their products in supermarkets and from non-traditional competitors such as McDonald’s and Burger King, who began selling frozen desserts in their restaurants. Because of this drop in sales, Carvel commissioned a study which concluded that it would be in Carvel’s best interests to begin distributing in supermarkets. Carvel accepted the recommendation and implemented its supermarket sales program.24

The Carvel supermarket sales program was not designed exclusively to benefit the franchisor. To the contrary, all Carvel franchisees were invited to participate by servicing the many supermarkets, convenience stores and other retail venues to which Carvel had agreed to supply its products at wholesale. Most Carvel franchisees welcomed the new business venture and the opportunity it provided. But a splinter group of Carvel franchisees refused to participate. They complained that they never expected that Carvel and other Carvel franchisees would compete with them for sales and revenue by supplying supermarkets and other accounts at wholesale. Carvel, on the other hand claimed that it created the supermarket program out of necessity, to respond to the consumer trend of purchasing ice cream mainly in supermarkets. That trend, Carvel noted, caused a dramatic decline in Carvel store customer traffic and was responsible for the closing of almost 30% of the chain’s stores. Carvel also relied on the aforementioned consultant’s report, which concluded that Carvel’s supermarket program was “…totally necessary if Carvel [was] to survive as a brand.”25

Carvel brought a declaratory judgment action in Connecticut federal court to affirm the legality of its supermarket program and the defendant franchisees asserted various counterclaims, including breach of contract, breach of the implied covenant of good faith and fair dealing and tortious interference with prospective economic relations. Carvel moved for summary judgment on its claim for declaratory relief, seeking an order that the Carvel supermarket program did not violate the two operative versions of the franchise agreement. The older form of agreement (Type A) granted franchisees a ¼ mile “exclusive territory,” while the newer form of agreement (Type B) was “site specific” only, with no territorial exclusivity. The Type B agreement also contained a specific reservation of rights on Carvel’s behalf to sell its products through alternative channels of distribution, including supermarkets.26

The court denied Carvel’s motion for summary judgment on the Type A franchise agreement, holding that “…the issue is not the degree of territorial protection afforded the (Carvel) franchisee by way of (the Type A franchise) agreement,” but rather whether the reservation of rights provision in the franchise agreement authorized the supermarket sales program. The court also placed great emphasis on a recital “acknowledgement” at the beginning of the contract, which stated that there was a “unique system” for the production, distribution and merchandising of Carvel products in free-standing Carvel stores.27

26 Id. at 57-59.
27 Id. at 60.
The court proceeded to grant (in part) Carvel's motion with regard to the Type B agreement, reasoning that it “unambiguously allow[ed] Carvel to implement the supermarket program.” However, the court held that notwithstanding Carvel’s clear contractual right to implement the supermarket program, Carvel could nevertheless have breached the implied covenant of good faith and fair dealing by doing precisely what its contract permitted it to do.

After the court’s ruling, the following claims remained to be litigated: breach of contract for selling in supermarkets and selling too close to the franchisee’s store (only available for those franchisees who signed a Type A franchise agreement), breach of the implied covenant of good faith and fair dealing (available to franchisees who signed either Type A or Type B agreements), and intentional interference with prospective economic relations, by unlawfully interfering with the relationships between Carvel franchisees and their customers by inducing customers to buy products from supermarkets (also available to franchisees who signed either Type A or Type B agreements).

There was no interlocutory appeal of the trial court’s decision, and the case proceeded to three separate jury trials. In each trial, the jury found for the franchisee and awarded damages in excess of $1 million. After Carvel’s post-trial motions were denied, it appealed all three verdicts.

The Second Circuit did not address all the issues that Carvel raised. Instead, it noted that there was an unsettled, significant question of New York law relating to the franchisees’ claims for tortious interference with economic relations, which the court believed would control the outcome of the case. The court therefore deferred its ruling on the contract and covenant of good faith and fair dealing issues and certified two questions to the New York Court of Appeals:

• Under applicable standards for a claim of tortious interference with prospective economic relations, did the evidence of the franchisor’s conduct in each of the three trials on review in these consolidated appeals permit a jury finding in favor of the franchisee? In answering this question, the Court of Appeals might wish to inform us whether, in the context of a tortious interference claim, New York would view the franchisor in this case as a competitor of the franchisees for the purposes of determining the applicable standard, and if so, whether a plaintiff must show that a competitor-defendant acted “wrongfully” but show that a “non-competitor” defendant acted “improperly.”

• Is public harm required for a punitive damages claim by a franchisee against its franchisor for tortious interference with the franchisee’s prospective economic relations with its customers?

In its decision, the New York Court of Appeals summarized the state of the law of tortious interference with prospective economic relations as follows:

• [T]he degree of protection available to a plaintiff for a competitor’s tortious interference with contract is defined by the nature of the plaintiff’s enforceable legal rights. Thus, where there is an existing, enforceable contract and a defendant’s deliberate

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28 Carvel Corporation v. Noonan, et al., 350 F.3d at 23. (Mr. Oppenheim’s law firm did not represent Carvel in this action.)
29 Id. at 26. The New York Court of Appeals did not address this issue in its recent decision because it was rendered moot based on its response to the first certified question.
interference results in a breach of that contract, a plaintiff may recover damages for
tortious interference with contractual relations even if the defendant was engaged in
lawful behavior. Where there has been no breach of an existing contract, but only
interference with prospective contract rights, however, plaintiff must show more culpable
conduct on the part of the defendant.

- Where a suit is based on interference with a nonbinding relationship, the plaintiff must
  show that defendant's conduct was not "lawful" but "more culpable." The implication is
  that, as a general rule, the defendant's conduct must amount to a crime or an
  independent tort. Conduct that is not criminal or tortious will generally be "lawful" and
  thus insufficiently "culpable" to create liability for interference with prospective contracts
  or other nonbinding economic relations.\(^\text{30}\)

Since the franchisees did not claim that the customers had binding contracts that Carvel
induced them to breach, but instead alleged that by implementing its supermarket program
Carvel induced customers not to buy Carvel products from the franchisees, the court ruled that
the franchisees were required to prove that Carvel’s conduct was criminal or independently
tortious. The New York Court of Appeals held that Carvel’s conduct was neither criminal nor
independently tortious because it did not constitute a crime or an independent tort and was not
aimed solely at harming franchisees, and was also not the sort of egregious wrongdoing that
might support a tortious interference claim absent such an independently unlawful act or evil
motive.\(^\text{31}\)

As a result, the franchisees could not recover on their interference claims unless an
exception to the general rule applied. That exception has been recognized, according to the
court, where a defendant engages in conduct for the sole purpose of inflicting intentional harm
on plaintiffs. But that exception was inapplicable because Carvel was motivated by normal,
economic self-interest; Carvel wanted to reverse a period of business declines and make itself
more profitable. Thus, the court found that Carvel was not acting solely to hurt the franchisees,
and indeed may have been indifferent to their fate.\(^\text{32}\)

The Court of Appeals also addressed the franchisees’ additional claim that Carvel used
"economic pressure" on them, which constituted "wrongful" conduct and supported the
franchisees’ claims for tortious interference. The court viewed the “economic pressure"
argument as ill-founded, for two independent reasons. First, the economic pressure that must
be shown is not, as the franchisees assumed, pressure on the franchisees, but on the
franchisees' customers. Conduct constituting tortious interference with business relations is, by
definition, conduct directed not at the plaintiff itself, but at the party with which the plaintiff has or
seeks to have a relationship.

Second, Carvel’s activities were not the sort of extreme and unfair "economic pressure"
that might be "wrongful" under existing New York cases. The crux of the franchisees' complaint,
the court noted, was that Carvel distributed its products through competitive channels, to an
extent and in a way that was inconsistent with the franchisor-franchisee relationship. As the
court observed: "...[T]he relationship between franchisors and franchisees is a complex one;
while cooperative, it does not preclude all competition; and the extent to which competition is

\(^{31}\) Id. at 189.
\(^{32}\) Id. at 190.
allowed should be determined by the contracts between the parties, not by courts or juries seeking after the fact to devise a code of conduct.”

Shortly after the Noonan decision, the parties settled their outstanding claims and dismissed the lawsuit. It appears that, at least for the moment, the saga between Carvel and its franchisees is over.

The Carvel cases epitomize the deleterious affect that a franchisor’s decision to sell products through alternative channels can have on the franchise relationship even if the agreement explicitly permits the conduct. Carvel’s decision to sell ice cream in supermarkets resulted in protracted and expensive litigation with its franchisees. The Baker decision, which permitted the franchisees to pursue their claims for breach of the covenant of good faith and fair dealing notwithstanding the clear language of the franchise agreement explicitly permitting the franchisor’s conduct, was certainly disturbing. Fortunately, the majority of courts that have considered the covenant of good faith and fair dealing in franchise cases have held that the “covenant” cannot be employed to change the express, unambiguous terms of the parties’ agreement.

b. Practical Solutions

The best protection for a franchisor against liability for selling through alternative channels of distribution is a specific reservation in the franchise agreement of the right to do so. Here is a sample provision:

**Reservation of Rights.** To offer and sell (either directly or through other franchisees), through channels and methods of distribution other than a dedicated [franchise], the same services and products which you will offer and sell under this Agreement, to any customer wherever located, including customers in your Territory and including customers near your [name for base or center] Location. These other channels and methods of distribution may include, without limitation, and except as otherwise provided in this Agreement: electronic marketing, such as computer network sales (including, without limitation, World Wide Web and/or other solicitations via the Internet or other on-line network); catalogues; shops, boutiques or licensed departments on the premises of another retail enterprise which also sells the products of third parties unrelated to us or our Affiliates; and other retail establishments of any kind other than a dedicated [franchise].

However, mature franchise systems frequently operate under antiquated franchise agreements that are silent regarding whether the franchisor has the right to sell through alternative channels within the franchisee’s territory. Franchisors must carefully review their agreements before developing and operating e-commerce Web sites or selling through other alternative channels. Before selling products through alternate channels, the franchisor should: (1) assess its existing franchise system and develop an economic model for its e-commerce approach that makes sense for that system; (2) review the legal issues and examine the current legal landscape; (3) review the franchise agreement to determine the existence of and scope of any protected territories; (4) determine whether the franchise agreement reserves the right of the franchiser to offer goods and services through alternative channels of distribution, and to what extent; (5) review all relevant portions of the franchise agreement that might be deemed ambiguous, and determine their effect; (6) review prior communications to determine whether

33 Id. at 193.
any implied obligations have been created; and (7) involve the franchisees in the establishment of the alternative distribution program.\textsuperscript{34}

If the franchisor decides to sell products through alternative channels and wants to gain the support of its franchisees, the franchisor should consider the following ameliorative steps: (1) the franchisor could direct any sales in a franchisee’s territory to that franchisee’s brick-and-mortar store; (2) the franchisor could direct any sales in a particular area to the closest franchisee and the customer would be required to pick up the item at the franchisee’s store; (3) the franchisor could have the nearest participating franchisee fill and ship the order; or (4) the franchisor could fill and ship the order and either give franchisees a percentage of the profit on a sale in a particular territory or contribute to the system’s advertising fund a certain percentage of all sales through alternative channels.\textsuperscript{35}

2. National and Institutional Accounts

Today, mature franchisors are able to sell their products or services through national or institutional account programs. "National or Institutional Accounts" are typically organizational or institutional customers of the franchisor whose presence is not confined to a particular territory. These national or institutional customers are able to leverage their broad purchasing power to obtain more favorable pricing arrangements with a franchisor. In addition, it is often the case that the national or institutional account will be reluctant to contract with the local franchisee, preferring instead to contract with the more established franchisor rather than multiple franchisees.

a. Legal and Practical Restraints

A national or institutional account can be a tremendous distribution opportunity for a mature franchisor. However, many franchise agreements from the 60s or 70s never contemplated national or institutional accounts. As a result, longstanding franchisees may hold contracts with territorial protections that would prevent the franchisor from servicing the national or institutional account without breaching the franchise agreement.

More modern franchise agreements typically provide a “carve out” for national or institutional accounts, permitting the franchisor to service those accounts even if it involves the sale of the franchised product or service within a franchisee’s designated territory. A typical provision follows:

\textbf{Reservation of Rights}. Both within and outside your Territory, [we reserve the right] to offer and sell [franchised] products at retail to National/Regional and Institutional Accounts. "National/Regional and Institutional Accounts" are organizational or institutional customers whose presence is not confined to your Territory, including (without limitation): hotels, restaurants, retail shopping stores, food stores such as supermarkets; federal, state, and local governmental and quasi-governmental agencies, branches or facilities; and any other customer not confined to your Territory. Only we will have the right to enter into contracts with National, Regional and Institutional Accounts with outlets or locations within your Territory.

\textsuperscript{34} Knack and Bloodhart, \textit{Drug Emporium: The Reality Of The Virtual Do Franchisors Need To Rechart The Course To Internet Success?}, 20 Franchise L.J. 101 at 137-139 (Winter, 2001).

\textsuperscript{35} Id, at 142, note 47.
b. Practical Solutions

Even if the franchise agreement permits the franchisor to enter into national or institutional accounts, there is still potential exposure for encroachment and breach of the covenant of good faith and fair dealing. In addition, even if there is no legal basis for the franchisee’s objection to the franchisor entering into an agreement with a national or institutional account to provide its products or services within a franchised territory, there is still the risk of system-wide discontent and backlash from the franchisees. As a result, many franchisors, whatever the franchise agreement terms, will work with an affected franchisee to allay the franchisee’s concerns and possibly even allow the franchisee to share in the economic benefits of the agreement.

There are three options available to the franchisor. First, the franchisor can reserve its right to service the national/institutional account unconditionally under the clear, unambiguous language in the franchise agreement as set forth above. Second, the franchisor can provide an option to the franchisee to service the account under the terms and conditions, including pricing, to which the franchisor and the national or institutional account have agreed. A franchisor should contemplate this possibility in advance and include a contract provision addressing the issue. For example:

We will give you the opportunity to service any outlets or locations of National/Regional and Institutional Accounts (collectively, “account”) in your Territory at the price we agree on with the Account. If, for any reason, you do not desire to service the Account or cannot service the Account for any reason, or if the Account desires for any reason to deal exclusively with us, our Affiliates or another franchisee and not with you, then we, our Affiliates or any other franchisee or subfranchisee may service the Account within your Territory, and you will be entitled to no compensation. The procedures governing our National/Regional and Institutional Accounts program will be set forth in our Manual.

A third option would be for the franchisor to service the account but pay a reverse royalty to the franchisee – a percentage of the revenues from servicing the account within the franchisee’s territory.

For mature franchisors operating under old franchise agreements that are silent regarding national and institutional accounts, there are only two options; either permit the franchisee to service the account and trail the account like any other customer or negotiate a reverse royalty or other concession to the franchisee, to permit the franchisor to serve the account in the franchisee’s territory.

3. Sale of Products at Non-Traditional Locations

In addition to national and institutional accounts, mature franchisors can also benefit from selling their products at non-traditional locations, such as military bases; workplace cafeterias; schools; kiosks; theaters/stadiums/hotels/institutions; seasonal outlets (beaches, ballparks and such); core unit “satellites” or “branches” and outlets on the premises of third party retailers.

The issues confronting franchisors that sell their products at non-traditional locations are the same issues that confront the franchisor that sells its products to national and institutional accounts. There is the very real possibility that selling from a non-traditional location will violate a franchisee’s territorial rights, especially if the franchisee is operating under a franchise
agreement written long ago before the franchisor even considered the concept of selling its products at non-traditional locations.

The available remedies are also similar to those available to a franchisor selling to a national or institutional account. First and foremost, the franchisor must make sure that its current contract permits it to sell its products or services at non-traditional locations. The following provision would suffice:

To offer and sell (either directly or through other franchisees), the same products and services which you will offer and sell under this Agreement, to any customer wherever located, including customers in your Territory and including customers near your franchised business from non-traditional locations, including (without limitation) supermarkets, airports; hotels; hospitals; toll plazas; universities; schools; factories; workplace cafeterias; federal or state military bases; stadiums; theaters (both movie and stage); federal, state or local government buildings and establishments; beaches, parks or other seasonal facilities; shops, boutiques or licensed departments on the premises of another retail enterprise which also sells the products of third parties unrelated to us or our Affiliates; and other retail establishments of any kind other than a dedicated Australian Homemade Shop and any such other institution.

We reserve the right in our sole discretion, to negotiate an agreement to provide the same products and services which you will offer and sell under this Agreement at these non-traditional locations in your Territory. You understand and acknowledge that this Agreement does not grant you any rights with regard to the sale of products and services at non-traditional locations.

As set forth more fully above in the discussion regarding national and institutional accounts, a franchisor can offer franchisees the opportunity to operate the non-traditional location, or to receive a reverse royalty.

C. Dealing with Increased Competition

A franchise system’s response its competition is a major factor in its ability to survive. Franchise systems have responded to changes in their competitive environment in different ways. This section will discuss changing product and services offered, pricing strategies and marketing programs.

1. Responses to Changes in Competition
   a. Change Product and Service Offerings

Franchisors, especially restaurant and hotel franchises, frequently change their products in response to competition. For example, many fast food restaurants have introduced “premium” coffees to compete with Starbucks® Coffee and “fresh” salads and sandwiches to compete with “fast-casual” restaurants like Panera and Chipotle. Hotels have added business centers, health clubs, spas and expanded children’s play areas and programs to attract the travelers who combine business and pleasure and want to bring their children on their trips.

Discontinuing a product line is another method of dealing with increased competition. Some products are discontinued because of mergers or acquisitions, such as Hardee’s acquisition of the Burger Chef system and the later conversion of Burger Chef restaurants into
Hardee’s® restaurants. More recently, General Motors’ decision to discontinue the Oldsmobile line has resulted in controversy and litigation.36

b. Change Pricing Strategies

One of the most common ways that franchisors deal with increased competition is to offer coupons and other discounts or bonus programs to their customers. These programs are intended to attract new customers and retain existing ones. While it is not very common for a franchise system to make dramatic changes in its pricing strategy, there have been examples of a franchise system splitting itself into different products, each with a different pricing strategy. In the hotel industry, both Holiday Inn® and Sheraton® Hotels divided their properties into different groups, each with a different pricing strategy. Holiday Inn created the Holiday Inn Express, Holiday Inn Select, and Holiday Inn SunSpree® Resorts. Each of these hotel groups has different pricing and is aimed at different market segments. Likewise, Sheraton created the Four Points brand to distinguish these hotels from full-service Sheraton Hotels.

c. Modify Marketing and Advertising Programs

Modifying marketing and advertising programs can include using different media for advertising and creating different marketing concepts altogether. The Internet has become a vehicle to both facilitate sales and, probably even more important, advertise goods and services.

2. Legal and Practical Restraints

a. Antitrust Issues

Non franchised competitors can deal with pricing and product issues differently than franchised systems can. A chain store system can establish uniform prices for all of its outlets. A franchisor cannot require all franchisees to charge the same prices for their products and services.37 While, in appropriate circumstances, the franchisor can establish maximum prices,38 in many cases, franchisees may reduce prices, causing intra-system competition that may not be healthy for the system.39

b. Contractual Limitations

Dealing with increased competition may require that franchisees invest in new equipment and facilities to offer new products and services. Whether the franchisor can require this investment once again depends upon the terms of the franchise agreement.40 This franchise agreement provision establishes the franchisor’s rights in this regard:

37 Resale price maintenance has consistently been condemned as per se illegal under Section 1 of the Sherman Act, 15 U.S.C. §1 et seq. See, Monsanto Co. v. Spray-Rite Service Corp., 104 S.Ct. 1464, Bus. Franchise Guide (CCH) ¶8141 (US S Ct 1984).
39 A full discussion of antitrust laws is well beyond the scope of this paper, but franchise antitrust issues are the subject of another workshop. See Lindsey and Wachsstock, Practical Application of Antitrust Constraints, American Bar Association, 29th Annual Forum on Franchising (2006)(Workshop 9).
40 For a discussion of similar issues in the context of changing consumer preferences, see Section II.A.3.a.
Modification of the System. Franchisor has the right to change or modify the System from time to time including, without limitation, the adoption and use of new or modified Marks or copyrighted materials, and new or additional computer hardware, software, equipment, supplies or techniques. Franchisee shall accept and use any such changes in, or additions to, the System as if they were a part of this Agreement as of the Effective Date. Franchisee shall make such expenditures as such changes, additions or modifications in the System as Franchisor may reasonably require. Any required expenditure for changes or upgrades to the System shall be in addition to expenditures for repairs and maintenance.

c. Franchise Registration, Disclosure Laws and Relationship Laws; Implied Covenant

Franchise registration, disclosure and relationship laws may limit a franchise system’s ability to deal with increased competition because they affect the franchisor’s ability to make modifications to the system and the franchisee’s obligations to comply. The primary effect of the relationship laws is the restrictions they place on a franchisor’s ability to terminate or not renew a franchisee. Also, franchise relationship laws obviously do not apply to non-franchised chain competitors. Therefore, if a chain system decides to close a store, relocate a store or make a significant investment to remodel the store, it can do so as its own business decision. If a franchisor wants to take any of these actions, the franchise relationship laws may impose good cause requirements and, in some cases, require the franchisee’s consent to the franchisor’s conduct.

3. Practical Solutions

One of the consequences of an increase in competition is that real estate prices escalate as good locations become in greater demand. If rent or land costs increase to a point where they jeopardize the profitability of the franchised unit, then the franchisor may have to look for locations with more reasonable rents.

In addition to different locations, the franchisor may be able to modify the design of the units to require less space or consider non-traditional sites. Over the past few years, Yum Brands has converted a large number of its single-brand units to multi-brand units. Instead of a stand-alone KFC restaurant, we now see a KFC combined with an A & W restaurant, or a Taco Bell with a Pizza Hut. This allows the franchisee to offer a wider range of products without having to incur duplicate costs for land building and equipment. Franchisors can also consider placing units in shopping malls, office building food courts, airports and other locations where competition is minimized and space requirements may be smaller.

D. The Need to Expand the System Through the Establishment of Additional Franchised or Company-Owned Units (Network Expansion and Encroachment)

This section discusses the mature franchisor’s need and ability to expand its system by establishing additional franchised or company-owned units while avoiding encroachment or other claims of breach of the franchise agreement.

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41 See discussion at Section II.A.3.b.
42 See discussion at Section II.A.3.c.
43 See discussion at Section II.A.3.d.
1. Co-branding with Other Retailers

In recent years, many franchisors have used co-branding to expand.44 Brands consist of trademarks, service marks, trade dress, signature products and services.45 Branding is extremely important in marketing a new concept, or in reinvigorating an old one by establishing an identity in the mind of the consumer.46 Co-branding allows the franchisor to create a synergy between two different products either within the same company, or between different companies, often without incurring the costs or risks associated with the development of new products, services or outlets.47

Some concepts lend themselves more to co-branding than do others. For example, we have seen gas stations co-brand with food service outlets to help meet customers’ high expectations of convenience, accessibility and quality.48 Many franchisors believe co-branding food concepts enables them to appeal to a broader market, and many franchisees agree.49 For example, Larry Durett, a franchisee of Yum! Brands, believes co-branding is the answer for increased sales for several reasons:

Multi-branding has a dramatic impact on the customer. It’s a barrier breaker for families, meaning that sometimes kids like to eat different things than adults. If you’ve got an A&W—Long John Silver’s, like we do in South Texas, you can see how it offers something for everyone. More globally, though, if you have a KFC—Taco Bell, you might get someone who wants a taco one day and who will come back the next day for chicken. When we add volume to these restaurants through multi-branding, we add incremental profits that we could not have gotten any other way. For example, if you take a good restaurant—like a $900,000 Taco Bell—and add a $400,000 Long John Silver’s, you have added incremental profits that would be impossible to get any other way.50

44 These are just a few concepts that have been co-branded. A review of June and July 2006 news articles shows that co-branding is as vibrant as ever. Country Kitchens of Ohio Co-Branding with Breaudeux Pizza, The Capital Times (Madison, Wisconsin), July 12, 2006, at D8; Richgels, New Franchise Aims at Upscale Diners, Yum! Brands Co-Branding With a Chain in Russia to Develop a Projected 100 Outlets, FD (Fair Disclosure) Wire, June 6, 2006; Yum! Brands, Inc. at Goldman Sachs Lodging, Gaming, Restaurant and Leisure Conference – Final; Long John Silver’s co-branding with Kentucky Fried Chicken, Journal of Business, June 2006, at A7; Wilson, Long John Silver’s Opens Inside KFC Eatery, Journal of Business, June 2006, at A7.


46 For example, to help Planet Smoothie compete with Jamba Juice, Raving Brands is testing co-branding efforts with Nestle Tollhouse cookies and Edy’s Ice Cream. Raving Brands believes this co-branding strategy has boosted sales in Atlanta’s Phipps Plaza. Support system: a franchisee-friendly formula and a bundle of fast-casual concepts position Raving Brands for national growth, Chain Leader, May 2006, at 53.

47 Long John Silver’s restaurants were combined with a KFC in areas where Long John Silver’s did not have a presence. By developing within an existing KFC, the construction and marketing expenditures were greatly decreased. Journal of Business, Id.

48 Hurwitz, at 378.

49 Taco Maker, Inc.’s Vice President of Franchise Development, Steven Krolak, said that by co-branding its Taco Maker restaurant with its Jake’s Over the Top restaurant, it could appeal to a broader market, enabling the company to develop outlets in Mexico, New Delhi and Puerto Rico. See Wallace, Deseret Morning News, CENTERVILLE Utah, The Associated Press State & Local Wire, July 5, 2006.

50 Yum! Brand owns the A&W, Long John’s Silver’s, Taco Bell, Pizza Hut and Kentucky Fried chicken which has enabled Yum! to maximize the potential of each brand. Yum! Reports That The Co-Branding Of These Brands Has Led To Increases In Sales As Much As 30%, Cornell Hotel & Restaurant Administration Quarterly, February 1, 2005, No. 1, Vol. 46; at 85; Enz, Multi-branding strategy: the case of Yum! Brands; CQ cases. Yum! Brands now operate
With co-branding comes reward, as well as risk. Ann Hurwitz’s 1995 article on co-branding establishes a great checklist to help evaluate whether co-branding is the right strategy. As Hurwitz suggests, the first step in the evaluation should be to identify a good strategic partner by ascertaining whether the partner will offer brand recognition/customer awareness, whether the partner will offer additional marketing opportunities, and whether the partner has a similar customer base. Failure to establish a good strategic partner may cause customer confusion, brand standards issues, financial returns or possible encroachment. Second, Hurwitz advises the franchisor to test the co-branding relationship to identify potential operational issues, and most important, to gather data to help determine whether the co-branding relationship will be beneficial. Third, if the franchisor still wishes to move forward with co-branding, Hurwitz advises that the franchisor must establish a clear structure for the co-branding relationship.

In addition, the franchisor should determine whether its franchisees have protected territories that will prohibit developing a co-branded store within a certain area; if so, opportunities may be so restricted that co-branding is impracticable. If co-branding is viable, there should be an approval procedure in the co-branding agreement for each potential site to avoid possible encroachment on a franchisee’s protected territory.

Even after following this approach, risks remain. Co-branding can divert attention from the core brand. Another risk is cannibalization of existing units’ sales, due to similar customer bases and marketing concepts. Co-branding can confuse customers, also causing cannibalization by the stronger concept. Finally, operating the co-branding concept can be extremely challenging and complex to handle.

2. Sale of Corporate Stores/Acquisition of Franchise Stores

Franchisors have used company-owned stores as a means to expand into new markets quickly, and then sell those outlets to franchisees. As recently as June 2006, Franchising World magazine stated that “judicious’ openings of company-owned stores can “be used to energize market penetration in existing markets or expedite entry into new ones”. Internationally, the sale of company-owned stores has enabled franchisors to expand in markets as far away as China. By opening a company-owned outlet first, the franchisor is able to test its concept and modify it as necessary, without depreciating the quality of its trademark, or otherwise injuring the more than 2200 multi-branded units in the United States, and those units account for almost 14 percent of its profits, with total sales of $ 24.2 billion in 2002, up from $ 22.3 billion in 2001. Yum! Brands, Inc., Annual Report for 2002, at 15.

51 Hurwitz states these marketing opportunities consist of increased advertising dollars, cross-marketing, and/or cross-promotional opportunities. Id, at 382. An example of such increased marketing is Power-Save Energy Corporation’s plans develop cross-promotions on its brochure and web-site, installation discount coupons in all customers' delivered units, and direct recommendations with its new co-branding partner, Mr. Electric, a subsidiary of the Dwyer Group, Inc., a worldwide franchise holding corporation supporting over 1100 franchisees in the United States and twenty-four foreign countries. Power-Save Energy Corp. is Pleased to Announce Mr. Electric as Its National Authorized Installer for the Power-Save 1200, PR Newswire, June 19, 2006.

52 This would include quality, service, cleanliness or other standards set by your franchise agreement if your co-branding partner does not have similar standards, especially where you are sharing a space.

53 Hurwitz rightly suggests that real data will help a franchisor justify the co-branding arrangement to your franchisees and gain their support for the initiative.

54 Enz, Multi-branding strategy: the case of Yum! Brands; CQ cases, Cornell Hotel & Restaurant Administration Quarterly, February 1, 2005, No. 1, Vol. 46; at 85.

goodwill associated with the franchise.\textsuperscript{56} Also, opening corporate stores enables a franchisor to attract new franchisees by providing them a store to “touch, feel and see”.\textsuperscript{57}

When a franchisor has economic woes, franchisors can sell corporate stores to raise capital. But in the past several years, franchisors have also sold corporate stores due to bankruptcy, or to get out of the business. For example, Ground Round, owned by American Hospitality Concepts, announced on February 13, 2004 that the company was suffering severe financial problems and would close 59 company-owned stores that day.\textsuperscript{56} The Ground Round franchisees banded together, formed the Ground Round Independent Owners Cooperative LLC and purchased the chain for $4.85 million.\textsuperscript{59} After the purchase, the new owners elected leaders, hired a law firm, created a buying co-op, renegotiated food contracts, and even introduced a new, low-carb menu.\textsuperscript{60} Professor John Rogers, the Dean of Business at American International College, suggested during an interview that this transaction could be an interesting model for franchising systems that have gotten a bit tired, and maybe the owners of the central franchise are looking for a way to move out of it or to recapitalize it. This would be a way to tap into both the entrepreneurial energy and the capital base of the franchise network.\textsuperscript{61}

We have also seen franchisors acquire franchisee’s stores through bankruptcy as well. One large-scale example is McDonald’s Corporation’s acquisition of franchised Boston Markets from Boston Chicken, Inc. Boston Chicken, Inc. filed for reorganization under Chapter 11 in October 1998. Through the bankruptcy, McDonald’s acquired 100 franchised units, and stipulated in the reorganization plan that it be allowed to close up to 100 underperforming Boston Market sites, whether franchised or company-owned. In a clever stroke, the acquisition enabled McDonald’s to expand without cannibalizing its hamburger business, acquire sites that it could convert to McDonald’s or its other brands\textsuperscript{62}, offer employment opportunities to its staff, and develop co-branded stores\textsuperscript{63}


\textsuperscript{57} Id, Franchising World, June 2006.

\textsuperscript{59} The acquisition group also absorbed US $42m (GB£23.07m) in claims against the bankrupt estate and related parties. CorpfinWorldwide.


\textsuperscript{62} McDonald’s also owns the Chipotle Mexican Grill, Donatos Pizza and Aroma Cafe brands. \textit{McDonald's to Add more Non-Burger Units}; \textit{Chicago Tribune}, March 30, 2000, Business; Pg. 4. Another writer speculated that McDonald’s original plan was to acquire the Boston Market sites then convert them to McDonald’s or Chipotle’s, but after remodeling, marketing and a new menu caused unit-to-unit growth of 7 to 8% each month, McDonald’s decided to keep many of the locations as Boston Markets. \textit{Boston Market Takes Improved Home-Style To Texas}; \textit{The Food Institute Report}, June 18, 2001, Pg. 3.

\textsuperscript{63} McDonald’s also planned to open Boston Markets at the supermarket chain Food Lion grocery stores as part of a “take and go” format. This test concept would allow customers to purchase rotisserie chicken, meat loaf, side dishes,
3. **Re-Alignment of Franchised Territories**

Re-alignment of franchised territories is another method to increase sales and expand a franchise system. Over time, demographics may change, requiring a change to franchised territories in order to serve customers more efficiently. Franchisor attempts to re-align territories have met with resistance from franchisees, especially in franchise systems where the franchisee may have been operating in the same location for decades.

One of the most expansive decisions addressing this subject is *Petereit et al. v. S.B. Thomas, Inc. et al.*\(^6^4\) In *Petereit*, distributors of Thomas' English Muffins – embittered when their sales territories were dramatically realigned as part of Thomas’ effort to boost its sluggish sales – sued, complaining that the re-alignment had "constructively terminated" the distributorship agreements. After determining that the distributors were franchisees under the Connecticut Franchise Act\(^6^5\), the Connecticut federal court held that Thomas' territorial realignment did constructively terminate the subject distributorships without the good cause required by the Act.

On appeal, the Second Circuit Court agreed that the distributors were "franchisees" under the Connecticut Franchise Act and that the territorial realignment resulted in constructive terminations:

> Although, as noted, Connecticut's courts have not spoken on whether a cause of action exists for constructive termination of a franchise, the remedial nature of the Act supports the view that such a claim lies. If the protections the Connecticut legislature afforded to franchisees were brought into play only by a formal termination, those protections would quickly become illusory. *We think it reasonable therefore to believe it was the legislature’s aim to have the umbrella of the Act's protection cover constructive as well as formal termination. To hold otherwise would allow franchisors to accomplish indirectly what they are prohibited from doing directly.*

> *We think (that constructive termination) may be found when a franchisor's actions result in a substantial decline in franchisee net income... Whether a decline in net income is substantial will necessarily depend on the particular facts and must be determined on a case-by-case basis* (emphasis added).\(^6^6\)

But the Court of Appeals held that Thomas in fact had good cause to terminate:

> The language of the Act leaves no doubt that good cause exists when the franchisee materially breaches the agreement. Equally clear is the legislature's plan that the meaning of good cause is broader than franchisee breach... Allowing the legitimate business concerns of a franchisor to be part of the "good cause" equation does not require a showing of unprofitability... When the franchisor demonstrates that its business decision is legitimate and made in good

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\(^6^5\) Connecticut General Statutes, "42-133e, et seq.

faith -- even if shown by hindsight to be made in error -- a court should not replace the grantor's decision with its own (citation omitted).

In the case at hand Thomas determined it could increase sales by increasing service frequency. This result it thought best accomplished by rationalizing its distributors' haphazard routes. The Act protects franchisees from the arbitrary exercise of the franchisor's greater economic strength. But this case does not concern such arbitrary action. Here we are faced with a legitimate business need to increase sales and the steps taken to further that goal. Thomas' goal of increasing sales constitutes "good cause" within the meaning of the Franchise Act. Thus, the Act does not prevent defendant from realigning plaintiffs' territories. (emphasis added).67

4. Expansion through Diversity Efforts and/or Urban Markets68

Utilizing diversity outreach as a means to attract new franchise candidates and expand to untapped markets has become more popular in recent years, especially recruitment of African-Americans and Hispanics. Minorities also are able to receive special grants that other groups cannot, thereby eliminating the largest hurdle faced by minorities who want to become business owners – the access to capital. Don DeBolt, the former president of the International Franchise Association, stated that franchisors are seeking minority franchisees because "They know it is just good business. Minority franchisees serve as a role model to attract other minority franchisees and of course, minority franchisees have the most expertise in reaching the ethnic consumer market they represent." 69 According to the IFA, McDonald’s, Days Inn, Burger King and Wendy’s are franchisors that are most recognized for their minority franchising efforts, although many other companies are expanding their efforts in this arena. The IFA has also created the Minorities in Franchising Committee to provide a support network and connect minority candidates with franchise concepts. In the Chicago market, The Coffee Beanery works with ethnic minority community groups and trade associations that have special loan programs arranged with local banks. Yum! Brands has developed a minority franchise recruitment program that includes discounts on the initial franchise fees, special loan programs and other inducements.70

When constructing a diversity program, it is important for the franchisor to consider understanding legal issues and constructing its program accordingly. An article in Franchising World suggests that the franchisor must first understand the differences between affirmative action, equal opportunity and diversity. Affirmative action creates legal directives for mandatory and voluntary programs that are created to eliminate past discrimination. Equal opportunity programs, however, prohibit discrimination on the basis or race, color, creed, religion, sex, age, national origin, sexual orientation, arrest or conviction record, disability, ancestry, marital status or political affiliation to all people equal access. Diversity initiatives, on the other hand do not

67 Id. at 27,108-27,109.
68 For more information on diversity programs, see Kotel, Meaney and Tyre, Embracing Diversity in Franchise Systems – And Managing Associated Legal Risks, American Bar Association, 29th Annual Forum on Franchising (2006)(Workshop 12).
69 Wood, Minority franchisees are useful role models in attracting other ethnic groups to set up in business - and have the experience of doing so themselves, Financial Times (London, England) June 26, 2001.
70 Id.
focus on funds or business practices, but are instituted to change a culture of an organization to maximize the potential of all persons participating in the organization.71

There are no specific laws governing administration of diversity programs, but the laws regarding equal opportunity and constitutional rights apply. Franchising World suggests that franchisors observe the following tenets when creating their diversity program: (1) avoid creating any set-asides or quotas; (2) do not focus on race as the sole determinant in the selection process; (3) avoid creating a program that infringes on other’s rights; and (4) keep the initiative temporary.72 With this framework, the franchisor can create a diversity program that will help it obtain a more diverse franchisee population.

5. Sales of Goods Under an Alternative Trademark

Some franchisors, instead of co-branding, have expanded their systems by manufacturing or selling goods or services under an alternative trademark. This can prompt litigation by franchisees, too. In 1999, General Nutrition Centers formed an alliance with Rite Aid to sell vitamins and supplements under the brand name PharmAssure™. GNC franchisees sued, claiming that the vitamins and supplements were virtually identical to GNC Brand Supplements and, therefore, violated the exclusive territory provision of its franchise agreement.73 The franchisor did retain the right in the franchise agreement to sell and distribute goods or services under another trademark inside the franchisee’s protected territory.74 The New Jersey federal court held that the contract gave GNC the right to sell non-GNC branded products in the franchisee’s territory, and that the PharmAssure™ products were not GNC brands.

71 How to survive scrutiny: auditing a franchisor’s diversity efforts: for franchisors, diverse communities in the United States represent new markets and new opportunities for system expansion, Franchising World, June 1, 2006.
72 Id.
73 Kazmierski v. General Nutrition Cos., 2000 U.S. Dist. LEXIS 20819 (D. N.J., 2000). The franchise agreement stated: For a period of two years, Franchisor, shall not itself operate, nor grant a franchise for the operation of, another General Nutrition Center under the System within the Protected Territory, as described on page 1. If after expiration of such two year period Franchisor identifies within the Protected Territory a site for development of a franchised GNC store which is (1) a new available site or an existing company-owned GNC store; (2) a transfer of an existing franchised GNC store repurchased by or made available to Franchisor; or (3) an existing independent store that does not convert to a GNC store but is made available to Franchisor, then Franchisor shall grant to Franchisee the right and option to franchise such site by providing to Franchisee a written notice and a completed agreement or Development Agreement for such site along with Franchisor's then current Uniform Franchise Offering Circular ("UFOC"). Id., at 4.
74 The franchise agreement stated, in relevant part: “Franchisor retains the right, among others, on any terms and conditions Franchisor deems advisable, and without granting Franchisee any rights therein, (i) to use, and to license others to use, the System and Proprietary Marks for the operation of General Nutrition Centers at any location outside of the Protected Territory; (ii) to sell and distribute, directly or indirectly, any goods or services, including, without limitation, GNC Brand Vitamins under the Proprietary Marks or any other proprietary marks to business or individual consumers located within or outside the Protected Territory, through the use of direct mail, mail order, Internet, catalog sales or any other similar method and (iii) to use and license the use of other proprietary marks in connection with the operation of retail vitamin, health food, nutrition, or fitness stores which are the same as, similar to, or different from the Franchised Business, and which may be located at any location; provided, however, that such stores shall not carry or offer for sale GNC Brand Vitamins if located within the Protected Territory….” Id at 5.
E. Acquiring a Competitor to Increase Market Share

Mature franchise systems can sometimes achieve substantial and immediate growth through a merger with, or acquisition of, another system. For a mature franchise system, however, participation in a merger is not without business and legal risks. Franchise systems and their counsel must take the appropriate steps to understand the areas and degree of potential exposure before the transaction so that they can properly assess whether the transaction is appropriate (and if so under what terms) and whether it will ultimately benefit the franchise system.

1. Legal and Practical Restraints

It is critical for a mature franchisor in a proposed acquisition to evaluate the legal and practical restraints. From a business perspective, it must first identify the ultimate goal of the acquisition. If the mature franchisor is acquiring a competitor, it must decide if the plan is to operate two competing businesses, convert the acquired system into its existing franchise system, convert the existing system into the acquired franchise system or co-brand the two systems. If the goal is conversion, the business team must examine the synergies between the two systems to see if they can be integrated easily and cost effectively. In addition, the parties must investigate potential territorial overlaps that will adversely affect the sales of both existing and acquired franchises. Most important, the parties must assess whether the franchisees, a critical third party in the transaction, will willingly go along with the post-merger plan.

The key legal issue is whether the franchise agreements address the contemplated activity. If a franchisee or group of franchisees sues to attempt to defeat the transaction, a court will likely refer to the express terms of the franchise agreements for guidance.

Unfortunately, mature franchise systems – for political and historic reasons – typically operate under "older" forms of franchise agreements that are silent regarding the franchisor's ability to merge, acquire or be acquired. But they are explicit about conferring certain rights upon franchisees and imposing certain obligations upon franchisors – rights and obligations that may impede or defeat altogether the ability to consummate the proposed merger or acquisition. For example, if the business plan is to merge with or acquire a competing franchise network with units proximate to the acquiror's franchised units and convert those units to the acquiror's brand and system, but the franchise agreement of either the acquiror or the target confers explicit territorial exclusivity upon franchisees (with the subject franchisor reserving few, if any, rights to "invade" any franchisee's exclusive territory other than for failure to meet performance standards or to comply with the terms of the franchise agreement), consummation of the transaction will result in multiple (perhaps universal) breaches of contract.

Even when a franchise agreement clearly does not grant a franchisee any territorial exclusivity, there is still exposure to the franchisor because courts have, in certain circumstances, deployed the implied covenant of good faith and fair dealing to find territorial protections where the contracts at issue ostensibly afforded none.

Further, absent franchise agreement language expressly authorizing the franchisor to make wholesale modifications to its system -- including change of concept, authorized product/services, names, marks, interior/exterior fixtures and advertising philosophy/methods --

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75 For an additional discussion of litigation resulting from a franchisor's merger and acquisitions, see Reilly, Stadfeld and Wharton, Litigation After Acquisition of a Competing Franchise System, American Bar Association, 29th Annual Forum on Franchising (2006)(Workshop 6).
a planned merger or acquisition contemplating conversion of the target company's franchisees may similarly be contractually prohibited.

Even when the targeted company's franchise network is to continue operating as before following the planned transaction, there is still no guarantee that affected franchisees will not commence litigation in order to disrupt the transaction.

2. Potential Causes of Action Advanced By Franchisees to Defeat an Acquisition

Given the clear, unequivocal language of many franchise agreements with regard to territorial exclusivity; the silence of most agreements regarding merger or acquisition activity; the amorphous implied covenant of good faith and fair dealing doctrine; and, the case law recited and analyzed below, it is frequently the case that -- unless adequate measures are taken to deflect and/or compensate territorially encroached, economically threatened or otherwise antagonistic franchisees -- these franchisees will sue for breach of contract; breach of the implied covenant of good faith and fair dealing; violation of applicable state franchise disclosure laws; common law fraud; violation of applicable state franchise relationship laws; breach of fiduciary duty; and unfair trade practices seeking to enjoin the transaction.

a. Breach of Contract

The majority of franchise agreements of mature franchisors are silent on the franchisor's ability to merge, acquire or be acquired. Frequently, vast numbers of these contracts (usually with the chains' largest franchisees) date back to the 70's, 60's or even earlier, and for political purposes have changed only slightly since then.

It is not uncommon for an "old" franchise agreement to provide "exclusive territories" to a franchisee; prohibit traditional modifications to the franchisor's system (including change of name, concept and interior/exterior fixtures and/or co-branding); and otherwise provide for franchisee rights and franchisor obligations which may make conversion of the acquired or merged chain difficult, if not impossible.

If a franchise agreement in a mature system prohibits the merger or would make it more difficult for the acquiror to achieve its ultimate objective as a result of the contractual provision, measures must be taken to mollify, compensate and/or release the affected franchisees in order to consummate the transaction.

Even when the subject franchise agreement explicitly sets forth a franchisor's right to sell out to a third party, a court may still intervene. In A.J. Temple Marble & Tile, Inc. v. Union Carbide Marble Care, Inc. et al.:76 the franchise agreement and UFOC repeatedly and explicitly authorized the franchisor to sell to another entity, subject to just two conditions – the assignee agreed to assume all contractual obligations to franchisees and the assignee was financially capable of doing so. Even though each condition was met, the trial court permitted a franchisee to proceed with two causes of action for common law fraud and violation of the New York Franchise Act77 by alleging that there was some specific, secret, pre-existing plan to have the franchisor sell out that was concealed from the franchisee.

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76 618 N.Y.S.2d 155, 162 Misc.2d 941, Bus. Franchise Guide (CCH) ¶10,523 (S.Ct., N.Y.Cty. 1994). Mr. Oppenheim's firm represented the Union Carbide defendants in this action.

Naturally, if the acquired or merged franchise network is not to be "converted" to the franchisor's name and concept, or if the acquisition is consummated by a franchisor holding company that is merely acquiring another chain, then many of these problems may disappear -- but not always. In First and First, Inc. et al. v. Dunkin Donuts, Inc. et al., Dunkin Donuts was set to acquire Mister Donut. The Mister Donut franchisees sought to enjoin the proposed acquisition claiming that the merger violated the Sherman Act, was the product of tortious interference with contract and would result in breach of contract. Rejecting plaintiffs' motion for a preliminary injunction, the court held that the Mister Donut franchisees had not proven a probability of success on their antitrust action:

Plaintiffs, for various reasons, do not want the proposed merger to take place and they have tried to define a relevant product market in which Mister Donut and Dunkin Donuts were the principal participants and in which the proposed merger would seem, therefore, to eliminate substantial competition. We are not unsympathetic to their concerns, but a federal antitrust action is not the appropriate vehicle in which to air them. The federal courts have on many occasions rejected self-serving efforts to define away competition would proffer market definitions that resemble the proverbial "strange red-haired, bearded, one one-eyed man-with-a-limp" (citation omitted).

The Court also denied the franchisees' motion for a preliminary injunction on their claims of breach of contract and tortious interference with business relations, observing:

We can find nothing in plaintiffs' franchise agreements which prevents Mister Donut from selling its stock. Moreover, the facts give us a clear picture of defendants, who have said over and over again, that they will honor all contractual commitments of Mister Donut. Beyond speculation, we have seen no proof that they will not and believe that if any violations ever do actually occur, they could adequately be handled in an action at law. In short, we find no breach, anticipatory or otherwise, or evidence of a lack of good faith or fair dealing (emphasis added).

b. Violation of the Implied Covenant of Faith and Fair Dealing

The implied covenant of good faith and fair dealing has also been deployed by franchisees challenging their franchisors' merger and acquisition activities. For example, in Clark et al. v. America's Favorite Chicken Co. et al., owners of several Popeye's Fried Chicken franchises appealed from a U.S. District Court's summary judgment order dismissing their claims about their franchisor's acquisition and operation of a competing franchise system, Church's Fried Chicken. The plaintiffs claimed that Popeye's (the corporate predecessor to appellant AFC) violated the implied covenant of good faith and fair dealing by consummating the acquisition. In affirming dismissal of the franchisees' claims, the Fifth Circuit noted that the franchise agreement at issue explicitly authorized the franchisor to "...develop and establish other franchise systems for the same, similar, or different product or services" – a contractual

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79 Bus. Franchise Guide (CCH) ¶9595 at 28.
80 Id. at 30.
81 110 F.3d 295 (5th Cir. 1997).
provision that the franchisees had unsuccessfully sought to negotiate out. Citing its decision in *Domed Stadium Hotel, Inc. v. Holiday Inns, Inc.* the court held:

This (franchise agreement) language unambiguously reserves to AFC the right to enter into (the franchisees’ trade) area and compete against them under a different set of proprietary marks. Moreover, the record establishes that appellants were aware of the significance of this provision... They cannot now be heard to argue that actions expressly authorized by this provision constitute a breach of the implied covenant of good faith and fair dealing... **In sum, the franchise agreement expressly reserves to AFC the right to do what precisely what appellants now charge it with: to compete against its franchisees under a different set of proprietary marks** (emphasis added).

A motion for summary judgment on an “implied covenant” claim challenging PepsiCo’s acquisition of franchisor Hot ’N Now failed in *Loehr et al. v. Hot ’N Now, Inc. et al.* The essence of the franchisee’s suit was that PepsiCo purchased Hot ’N Now solely to use it as an experiment to improve the operations of another of its franchising subsidiaries, Taco Bell. The franchisee alleged that the defendants destroyed his business by materially altering Hot ’N Now’s fast food concept, and asserted causes of action for breach of contract and breach of the implied covenant of good faith and fair dealing. Even though the plaintiff’s agreement specifically permitted the transaction, the court denied PepsiCo’s motion. The court explained:

“...(T)he implied covenant of good faith limits the controlling party's discretion and the controlling party 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” (citation omitted). Therefore, the issue of whether defendant's (sic) breached its (sic) implied duty of good faith and fair dealing is a question of fact most properly resolved by the jury.

Also, in *St. Charles Foods, Inc. v. America’s Favorite Chicken Company,* the Eleventh Circuit held that a franchise agreement granting the franchisee a right of first refusal for development of new franchises in the same county was ambiguous as to whether it applied to both of the franchisor’s brands (Church’s and Popeye’s) or just the brand under which the franchisee had operated (Popeye’s). Accordingly, the court reversed the dismissal of the franchisee’s claims against the franchisor for granting a competing franchise in the same county and not offering the franchisee a right of first refusal.

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82  732 F.2d 480 (5th Cir. 1984).
83  *Id.*  Cf. *A.J. Temple Marble & Tile, Inc. v. Union Carbide Marble Care, Inc., et al., supra.* at n. 93, where a franchisee’s "implied covenant" claim complaining of the sale of its franchisor to a third party was permitted to survive a motion to dismiss even in the face of clear franchise agreement language specifically authorizing such a sale. While the franchisor had the right to sell out, observed the court, an "implied covenant" inquiry was proper regarding the franchisee’s contention that "(Union Carbide Marble Care) sold the system to an entity with no experience as a franchisor, with no reputation, recognition or renown in the marble or stone care business...".
84  *Bus. Franchise Guide (CCH) ¶11,352 (S.D.Fla. 1998).*
85  *Id.*
86  198 F.3d 815 (11th Cir. 1999).
c. **Violation of State Franchise Disclosure Laws/Common Law Fraud**

Even when all subject franchise agreements clearly authorize the contemplated merger or acquisition, claims of common law fraud and/or violation of state franchise disclosure laws can be advanced. The most common fraud allegation is a claim that the selling franchisor misrepresented its intentions during the sale process. Here, the franchisee will claim that the mature franchisor knew that it intended to sell the system but did not disclose that information to the franchisee before selling it the franchise. *Century Pacific, Inc. et al. v. Hilton Hotels Corporation, et al.* illustrates this point. In *Century Pacific*, the plaintiffs entered into franchise agreements with Red Lion Hotels, which at the time was a subsidiary of Hilton Hotels Corporation (“Hilton”). Hilton acquired the Red Lion brand as part of its larger acquisition of Promus Hotels, Inc, which owned the Embassy Suite, Hampton Inns and Homewood Suites hotel brands.

According to the plaintiffs, when they entered into their franchise agreements, Hilton had secretly decided to market the Red Lion brand for sale while publicly claiming that it planned invigorate and expand the brand. The franchisees further alleged that Hilton decided to lock-in as many long term franchise agreements as possible before the sale, to maximize the price for the Red Lion brand.

The franchisees asserted that during the negotiations to purchase the franchises, Hilton induced the owners to enter into the franchise agreements by promoting the value of the Hilton name and the benefits of being a member of the Hilton Family of brands (i.e., access to Hilton’s worldwide reservation system, cross-selling opportunities with sister brands, participation in Hilton group purchasing plans and future participation in the prestigious Hilton HHonors program). Hilton’s employees also purportedly assured the franchisees that the Red Roof brand was important to the Hilton family and that there was no intention to sell the brand. According to the franchisees, they relied on these oral representations in ultimately deciding to purchase the franchises.

Less than one year after the plaintiffs entered into their franchise agreements, Hilton sold Red Lion to WestCoast Hospitality Corporation. The franchisees sued Hilton, Doubletree Corporation (another Hilton subsidiary), and Red Lion claiming violations of the New York Franchise Sales Act, common law fraud, negligent misrepresentation and fraudulent omission. The defendants moved to dismiss the complaint in its entirety. The district court dismissed the plaintiffs’ claims under the New York Franchise Sales Act because it did not apply to the transaction, but allowed the common law claims for fraud and misrepresentation to proceed.

The *Century Pacific* case highlights the dilemma for mature franchisors contemplating an acquisition. A franchisor must be careful not to disclose too much about a planned sale or acquisition, especially when the franchisor is a publicly traded company. However, as this case illustrates, failure to disclose planned sales activity can expose the franchisor to liability to franchisees that purchased a franchise based on representations about the plan for the systems, which later turn out to be untrue.

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87 See discussion of A.J. Temple Marble & Tile, Inc. v. Union Carbide Marble Care, Inc. et al., supra.
89 Id. at 2.
90 Id.
91 Id.
While there is no failsafe method for shielding the franchisor from liability in these situations, including in all franchise agreements clear and unambiguous statements about the franchisor’s right to sell the brand at any time to any purchaser, coupled with a broad integration clause, will provide maximum protection against franchisee claims after a merger or acquisition.

d. **Violation of State Franchise Relationship Laws**

Eighteen states have franchise laws which regulate the franchise "relationship" itself. Franchisees challenging planned mergers or acquisitions will frequently attempt to deploy one or more elements of these statutes, claiming that the planned transaction will so violate existing contractual rights and/or alter the acquired chain's identity (when the acquired chain is to be "converted" to the acquirer's name and format) that a "constructive termination" of the franchise agreements will have occurred in violation of the "no termination without good cause" tenets of franchise relationship laws.

e. **Unfair Trade Practices/Violation of State “Little FTC Acts”**

Another common cause of action after a franchise system merger or acquisition is for common law unfair trade practice or violation of a state “little FTC Act”, particularly where the acquisition involves one competitor acquiring another. While these claims are typically unsuccessful, they can result in costly litigation for the acquirer.

In *Hanson Hams v. HBH Franchise Company*, a subsidiary of HoneyBaked Ham, a ham retail store franchisor, acquired Heavenly Ham, its major competitor. The plaintiff, a Heavenly Ham franchisee in Florida, sued HBH, the parent company for the competing franchise systems. The only claim in the complaint was that HBH's treatment of the Heavenly Ham franchisees post-acquisition was unfair, deceptive, and unconscionable in violation of the Florida Deceptive and Unfair Trade Practices Act ("FDUTPA"). The plaintiff alleged that the acquisition pitted two competing franchise systems against each other and that HBH's goal was to treat the systems disproportionately and ultimately drive the Heavenly Ham franchise system

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92 Arkansas Franchise Practices Act, Arkansas Code Ann., Title 4, Ch. 72, Section 4-72-201 et seq.; California Franchise Relations Act, California Business and Proessions Code, Div. 8, Ch. 5.5, Section 20000 et seq.; Connecticut General Statutes, Title 42, Ch. 739 Section 42-133e et seq.; Delaware Franchise Security Law, Delaware Code Ann., Title 6, Ch. 25, Section et seq.; Hawaii Rev. Stat., Title 26, Ch. 482E, Section 482-E6; Illinois Franchise Disclosure Act, Illinois Compiled Statutes, Ch. 815, Sections 705/18-705/20; Indiana Deceptive Franchise Practices Law, Indiana Code, Title 23, Art. 2, Ch. 2.7, Section 1 et seq.; Iowa Code, Title XX, Ch. 523H, Sections 523H.1 et seq.; Michigan Franchise Investment Law, Michigan Compiled Laws, Ch. 445, Section 445.1527; Minnesota Statutes, Ch. 80C, Section 80C.14; Mississippi Code Ann., Title 75, Ch. 2, Section 75-24-51 et seq.; Rev. Stat. of Missouri 1986, Ch. 407, Section 407.400 et seq. and 407.420; Nebraska Franchise Practices Act, Rev. Stat. of Nebraska, Ch. 87, Art. 4, Section 87-401 et seq.; New Jersey Franchise Practices Act, New Jersey Rev. Stat., Title 56, Ch. 10, Section 56-10-1 et seq.; South Dakota Franchises for Brand-Name Goods and Services Law, South Dakota Codified Laws, Title 37, Ch. 37-5A, Section 37-5A-51; Virginia Retail Franchising Act, Virginia Code, Title 13.1, Ch. 8, Section 13.1-564; Washington Franchise Investment Protection Act, Revised Code of Washington, Title 19, Ch. 19.100, Section 19.100.180 and 19.100.190; Wisconsin Fair Dealership Law, Wisconsin Statutes, Ch. 135, Section 135.01 et seq.; District of Columbia Franchising Act, District of Columbia Code, Title 29, Ch. 12, Section 29-1201 et seq.; Puerto Rico Dealers' Contracts Act, Laws of Puerto Rico Ann., Title 10, Chapter 14, Section 278 et seq.; and Virgin Islands Franchise Business Act, Virgin Islands Code Ann., Title 12A, Chapter 2, Subchapter III, Section 130 et seq.


95 Id.
out of business.96 According to the plaintiff, Heavenly Ham franchisees paid more money for advertising in their first year than the HoneyBaked Ham franchisees paid; HoneyBaked Ham franchisees received reduced royalties unavailable to Heavenly Ham franchisees; and HoneyBaked Ham franchisees received lower prices for the same ham and turkey products.

Following discovery, HBH moved for summary judgment. Initially, the court noted that circumstances could exist where a corporation could be liable for violation of FDUTPA by not according two of its related entities the same treatment, but only if a plaintiff could successfully prove that the defendant committed an unfair act -- defined under the statute as an act which offends established public policy or is immoral, unethical oppressive, unscrupulous or substantially injurious to the public.97 The court observed that the plaintiff was not being treated differently post-acquisition than it was treated before the acquisition. To the contrary, plaintiff’s only claim was that it should receive the benefits afforded HoneyBaked Ham franchisees simply because, as a result of the acquisition, both franchise systems were wholly-owned by a common parent. The court granted HBH’s motion for summary judgment because the plaintiff’s franchise agreement explicitly permitted the franchisor to sell the franchise system to a third party even if the third party was a competitor and the challenged conduct did not offend established public policy or otherwise violate the FDUTPA.

3. Practical Solutions

First and foremost, it is imperative that franchise counsel ensure that their clients’ franchise agreements contain explicit, expansive and conclusive language unconditionally permitting future mergers or acquisitions and permitting the acquiring franchisor to lead the acquired company in any direction that it sees fit. For example:

Reservation of Rights. We specifically reserve all other rights to ourselves and our Affiliates. For example, and without limitation, we and our Affiliates have the right, now or in the future:

To purchase, merge, acquire, be acquired by or affiliate with an existing competitive or non-competitive franchise network, chain or any other business regardless of the location of that network’s, chain’s or business’s facilities, and to operate, franchise or license those businesses and/or facilities as Businesses operating under the Proprietary Marks or any other marks following the purchase, merger, acquisition or affiliation, regardless of the location of these facilities, which may be within the Territory, and proximate to your [name for base or center] Location.

In addition, the franchise agreement must reserve the franchisor’s right to assign its rights under the agreement without the consent of the franchisee:

Assignment by Us. We will have the right to assign this Agreement, and all of our rights and privileges under this Agreement, to any person, firm, corporation or other entity, provided that, if the assignment results in the performance by the assignee of our functions under this Agreement: (i) the assignee must, at the time of the assignment, be financially responsible and economically capable of performing our obligations under this Agreement, and (ii) the assignee must expressly assume and agree to perform these obligations.

96 Id. at 5.

97 Id. at 5, citing PNR, Inc. v. Beacon Property Management, Inc., 842 So.2d 773, 777 (Fla. 2003) (citations omitted).
You agree and affirm that we may sell our company, our assets, our Proprietary Marks and/or our system to a third party; may go public; may engage in a private placement of some or all of our securities; may merge, acquire other corporations, or be acquired by another corporation; and/or may undertake a refinancing, recapitalization, leveraged buyout or other economic or financial restructuring. With regard to any of the above sales, assignments and dispositions, you expressly and specifically waive any claims, demands or damages arising from or related to the loss of our name, Proprietary Marks (or any variation thereof) and System and/or the loss of association with or identification of "[Name of Corporation]" as the “Franchisor” under this Agreement. You specifically waive all other claims, demands or damages arising from or related the foregoing merger, acquisition and other business combination activities including, without limitation, any claim of divided loyalty, breach of fiduciary duty, fraud, breach of contract or breach of the implied covenant of good faith and fair dealing.

If we assign our rights in this Agreement, nothing in this Agreement requires us to remain in the Business or to offer or sell any services or products to you.

To be able to effect a change in the acquired or acquiror system, the franchisor must also specifically reserve its right to require the franchisee to change the marks and system:

**Discontinuance or Substitution of Proprietary Marks.** If it becomes advisable at any time, in our sole judgment, to modify or discontinue use of any Proprietary Mark and/or to adopt or use one or more additional or substitute Proprietary Marks, then you agree to comply with our instructions. Our only obligation if this happens will be to reimburse you for your documented expenses of compliance, such as changing signs, stationery etc. You waive any other claim arising from or relating to any Proprietary Mark change, modification or substitution. We will not be liable to you for any expenses, losses or damages sustained by you as a result of any Proprietary Mark addition, modification, substitution or discontinuation except as provided above in this Section. You covenant not to commence or join in any litigation or other proceeding against us for any of these expenses, losses or damages.

Aside from language in the franchise agreement, the franchisor must maintain constant communications with the franchisees regarding the transaction and the plans for the system – after the transaction closes. When the transaction will have a negative impact on an existing franchisee, the franchisor should be willing to take reasonable action to remedy the problem. For example, in the case of territorial overlaps, the franchisor can consider the following ameliorative steps:

- A reduced continuing royalty for the balance of the term of the franchise, or a waiver of royalties entirely for an extremely limited period of time.

- Any diminished or waived royalty payments should only be granted in accordance with a schedule which objectively reflects demonstrable, caused and proximate diminution of existing franchisee revenues solely attributable to the merger or acquisition, on a "sliding scale".

- Reduction or temporary suspension of advertising fee requirements, with the franchisor making up the difference.
A commitment by the acquiror or the newly combined franchisor to engage in a supplemental advertising program in encroached territories at its expense.

Where no other option would truly ameliorate the negative impact of territorial encroachment following the merger or acquisition activity, the acquiror or merged franchisor may extend one of two offers – in exchange for general releases: (i) buy out the affected franchisee's business at a commercially reasonable price, or (ii) when the acquired chain will be "converted" to the acquiror's format, offer to release territorially encroached franchisees from their franchise agreements (and the covenants not to compete contained therein), grant them a perpetual license to use the acquired chain's name, mark and system and work with these soon to be former franchisees to establish purchasing and advertising cooperatives, all to permit them to "carry on" the otherwise defunct acquired.

F. Regulatory Change

1. Regulatory Changes Affecting Franchise Systems

Changes in federal, state and local laws and regulations can require a franchise system to change its methods of operations or its standards. This section will note several recent state and federal legislative and regulatory changes that have affected franchise systems and discuss how the systems can deal with these changes.

Privacy Regulations. The federal government has enacted several pieces of legislation that affect privacy issues. The Privacy Act of 1974 provides safeguards against the invasion of individuals' privacy by requiring federal agencies to allow individuals to determine what records about them are collected and used, to discover what records about them are being collected or used, to be subject to civil suit for damages arising from the willful or intentional action violating individual's rights under the Act. The Health Insurance Portability and Accountability Act of 1996 ("HIPAA") requires the Department of Health and Human Services to establish national standards for the organization and security of electronic health care records, providers, health plans, and employers, in order to improve the efficiency of the nation's health care system. The Children's Online Privacy Protection Act of 1998 regulates the online collection of personal information of children under 13 years of age and includes direction on what is to be included in a privacy policy, when and how to seek parental consent, and what web operators are responsible for. Franchise systems that collect information about their customers that comes within the scope of any of these laws must be prepared to deal with the information properly or face significant consequences.

Immigration Law. Many franchised businesses, especially in the food and lodging industries, rely heavily on low-cost labor. A significant pool of low cost labor comes from recent immigrants to the U.S and in some cases, illegal aliens. The Immigration and Naturalization Act regulates immigration and citizenship. It establishes quotas for

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98 5 U.S.C. § 552a,
99 42 U.S.C. §§ 300gg et seq.,
101 A discussion of state and international privacy regulations is beyond the scope of this paper. For additional information on privacy in transactions with Europeans, see Cannon, What Franchisors Need to Know About Privacy Rights, a Safe Harbor, and Standard Contractual Clauses Before Exchanging Personal Information with Europeans, 22(3) Franchise L.J. (Winter 2003) at 176.
102 8 U.S.C. §§ 1101 et seq.
immigration and refugees and includes provisions regarding the admissibility and removability of terrorist suspects. The Migrant and Seasonal Agricultural Worker Protection Act103 provides employment related protection for migrant and seasonal agricultural workers, including provisions on payment, treatment, and working conditions.

**Anti-Terrorism Laws.** “Anti-Terrorism Laws” include several federal statutes, regulations and Executive Orders issued in the wake of the September 11, 2001 tragedy.104 Their impact on our daily lives, especially users of public transportation or those engage in any form of domestic or international travel, has become pervasive.

2. **Legal and Practical Restraints**

Most franchise agreements contain provisions that require compliance with applicable laws, rules and regulations. Where, however, the regulatory provision may run counter to the system standards of the franchise, the franchisor and franchisee may be faced with a dilemma – breach the franchise agreement or violate the law. Franchise systems in regulated professions may be most likely to confront this problem.105 The following is a provision one of the authors has used for a retail pharmacy franchise in these circumstances:

> Notwithstanding our right to require you to conduct business at the Premises in accordance with the System Standards, you and we recognize that the practice of pharmacy is a profession requiring independent judgment, skill and training and is governed in many particulars by state and federal authorities. Any inconsistency between System Standards or our advice and the dictates of good pharmacy practice, or any legal requirement of that practice, is inadvertent and not an effort to cause you to deviate from proper practices. Therefore, you and we understand and agree that (i) in all cases, lawful, regulatory requirements take precedence over both any inconsistent advice, counsel or other guidance, whether written or oral, given by us on any topic and any inconsistent System Standards we prescribe; (ii) no business advice given by us nor any System Standard we prescribe shall be taken as advice in respect of the practice of the profession of pharmacy, as defined by law; (iii) your judgment, or the judgment of your managing pharmacist, governs in all matters pertaining to the compounding and dispensing of medications, the advising of patients, communications with physicians on professional matters and each and every aspect of the professional practice of pharmacy; (iv) in any case in which you believe our advice or System Standards contravene the practice of the profession of pharmacy or any legal requirements of that practice, you will notify us, orally and in writing, immediately; and (v) you and your managing pharmacist are solely responsible for the practice of pharmacy at the Premises and the results of that practice.

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104 These statutes, Executive Orders and Regulations include Executive Order 13224 issued by the President of the United States, the Terrorism Sanctions Regulations (Title 31, Part 595 of the U.S. Code of Federal Regulations), the Foreign Terrorist Organizations Sanctions Regulations (Title 31, Part 597 of the U.S. Code of Federal Regulations), the Cuban Assets Control Regulations (Title 31, Part 515 of the U.S. Code of Federal Regulations), the USA PATRIOT Act, and all other present and future federal, state and local laws, ordinances, regulations, policies, lists and any other requirements of any governmental authority (including, without limitation, the United States Department of Treasury Office of Foreign Assets Control and any government agency outside the U.S.) addressing or in any way relating to terrorist acts and/or acts of war.

3. **Practical Solutions**

Franchisees often look to their franchisors for guidance in dealing with regulatory changes. While franchisors will want to be careful not to provide legal advice, the franchisor that moves swiftly to understand the impact of a new law or regulation on the business, provides resources for the franchisees to understand the impact on their businesses, and implements the necessary changes to take advantage of the positive impacts of new laws or mitigate the impact of unfavorable changes will be providing effective leadership to its system. It will also be able to establish uniformity throughout the system in dealing with the regulatory change so customers, no matter which franchise outlet they utilize, will be treated the same.

A franchisor’s failure to respond to a regulatory change can damage the system, become the source of unrest among franchisees that look to the franchisor for leadership and guidance, and possibly subject the franchisor and the franchisee to civil or criminal liability. For example, when the provisions of the Americans with Disability Act dealing with access to facilities became effective, certain advocacy groups and the U.S. government took action against some franchisors to hold them responsible for the design of franchised outlets.

### G. Changes in Internal Practices

How can a franchisor change its internal practices over time to handle legal and practical issues? As a franchise system matures, the franchisor may need to change parts of its franchise program, from the critical to fairly insignificant. The ability to make those changes quickly and with the least amount of system upheaval is the franchisor’s main objective.

A change in the franchisor’s system standards, or implementation of a system standard enforcement program to make certain that the quality, uniformity and delivery of their products or services provide the best experience for the customer, might be the best way to enhance the customer’s trust and improve the perception of the franchisor’s brand. Before implementing such changes, a franchisor should take the following steps to ensure that its new standards are enforceable:

1. Analyze the current franchise agreement
2. Analyze prior writings or oral discussions

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107 See, *Clark and A.D.A. Access Today v. McDonald's Corporation and Ygraine, LLC.* Bus. Franchise Guide (CCH) ¶12,540, (D. N.J. 2003) and *Clark and A.D.A. Access Today v. Burger King Corporation and Dime-Mor II, Inc.,* Bus. Franchise Guide (CCH) ¶12,541 (D. N.J. 2003), where a non-profit national advocacy organization for people with physical disabilities was held to lack standing to sue fast food franchisors and their franchisees under the Americans with Disabilities Act (ADA) because it failed to allege facts that it was suffering, or was under threat of suffering, discrimination at the hands of the defendants. The complaints alleged that the owners and operators of the franchisor’s restaurants throughout the United States discriminated against disabled persons in violation of the ADA by: (1) failing to remove architectural and communication barriers where that removal was readily achievable; (2) failing to make alterations that would allow, to the maximum extent feasible, ready access to the altered portions of their facilities to individuals with disabilities, including individuals who used wheelchairs; and (3) failing to construct and design new facilities that were readily accessible to individuals with disabilities, except where structurally impracticable.

108 See, *United States v. Days Inns of America, Inc. and Hospitality Franchise Systems, Inc.,* Bus. Franchise Guide (CCH) ¶11,482 (8th Cir. 1998), where the court held that a hotel franchisor did not exercise significant authority over the design and construction of a franchise property to meet the requirements of the Americans with Disabilities Act, but could be held liable under the statute’s “design and construction” provision if it knew that the franchisee had designed and constructed a facility that did not meet the statute’s requirements.
3. Ascertain whether the standard is reasonable and material
4. Determine whether the standard is being enforced in good faith
5. Determine if the standard has been waived

Below is a review of cases that elucidate each step, as well as a brief discussion of the relevant the law on preliminary agreements, parol evidence, good faith and fair dealing, and statutory restrictions.

1. **Analyze the Current Franchise Agreement**

   The first step should be a thorough reading of the franchise agreement and operations manual (or any other manuals relevant to the franchise system) to determine whether either provides a means to implement the desired changes. Clauses that state the franchisor has system standards that it may modify from time to time, and most important, that the franchisee agrees it must comply with those modifications or face termination of the franchise, will provide the franchisor with a contractual basis to implement and modify its system standards and can be the key to a successful implementation of change.

   In *Trail Burger King, Inc. v. Burger King of Miami, Inc.*, the franchisor changed its standards and specifications for the amount of meat used in its hamburgers and the condiments offered to customers. After Trail refused to comply with the new standards, causing a default of its franchise agreement, Trail sued, alleging that its refusal to comply with the new standards and specifications did not constitute a default. Trail argued that the new standards and specifications did not exist when it signed the franchise agreement, and therefore were a modification of the agreement that called for the written consent of both parties. The court reviewed the language of the franchise agreement, which enabled Burger King to set and maintain "formulas or specifications of materials and standards of cleanliness or sanitation" as well as the "recommended menu and prices" to ensure uniformity in its restaurants. Further, the franchise agreement provided "with respect to the formula for production of hamburgers, cheeseburgers, Whopper-Burgers, Whopper-Hamburgers, and Whoppers, the meat used shall meet the specifications of the Company as to quality and as to size for the respective types of sandwich." The court determined that based upon the clear language in the contract, Burger


110 The relevant sections of the agreement which relate to the standards and specifications are summarized as follows:

8.(a) Licensee hereby agrees not to deviate from the formulas or specifications of materials and standards of cleanliness or sanitation set and maintained by Burger-King of Miami, Inc. in the operation of this business.

... (c) To insure uniformity, the recommended menu and prices which are subject to change, for products to be sold under this license are as follows:... other items to be agreed upon by the parties by letter as Company approves.

... (e) Licensee specifically agrees to sell milk shakes under formulas prescribed by Company, which at the present time are produced by Sami-Shake machines, without less than nine (9) ounces per twelve (12) ounce paper cup, from a milk shake mix which contains a minimum content of 4.2% butter fat, or such other mix as may be approved in writing by the Company, and with respect to the formula for production of hamburgers, cheeseburgers, Whopper-Burgers, Whopper-Hamburgers, and Whoppers, the meat used shall meet the specifications of the Company as to quality and as to size for the respective types of sandwich.

*Id.* at 57.
King had the right to make modifications to its standards and specifications and to terminate any non-complying Franchisee.

Another recent case showing the franchisor’s right to change its system standards, if that right is retained in the franchise agreement, is Custom House Hotel, LLP v. Doubletree Hotel Systems, Inc.\textsuperscript{111} In Custom House, Hilton Hotels Corporation introduced a new program called the Hilton Honors Program (“HHP”) after acquiring the Doubletree Hotel chain. The HHP required the franchisee to make additional expenditures by presenting a specific chocolate chip cookie in a certain manner along with free USA Today Newspapers. Custom House did not wish to comply with the requirement, alleging that the HHP program did not exist in 1996, when it executed its franchise agreement, and thus could not be incorporated into its contract. Custom House also alleged that the HHP should be treated as a marketing program pursuant to Section 9 of its 1996 franchise agreement, and paid for by the marketing fund. The arbitrators determined that Section 3 of the franchise agreement permitted the franchisor to define its brand standards without the Franchisee’s consent, and that it could change those standards over time. On that basis, the arbitrators required Custom House to participate in the HHP.

2. Analyze Prior Writings or Oral Discussions

Prior discussions or writings with the franchisee which could be interpreted as modifying the franchisor’s system standards or its ability to enforce those standards can make analysis of the franchisor’s rights much more difficult. The second part of the analysis should include a review of any prior writings and oral communications that might be at odds with the terms and conditions of the franchise agreement. Such conflicts often arise from preliminary agreements, or “agreements to agree,” which raise issues concerning whether the parties intend to be bound, and whether the terms are sufficiently definite to be enforceable.\textsuperscript{112}

Days Inns Worldwide, Inc. v. Sai Baba, Inc.\textsuperscript{113} provides a good example of a case where a preliminary commitment that was not binding. Days Inns terminated Sai Baba’s franchise agreement due to Sai Baba’s repeated failure to meet minimum quality standards. Sai Baba counterclaimed for equitable reformation of contract, breach of the implied covenant of good faith and fair dealing, and violation of the Indiana Deceptive Trade Practices Act.\textsuperscript{114} The basis of Sai Baba’s counterclaim was a “slip” that the parties drafted, but never signed, before signing the license agreement. The slip provided that if Sai Baba failed to score at least 425 on a quality assurance review before November 8, 1999, the license agreement would be null and void.\textsuperscript{115} The license agreement contained an integration clause, as well as a clause entitled "Your Improvement and Operating Obligations," which listed the improvement obligations and

\textsuperscript{111} JAMS Arbitration Service, Arbitration No. 1100037904 (July 29, 2003); Business Franchise Guide (CCH) ¶13,067.


\textsuperscript{113} 300 F. Supp. 2d 583 (N.D. Ohio 2004).

\textsuperscript{114} IND. CODE ANN. § 23-2-2.7-1 (LexisNexis 2006).

\textsuperscript{115} 300 F. Supp. 2d at 587. Sai Baba executed a license agreement with Days Inns on June 23, 1999. Sai Baba alleged that on November 1, 1998, they signed and returned to Days Inns a "slip page" that altered the standard license agreement and stated:

\textbf{Conditions for a Legally Binding Contract.} All parties (we and you) hereto understand and agree that in the event said Days Inns fails to score a minimum of 425 points for quality assurance on or before November 8, 1999, then this entire license agreement, any and all documents related thereto, all notes executed by you, or any other evidence of indebtedness executed by you to us or any related parties shall become null and void; no franchise granted to you.
Moreover, the license agreement also stated that Days Inns would have the right to terminate the agreement if Sai Baba did not make the required improvements or achieve the required quality assurance scores. The court applied the parol evidence rule, which states “...a binding integrated agreement discharges prior agreements to the extent that it is inconsistent with them.” To determine whether a binding integrated agreement existed, the court applied the following test: (1) did a writing exist; (2) was the writing at odds with the intention of the parties; and (3) did the agreement contain an integration clause. The court held that because the contract was entered after the “slip” and contained an integration clause, the parol evidence rule barred integration of the “slip.”

3. Ascertain Whether the Standard Is Reasonable and Material

Reviewing the cases presented above, the purpose of the franchisor systems standards, or changing of the system standards, was readily apparent. In *Trail*, Burger King wanted to control the amount of meat and type of condiments to ensure uniformity in its system. In *Sai Baba*, Days Inns wanted to ensure that its customers had a good experience at its hotels by ensuring that franchisees met certain quality standards. In both cases, the courts considered whether the franchisor’s system standards were reasonable in order to determine if the standards were enforceable. If they were unreasonable, the courts would not have enforced them.

*Crown Central Petroleum Corp. v. Waldman* further illustrates this point. Crown Central Petroleum terminated its franchise agreement with Waldman, because of Waldman’s failure to operate its Crown gas station 7 days a week, 24 hours a day, as the franchise agreement required. However, the gasoline crisis of 1979 made it difficult for gas stations to maintain enough gas to stay open. Crown had issued a notice to its franchisees, stating that it would permit them to close for certain hours each day, but that the stations must be open 7 days a week. Crown believed that this modification was reasonable to meet the exigencies of the gasoline crisis, while at the same time enabling it to maintain uniformity among dealers, and preserve the goodwill associated with its trademark. Waldman objected to Crown’s continuous operations requirement because it was “an invitation to the public to waste gas.” The court found that Crown’s continuous operations requirement was a “key policy, what has been referred to as a hallmark policy of Crown Central Petroleum.” The court analyzed the reasonableness of the requirement in the face of the gas crisis, and concluded that

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116 Id. at 589. Section 3.1 of the June 23, 1999 license agreement went on to state:

**Improvements.** You must select and acquire the Location and acquire, equip and supply the Facility in accordance with System Standards for entering conversion facilities. You must begin improvement of the Facility no later than thirty (30) days after the Effective Date. The Facility must score 400 points (or equivalent) within ninety (90) days after the Effective Date and 425 points (or equivalent) within nine months after the Effective Date. All improvements will comply with System Standards, any Approved Plans, Schedule B and any Punch List attached to this Agreement. Your general contractor or you must carry the insurance required under this Agreement during renovation. If you do not commence or complete the improvement of the Facility by the dates specified in this Section 3.1, or the Facility does not meet the post-transfer quality assurance inspection standard, or complete the post-transfer improvements specified in the Punch List after the Effective Date, then we may, in our sole discretion, terminate this Agreement by giving written notice to you. Time is of the essence for the Improvement Obligation. We may, however, in our sole discretion, grant one or more extensions of time to perform any phase of the Improvement Obligation. The grant of an extension will not waive any other default existing at the time the extension is granted. (Doc. 1 Ex. A, at 1-2).


…should not weigh in balance the economic advisability of continuous operation at most locations…if there is a reasonable basis for it. The reasonable basis suggested is that this policy not only makes business on the midnight shift, it attracts customers at other times, customers who have been served on the midnight shift and developed some relationship with the station or its personnel; customers who think in terms of getting gas at Crown because they know it is always open.

The court reasoned that this “common sense” basis founded on common understanding and experience made the franchisor’s policy reasonable and enforceable.119

Case law strongly supports the franchisor’s right to modify its system standards if that right is stated in its franchise agreement – even if the change could have an adverse financial impact on the franchisee. Economou v. Physicians Weight Loss Centers120 is instructive. There, terminated franchisees attempted to enjoin the franchisor from enforcing franchise agreement covenants not to compete. Economou argued that Physicians Weight Loss Centers had breached the franchise agreements by: (1) modifying the diet from a guaranteed weight loss of 3-7 pounds per week through a 700 calorie “very low caloric diet,” to a guaranteed weight loss of 2 pounds per week through a 900 calorie “low caloric diet,” and (2) modifying the Physician Weight Loss Centers’ distribution of a “Dieters Information Sheet,” which discussed the potential hazards of the “very low caloric diet.”121 The franchise agreement provided in relevant part:

Franchisor reserves the right to modify or change the System, Marks, the various training programs offered to Franchisees and their employees, and the Manuals at any time, and from time-to-time by the addition, deletion or other modification to the provisions thereof, and such modification shall be made in the sole judgment of Franchisor to protect Franchisor Marks and goodwill, to comply with any applicable law, statutes or judicial or administrative decision, or to improve the quality of services, training or products offered.122

Economou closed four of its five centers due to economic distress, and lost the fifth center because it failed to pay required royalties to Physicians Weight Loss Centers. The court held that because Physicians Weight Loss Centers had expressly provided in the franchise agreement that it could modify its system, it did not breach the franchise agreement despite the court’s finding that there was a causal connection between modification of the diet and the franchisee’s economic woes. Moreover, the court held that the inclusion of the Dieter’s Information Sheet was reasonable because it was developed in response to an investigative report that found that the franchisor’s diet might cause certain side effects.123

Similar cases are TLH International v. Au Bon Pain Franchising, Corp.124 and Johnson v. Arby’s, Inc.125 In TLH, the franchisor decided to change its restaurant size, and in Johnson, the

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121 Id. at 1027.
122 Id. at 1028.
123 Id. at 1037.
franchisor decided to change its building design. In both instances, the change involved larger, more expensive units that became more complicated to operate. The TLH franchisee claimed that it was unable to develop its required stores because the system changes made those obligations “inherently impossible,” but the court took a different view:

Here again, the plaintiff may be choosing to ignore its own inability to correctly assess and carry out a business program and seeks to characterize its own shortcomings as a fraud perpetrated upon it by the defendants. It would be a rare opportunity which could guarantee the expansion described and it would be a rather naïve Franchisee who believed the statements were a guarantee.

The court then found that Au Bon Pain had the contractual right to modify its system despite the financial cost to the franchisee.

In Johnson, Arby’s developed a new freestanding building design and required all new restaurants to be developed according to that design. Johnson, a Tennessee developer who had committed to develop a specific number of Arby’s restaurants, sought a declaratory judgment that Arby’s could not require him to build restaurants using the new design. The court reviewed the development agreement, which expressly authorized Arby’s to vary its building design requirements, and ruled that Arby’s exercise of its right to modify the design was not in breach of the franchise agreement.

It is important to remember that some statutes may impose a higher duty of care on the franchisor to ascertain whether the economic affect of the new standard makes it unreasonable. In Beilowitz v. General Motors Corp., a New Jersey distributor claimed that the GM had violated the New Jersey Food Processors Association by requiring Beilowitz to sign a renewal agreement requiring him to market AC Delco products. Beilowitz asserted that the new program would require him to sacrifice $1 million in sales and incur operating losses of more than $1 million. The court concluded that it was clearly an unreasonable standard of performance within the meaning of the NJFPA to require a Franchisee “to operate at a substantial financial loss while the franchisor attempts to implement a new and unproven marketing strategy.”

4. Determine Whether The Standard Is Being Enforced In Good Faith

Crown Central Petroleum Corp. v. Waldman provides a platform for the next phase of our analysis – whether system standards are being enforced in good faith. The Crown franchisee asserted that Crown’s requirements were merely subterfuge – that is, Crown was acting in bad faith because it really wanted to convert its high volume product outlets into

127 Id.
128 Id. at 5. Au Bon Pain’s development agreement also specifically provided that the marketing concept and system “may be changed, improved, and further developed by Franchisor from time to time.” Id.
129 Bus. Franchise Guide (CCH) ¶12,018 (E.D. Tenn. March 15, 2000). See also, Dunham and Toomey, The Evolution of the Species: Successfully Managing Franchise System Change, 24 Franchise L.J. 231 (2005) (the authors analyzed the TLH and Johnson cases and concluded that well-drafted agreements are essential tools in the franchisor’s defense to claims of breach of the implied covenant of good faith and fair dealing
130 Id. at 11, citing 233 F. Supp. 2d 31 (D.N.J. 2002).
131 Id.
company operations to make more profit. After concluding that Crown’s policies were both reasonable and material, as discussed previously, the court then reviewed the termination sections of the Petroleum Marketing Practices Act, of June 19, 1978, Pub. L. No. 9-297, 15 U.S.C. §§ 2801 et seq. ("PMPA"). The court held that, although Crown did not prove its argument that the franchisee failed to exert good faith efforts to carry out the terms of its franchise agreement, good faith was not an express condition for termination in the two sections of the PMPA Crown cited as a reason for termination.

Similarly, in In re Sizzler Restaurants, the court reasoned that Sizzler had a discretionary right to change its franchise system unless it acted “dishonestly or outside of accepted commercial practices, or with an improper motive or in an unreasonable manner that was arbitrary, capricious, or inconsistent with the reasonable expectations of the parties.” In this case, Sizzler began its restaurant concept with a buffet court, but later abandoned the buffet concept. Sizzler showed that it abandoned the buffet in response to problems like lower average checks and a diminished customer perception of the quality of the chain. The court decided that as long as Sizzler’s decision-making process was honest or “within accepted commercial practices,” it would not second-guess the franchisor’s business judgment.

5. Determine If The Standard Has Been Waived

Generally, courts have held that a waiver does not exist if the franchisor states in writing that it is not waiving a provision of its contract but merely providing for a temporary change. In Days Inns of Am., Inc. v. Patel, the parties entered into a franchise agreement which required Patel to make renovations to comply with Days Inns’ "system standards," "appropriate plans," and "punch list". Patel agreed to achieve a quality assurance score of at least 425 within nine months of entering into the franchise agreement. Days Inns reserved the right to terminate the franchise agreement even if Patel maintained the property in compliance with the quality assurance guidelines. Patel failed five consecutive quality assurance inspections, so Days Inns terminated the franchise agreement and sued Patel to force him to cease operating the hotel as

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133 Before the 1960’s, Crown marketed gasoline through two and three-bay service stations, but later discovered that this method was economically unfeasible, and changed its model to the multi-pump method often seen today. Id. at 6.
135 Good faith was only an express condition if the Franchisor decided to withdraw from the geographic market or if the Franchisor and Franchisee failed to agree to changes or additions to the franchise agreement that were made in good faith. 15. U.S.C. § 2802(b)(2)(E) & (3)(A)(i).
137 Id. at 474.
138 Id. at 471. Sizzler’s decisions concerning the reorientation of the marketing concept had the support of the marketing committee of the board of trustees of the Sizzler Franchisee organization, the National Sizzler Franchisee Association ("NSFA"). In its August 1, 1991 Marketing Committee Report, the NSFA stated as follows:

The committee supports the Sizzler position that Buffet Court is not the long-term answer to sales and profitability for the Sizzler system. Higher food costs, much lower average checks, and an extremely high share of our guests ordering Buffet Court as a meal requires a change in Sizzler position.

Id. at 471.
139 Ironically, in 1993, there were reports of E-Coli incidents at several Sizzler franchise restaurants in Oregon and Washington. As part of its response to these purported outbreaks, Sizzler set aside a $ 4.9 million reserve to cover the costs and contingencies of recovery and marketing assistance to Franchisees. Id. at 473.
a Days Inns and remove the Days Inns trademarks. Patel did not dispute that he had breached the franchise agreement by failing the quality inspections, but instead asserted that Days Inns had waived the requirements by providing several notices of default although Patel had failed to cure. The court found the waiver argument to be meritless because Days Inn's franchise agreement clearly provided that:

...no failure or delay [by Days Inns] in requiring strict compliance with any obligation of this Agreement . . . shall constitute a waiver or modification of any such obligation, requirement, right, or remedy or preclude exercise of any such right or remedy or the right to require strict compliance with any obligation set forth herein.

This clear provision of the contract demonstrated that Days Inns had not waived its quality assurance requirement despite the repeated notices of default.

III. CONCLUSION

The foregoing discussion only begins to scratch the surface of issues that affect mature franchise systems and the ways that these systems can respond to the need for change. The systems that cannot respond to change will find that they may not be able to survive or may become takeover targets by systems that can effectively respond to change. Not only is it important to be able to respond effectively to change, but the successful and innovative systems will actually be in the forefront of creating change that is beneficial to their systems.

To respond effectively to changes that come in the future, franchise agreements drafted today will need to be flexible documents. They will need to build in mechanisms for change that do not allow either the franchisor or the franchisee to obtain material advantages over the other that were not contemplated when the agreement was executed. That is the challenge facing us today!

141 On December 29, 1995, Days Inns found that Patel had breached the quality assurance guidelines. The inspector noted dirty and damaged guest rooms, including burns in the bedding, dirty toilets, severely stained carpets and ceilings, and food left uncovered in the restaurant. Patel received a failing grade. Days Inns provided Patel with notice of its default and advised Patel he had 30 days to cure. Days Inns conducted another quality assurance inspection and Patel received another failing score. Days Inns and Patel entered into an agreement in which Patel agreed to make improvements to satisfy Days Inns' quality assurance requirements, but Patel breached that agreement, earning another failing score on a quality assurance inspection. Days Inns provided notice of the breach and a 30-day opportunity to cure. Days Inns conducted another quality assurance inspection, and Patel received yet another failing score. Days Inns gave Patel another, final notice and 30-day opportunity to cure. Despite that, Patel failed a fifth quality assurance inspection. Id. at 930-932.

142 Id. at 933, n. 2.

143 Patel asserted he was not liable under the doctrines of commercial impossibility, commercial impracticability, and commercial frustration. These defenses are noteworthy because of their similarity to the defenses expounded by Waldman in Crown, i.e., that a current event or situation should excuse performance of an obligation of the franchise agreement. In the present case, Patel stated that closure of the Lincoln Parkway ingress to his facility, made it commercially impossible and impractical for him to satisfy his obligations under the franchise agreement. The court found that Patel’s argument was really one based on inability to pay – that closure of the road caused him to lose money making him unable to spend the funds necessary to comply with the franchise agreement. This defense was not adequate to prove commercial impossibility or impracticability. In addition, the evidence demonstrated that the roadwork did not commence until June 1996, and Patel had breached the franchise agreement prior to that date. Thus, Patel’s prior breach prevented his successful assertion of the defense of commercial impossibility or impracticability. Id. at 12-16.