THE MATERIALITY REQUIREMENT FOR FRANCHISE TERMINATIONS

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I. INTRODUCTION

The issue of materiality arises in a number of contexts important to franchise relationships. For example, many franchise agreements provide a party with certain rights or obligations in the event the other party commits a material breach or fails to comply with a material provision of the agreement. In addition, many states have statutes governing the termination or expiration of franchise relationships. Although the statutes vary in many respects, most require some form of good cause for ending the franchise relationship, which generally means that the franchisor must be able to identify a material basis for termination. Further, under the common law of many states, a party to a contract may have a right to rescind, or discontinue performance under, the contract if the other party commits a material breach. As one court put it:

It is hornbook law that when one party to a contract commits a material breach, the non-breacher has the option of either continuing the contract and suing for partial breach, or terminating the agreement in its entirety. In the case of a non-material breach, the termination option is not open to the non-breacher.

What, then, does the term “material” mean and how can a party determine whether a breach or contract provision meets the materiality requirement? The question is not always an easy one. In fact, courts and commentators have long recognized that the line dividing a material breach from a trivial breach is “wavering and blurred” and “cannot be settled by a formula.” The same act or omission may be deemed material in one situation and immaterial in another. This paper is intended to provide franchisors and franchisees with some guidance on the issue of materiality in franchise terminations.

II. STATE TERMINATION STATUTES

At least nineteen states, in addition to Puerto Rico and the Virgin Islands, have laws governing franchise terminations. Most termination statutes require that a franchisor have “good cause” to terminate or fail to renew a franchise agreement. These statutes generally define good cause as including the franchisee’s failure to comply, or to comply substantially, with any material and/or lawful requirement of the franchise agreement or otherwise imposed upon him by the franchisor. Some of these statutes expressly incorporate a materiality standard into the definition of “good cause.” But, either way, courts generally interpret a “failure to substantially comply” as synonymous with a “material breach.” As the U.S. Court of Appeals for the Third Circuit put it: “we see no real or practical difference between a conclusion that a party

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1 See, e.g., Southland Corp. v. Froehlich, 41 F.Supp.2d 227 (E.D.N.Y. 1999) and Southland Corp. v. Mir, 748 F.Supp. 969 (E.D.N.Y. 1990) (a material breach that goes to the essence of the contract constitutes grounds for rescission without opportunity to cure); Dunkin’ Donuts Inc. v. Gav-Stra Donuts, Inc., 139 F.Supp.2d 147, 155 (D. Mass. 2001) (“[i]t is well-settled that a material breach of contract by one party excuses the other party from performance as a matter of law”).

2 General Motors Corp. v. New A.C. Chevrolet, Inc., 263 F.3d 296 (3rd Cir. 2001) (citing 2 E. Allan Farnsworth, Farnsworth on Contracts § 8.16, at 495-96 (2d ed. 1998)).

3 Jacob & Youngs v. Kent, 129 N.E. 889 (1921); 2 Williston on Contracts, § 841.
materially breached a contract and a conclusion that the party failed to substantially comply with its obligations under the contract. To decide otherwise would be simply to engage in linguistic games."4

Although the state statutes governing termination are similar, they do differ in certain respects. Arkansas’ termination statute, for example, contains a typical definition of “good cause,” which includes any “[f]ailure by a franchisee to comply substantially with the requirements imposed upon him or her by the franchisor, or sought to be imposed by the franchisor . . . .”5 California’s statute similarly defines good cause as “the failure of the franchisee to comply with any lawful requirement of the franchise agreement” after being given notice and an opportunity to cure.6 The California statute provides that a franchisor may immediately terminate a franchise without an opportunity to cure if, among other things, the “franchisee makes any material misrepresentations relating to the acquisition of the franchise business or the franchisee engages in conduct which reflects materially and unfavorably upon the operation and reputation of the franchise business or system.”7

The Nebraska, New Jersey, and Minnesota statutes have similar definitions of “good cause.” The Nebraska statute defines “good cause” as “failure by the franchisee to substantially comply with the requirements imposed upon him or her by the franchise.”8 The Nebraska statute requires 60 days written notice of termination or non-renewal, except in certain circumstances, including, for example, voluntary abandonment of the franchise and conviction of an offense related to the business. The New Jersey statute has comparable notice requirements to those found in the Nebraska law. The New Jersey statute also defines “good cause” as “failure by the franchisee to substantially comply with those requirements imposed upon him by the franchise.”9 The Minnesota statute defines “good cause” as “failure by the franchisee to substantially comply with the material and reasonable franchise requirements imposed by the franchisor.”10 The statute includes a non-exhaustive list of grounds that qualify as good cause, including the bankruptcy or insolvency of the franchisee, assignment for the benefit of creditors or similar disposition of the assets of the franchise business, voluntary abandonment of the franchise business, conviction or a plea of guilty or no contest to a charge of violating any law relating to the franchise business, and any act by or conduct of the franchisee which materially impairs the good will associated with the franchisor’s trademark, trade name, service mark, logotype or other commercial symbol.

Connecticut’s statute states that a franchisor may not terminate, cancel or fail to renew a franchise, “except for good cause shown which shall include, but not be limited to the franchisee’s refusal or failure to comply substantially with any material and reasonable

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obligation of the franchise agreement . . .”¹¹ The Illinois, Hawaii, Michigan, and Washington laws contain similar good cause provisions.¹² These definitions are broader than those discussed above in that they expressly do no limit “good cause” to a franchisee’s refusal or failure to comply with the franchise agreement, thus allowing more flexibility as to what might be considered “good cause” for termination. The Wisconsin and Virgin Islands statutes are also broader.¹³ They each explicitly include the franchisee’s “bad faith in carrying out the terms of the franchise” as “good cause” for termination.

Iowa’s termination statute, Iowa Code § 523H.7, defines “good cause” as “cause based upon a legitimate business reason.” The statute expressly incorporates a materiality standard in three subparts. It states that “good cause’ includes the failure of the franchisee to comply with any material lawful requirement of the franchise agreement, provided that the termination by the franchisor is not arbitrary or capricious when compared to the actions of the franchisor in other similar circumstances.”¹⁴ It also states that, although a franchisor generally must provide a franchisee with written notice and opportunity to cure a default, a franchisor may terminate a franchisee upon notice but without an opportunity to cure under certain limited circumstances, including if the franchisee commits a material breach and has already had at least three other material breaches within the same twelve-month period for which it was given notice and an opportunity to cure, or if the franchisee is convicted of a felony or any other criminal misconduct which materially and adversely affects the operation, maintenance, or goodwill of the franchise in the relevant market.¹⁵

The laws of Delaware, Indiana, South Dakota and Virginia are somewhat different. Delaware’s law simply provides in relevant part that no franchisor may “unjustly” terminate, or fail or refuse to renew, a franchise and that a termination or failure to renew is made “unjustly” if it “is without good cause or in bad faith.”¹⁶ Unlike most termination statutes, the Delaware statute does not define good cause. The Indiana law is unique in that it makes it unlawful “for any franchise agreement . . . to contain [a provision] [p]ermitting unilateral termination of the franchise if such termination is without good cause or in bad faith.”¹⁷ Good cause under the Indiana law means “any material violation of the franchise agreement.”¹⁷ Virginia law provides that “[i]t shall be unlawful for a franchisor to cancel a franchise without reasonable cause or to use undue influence to induce a franchisee to surrender any right given to him by any provision contained in the franchise.”¹⁸ “Reasonable cause” and “undue influence” are not defined in the


¹⁴ Iowa Code § 523H.7, subd. 1.

¹⁵ Iowa Code § 523H.7, subs. 3f and 3h.


South Dakota prohibits any person, “whether by means of a term or condition of a franchise or otherwise,” from engaging in “any unfair or inequitable practice in contravention of such rules as the director may adopt defining the words “unfair and inequitable” as applied to franchises.” No rules have been enacted yet.

The Missouri and Mississippi statute both focus on notice to the franchisee. The two statutes contain virtually identical provisions requiring 90 days notice of termination or non-renewal, except when “criminal misconduct, fraud, abandonment, bankruptcy, or insolvency of the franchisee, or the giving of a no account or insufficient funds check” is the basis for termination.

The Puerto Rican law governing termination and non-renewal of a franchise relationship provides that “[n]otwithstanding the existence in a dealer’s contract of a clause reserving to the parties the unilateral right to terminate the existing relationship, no principal or grantor may directly or indirectly perform any act detrimental to the established relationship or refuse to renew said contract on its normal expiration, except for just cause.” The Puerto Rican law defines “just cause” as the “nonperformance of any of the essential obligations of the dealer’s contract, on the part of the dealer, or any action or omission on his part that adversely and substantially affects the interests of the principal or grantor in promoting the marketing or distribution of the merchandise or service.” The law also sets forth a number of exceptions and presumptions for purposes of determining whether there is “just cause.”

III. HOW COURTS DEFINE “MATERIAL”

Although most of the statutes governing termination and non-renewal of a franchise relationship expressly define “good cause” and “just cause” as requiring some sort of material or substantial basis for the termination or non-renewal, they provide little guidance for evaluating the materiality or substantiality of an action or contract provision. Under the common law, courts have defined a material breach as a breach that goes “to the root of the agreement between the parties” or a breach that is “so substantial that it defeats the object of the parties in making the contract.”

19 “Reasonable cause” is not the same as “any cause.” G.M. Garrett Realty, Inc. v. Century 21 Real Estate Corp., 17 Fed. Appx. 169 (4th Cir. 2001). The fact that the franchisee admitted owing some fees under the franchise agreement did not automatically give Century 21 reasonable cause to terminate the agreement under the Virginia statute, when the franchisee disputed the amount owed, continued to pay certain sums to the franchisor during the term of the agreement, and engaged in continued negotiations with Century 21 to determine the correct amount owed. (Author Ellen Lokker was one of the attorneys for Century 21 in this case.)

20 SDCL § 37-5A-51.

21 V.A.M.S. § 407.405; and Miss. Code Ann. § 75-24-53.

22 10 L.P.R.A. § 278a.

23 10 L.P.R.A. § 278(d).

24 10 L.P.R.A. § 278a-1.

purpose of the contract."26  "A material breach of an agreement occurs when there is a breach of an essential and inducing feature of the contract."27  "Materiality goes to the essence of the contract; a breach is material if it ‘will deprive the injured party of the benefit that is justifiably expected’ under the contract."28

According to the Restatement (Second) of Contracts, the law employs a “standard of materiality that is necessarily imprecise and flexible.”29 The Restatement sets forth five factors to guide the determination of whether a failure to render performance constitutes a material breach:

(a) the extent to which the injured party will be deprived of the benefit which he reasonably expected;

(b) the extent to which the injured party can be adequately compensated for the part of that benefit of which he will be deprived;

(c) the extent to which the party failing to perform or to offer to perform will suffer forfeiture;

(d) the likelihood that the party failing to perform or to offer to perform will cure his failure, taking account of all the circumstances including any reasonable assurances;

(e) the extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing.30

In most cases, the question of materiality “is primarily a question of fact, the resolution of which is necessarily a function of context and circumstances.”31 That said, there may be circumstances in which the question of materiality is a question of law for the judge.32

28 General Motors Corp. v. New A.C. Chevrolet, Inc., 263 F.3d 296 (3rd Cir. 2001) (citing 2 E. Allan Farnsworth, Farnsworth on Contracts § 8.16, at 497 (2d ed. 1998)).
30 Id. at § 241.
31 Dopp v. Pritzker, 38 F.3d 1239, 1244 (1st Cir. 1994); 2 E. Allan Farnsworth, Farnsworth on Contracts § 8.16, at 443 (1990)).
32 Frank Felix Assocs., 111 F.3d at 284. See Krantz, Inc., 408 F.Supp.2d at 863 (issue of materiality of breach decided as matter of law where there were no questions of fact that were either material or genuine).
IV. CASES FINDING MATERIAL BREACH BY FRANCHISEE PROVIDING GOOD CAUSE FOR TERMINATION

A. Failure To Pay Amounts Owed

Most courts agree that a failure to pay amounts owed is a material breach that justifies termination of the franchise relationship. Many franchise agreements and/or state termination statutes, however, require notice and an opportunity to cure, or require that the franchisee’s failure to pay and cure must be repeated, before the breach becomes material and before termination is permitted.

In *Tatan Management v. Jacfran Corp.*, the court held that the franchisees’ failure timely to pay the franchisor royalties, and the franchisor’s approved supplier for merchandise, provided just cause for termination under the Puerto Rico Dealers’ Contracts Act. The court stated that the franchisees’ argument that the payment of royalties was not an “essential obligation” under the Franchise Agreement failed “in the face of case law, the contractual language, and the nature of the relationship between the parties.” The court noted that the franchisor, Jacfran, was:

in the business of granting franchisees licenses to use the trademarks and promote and sell the “Jacadi” merchandise. The royalties constitute the benefit, or the consideration, given to Jacfran in exchange for the right to use the licenses. Without the royalty fees, Jacfran has no business as a “Jacadi” franchisor. To argue that in such a franchisor-franchisee relationship the payment of royalty fees for the use of licensed trademarks is not an essential element of the agreement is absurd.

The court likewise rejected the franchisees’ argument that their failure timely to pay Jacfran’s approved supplier, Jacadi USA, was not an “essential obligation” under the Franchise Agreement. The court stated that the fact Jacadi USA was not a party to the Franchise Agreement did not mean “that the payment to Jacadi USA for delivered merchandise is not an essential obligation of the dealer’s contract between Plaintiffs and Jacfran.” Instead, the court stated, the “contractual language, legal, policy, and common-sense considerations dictate that payment for the licensed merchandise – whether to the franchisor or to an approved supplier – constitutes an essential obligation under a franchise agreement such as the one before the Court.” The court also found that the fact that Jacfran and Jacadi USA “tolerated due balances and attempted to resolve the dispute amicably through reasonable payment plans” did not mean that they altered the terms of the parties’ agreements and somehow excused the franchisees’ timely performance.

In *In re Montcastle*, the U.S. Bankruptcy Court for the Western District of North Carolina found that a printing shop franchisor, Postal Instant Press (“PIP”), was entitled to file a claim in its former franchisees’ bankruptcy action for past due royalties, amounts due for equipment, future royalties and advertising fees, attorneys fees and interest. In discussing PIP’s right to claim future royalties and advertising contributions, the court stated:


34 Bus. Franchise Guide (CCH) ¶ 10,534 (September 2, 1994).
PIP contracted to provide the Montcastles with certain services, for which PIP would receive a 20 year stream of payments. The Montcastles agreed to provide PIP with this benefit. The franchise agreement allowed PIP to terminate the contract upon the Montcastles material breach, and pursue the benefit of their bargain. In failing to make the required payments to PIP, the Montcastles committed a material breach.

In Original Great American Chocolate Chip Cookie Co., Inc. v. River Valley Cookies, Ltd., the U.S. Court of Appeals for the Seventh Circuit held that a failure to cure a past-due payment of service fees constituted a material breach of a franchise agreement.\(^{35}\) Similarly, in Dunkin’ Donuts Inc. v. Liu, the Third Circuit affirmed the district court’s decision that a franchisor properly terminated its franchisees’ sublease and franchise agreement because the franchisees failed to make timely payments due under the agreements.\(^{36}\) The court rejected the franchisees’ argument that the franchisor had an improper motive for terminating the agreements. It stated “the terms of the Agreement authorized termination of the Franchise based upon material breach, such as unpaid rent and fees. As such, even if the Lius had produced sufficient evidence of Dunkin’s ulterior motive, motivational analysis would have been irrelevant because the Lius’ non-payment constituted a material breach of the contract, which provided Dunkin’ legitimate grounds for termination.”\(^{37}\)

**B. Failure To Maintain Standards**

One of the most important components of franchising is the maintenance of uniform and consistent standards of operation and quality through the entire franchise system. If a franchisor does not, or cannot, enforce and protect its system standards, the franchise system is unlikely to succeed. Recognizing how important the maintenance of uniform system standards is to a franchisor, courts have consistently held that a franchisee’s failure to comply with a franchisor’s reasonable standards — whether related to operational processes, appearance of facilities, use of approved vendors or products, issues of health, safety and sanitation, or other matters — constitutes a material breach justifying termination of the relationship.

In McDonald’s Corp. v. Robertson, for example, the court held that the franchisee’s “failure to comply with McDonald’s QSC [quality, safety and cleanliness] and food safety standards constituted a material breach of the franchise agreement sufficient to justify termination.”\(^{38}\) The court first noted that the franchisee had agreed in the franchise contract that “[t]he foundation of the McDonald’s System and the essence of [the franchise contract] is the adherence by [the franchisee] to standards and policies of [McDonald’s] providing for the uniform operation of all McDonald’s restaurants within the McDonald’s System.” The franchisee also “acknowledged the importance of uniformity of food specifications, preparation methods, quality and appearance, facilities and service.” The court then reasoned:

\(^{35}\) 970 F.2d 273 (7th Cir. 1992). See also My Favorite Muffin, Too, Inc. v. Wu, Bus. Franchise Guide (CCH) ¶ 12,321 (N.D. Ill. April 29, 2002) (failure to pay royalties and marketing fund fees was an "obvious material breach of the underlying franchise agreement.")


\(^{37}\) Id.

\(^{38}\) McDonald’s Corp. v. Robertson, 147 F.3d 1301, 1309 (11th Cir. 1998).
The QSC and food safety standards produced by McDonald’s constitute some of the “standards and policies” with which McDonald’s franchisees must comply. Thus, continued violation of these standards appears to constitute a material breach of the franchise agreement. Moreover, as the district court noted, as a world-wide fast food chain, McDonald’s has a clear interest in securing a uniform product and service of high quality at all of its locations. McDonald’s also has a strong legal interest in avoiding disputes stemming from the cleanliness and safety of its products. Accordingly, there can be no real doubt that repeated and continued serious violations of the QSC and safety standards, such as those alleged by McDonald’s and unchallenged by the franchisees, constituted material breaches of the franchise agreement warranting termination.39

Other courts have reached the same conclusion on similar facts.40

In Maple Shade Motor Corp. v. Kia Motors of America, Inc., the court found that the franchisee’s failure to establish a showroom for its Kia franchise separate and apart from its Mazda franchise as required under an addendum to the parties’ franchise agreement was a material breach by the franchisee that provided good cause for termination of the franchise under the New Jersey Franchise Practices Act.41 The court noted that the contract addendum specifically provided that construction of the Kia showroom was a material term of the agreement and that failure to do so was grounds for nonrenewal. The court also observed that the separate Kia showroom was discussed and separately negotiated by the parties at the outset of their relationship and that the franchisor provided the franchisee with specific notice that its behavior was a violation of the agreement. Similarly, in Woodard v. General Motors Corp., the court held that an automobile manufacturer’s termination of a dealer was justified because the dealer failed to comply with the manufacturer’s requirements as to the appearance, location, size and layout of its dealership.42 And in Gordon v. Crown Central Petroleum Corp., the court held that the termination of a service station operator was justified for failure to keep the service station open twenty-four hours, seven days a week as required under the parties’ agreement.43

39 Id.


42 298 F.2d 121 (5th Cir.), cert. denied, 369 U.S. 887 (1962).

C. **Trademark Violations**

A franchisor’s trademarks, and the strength and goodwill associated with the trademarks, are one of a franchisor's most valuable assets. Franchisors must be able to protect and control the manner in which their franchisees use their trademarks. If a franchisor fails or is unable to protect and control its trademarks, the marks may become diluted, i.e. less likely to identify the franchisor's goods or services, and the goodwill associated with the marks may deteriorate. Because the strength and reputation of a franchisor's trademarks are so important to the success of the entire franchise system, courts generally hold that a franchisee's misuse of a franchisor's trademark is a material breach justifying termination.

In *Novus du Quebec, Inc. v. Novus Franchising, Inc.*, for example, the court concluded that a franchisor, Novus, likely had good cause to terminate its agreement with a subfranchisor (“NDQ”) based in part upon NDQ's blatant disregard of Novus’ requirements regarding the use of its trademarks.\(^{44}\) The parties in *Novus* had entered into an Area Franchise Agreement under which NDQ was granted the right to use and sublicense the “NOVUS Marks & System” in the province of Quebec, Canada for an initial term of ten years. The parties’ agreement and Novus’ operations manual contained certain requirements relating to the use of Novus’ trademarks by NDQ’s subfranchisees. After Novus terminated the Area Franchise Agreement on grounds that included NDQ’s failure “to conform with and enforce Novus’ uniformity and quality standards,” NDQ sued alleging that the termination violated the Minnesota Franchise Act. In denying NDQ’s motion for a preliminary injunction, the court held that NDQ was unlikely to succeed on the merits of its claims because Novus had good cause to terminate based upon the numerous trademark violations committed by NDQ’s franchisees.

In *Manpower Inc. v. Mason*, the court concluded that an employment agency franchisee, Mancan-Columbus, had violated its obligation under its franchise agreement not to use the franchisor’s name without its consent.\(^{45}\) One of Mancan-Columbus’ principals had established a consulting firm known as the Ascend Group, which he falsely represented to the public was a division of the franchisor, Manpower Inc. The court found that Mancan-Columbus' misrepresentation and misuse of Manpower’s name violated the franchise agreement and, when considered along with numerous other violations, made it highly likely that Manpower would “succeed on the merits of its claim that Mancan-Columbus breached its franchise agreement in material ways and that the breaches destroyed the essential object of such agreement.” The court also said, however, that “in itself this violation might not justify rescission.”

D. **Sale Of Competing Products And Other Violations Of In-Term Non-Competes**

Courts tend to agree that it is a material breach for a franchisee to offer or sell the products of a competitor in violation of the terms of the franchise agreement or to otherwise violate an agreement not to compete during the term of the franchise.

The sale of competing products was at issue in *General Motors Corp. v. New A.C. Chevrolet, Inc.*, where the U.S. Court of Appeals for the Third Circuit considered whether an automobile dealer materially breached its franchise agreement with General Motors by adding a

\(^{44}\) Bus. Franchise Guide (CCH) ¶ 10,823 (D. Minn. December 5, 1995).

\(^{45}\) 405 F.Supp.2d 959 (E.D. Wis. 2005).
Volkswagen franchise to its dealership business without General Motors’ approval. General Motors sued, seeking a declaration that its proposed termination of the dealer for adding the Volkswagen franchise was in compliance with the parties’ agreement and applicable law. It asserted that the dealer’s actions breached both a contract provision that prohibited any “change in location or in the use of Premises, including addition of any other vehicle lines, . . . without [GM]’s prior written authorization” and a provision that defined as a material breach “[a]ny sale, transfer, relinquishment, or discontinuance of use by Dealer of any of the Dealership Premises or other principal assets required in the conduct of the Dealership Operations, without [GM’s] prior written approval.”

On General Motors’ motion for summary judgment, the trial court determined that there was no genuine issue that the dealer had committed a material breach of the franchise agreement by operating a Volkswagen franchise on its dealership premises and that General Motors had good cause to terminate the dealer under the NJFPA. On appeal, the dealer argued, among other things, that even if its addition of a Volkswagen line was a breach of the parties’ agreement, the breach was not material, because General Motors permits other dealers to operate additional vehicle lines, and therefore not a proper ground for termination.

The Third Circuit disagreed. In affirming the trial court on the issue of materiality, the Third Circuit stated, “[w]e think there can be no dispute that New AC’s insistence on adding a Volkswagen franchise to its dealership, contrary to GM’s repeated objections to this decision, rose to the level of material breach.” The court recognized that “a breach is material if it ‘will deprive the injured party of the benefit that is justifiably expected’ under the contract.” It then reasoned that General Motor’s justifiable expectations regarding the dealer’s performance were best evidenced by the provisions of the parties’ agreement itself, which expressly conferred upon General Motors the power to disapprove of a proposal to “dual” another vehicle line. The court acknowledged that, if the dealer had proffered evidence that General Motors routinely permitted dealers similarly situated to it to operate competing vehicle franchises, then such evidence might support the argument that its breach was not material. The dealer, however, made no such showing and consequently the court held that termination was justified, and affirmed.

In Manpower Inc., the court held that the franchisee, Mancan-Columbus, materially breached the franchise agreement by employing Manpower competitors as subcontractors to fill orders outside of its authorized territory. The court found that Mancan-Columbus’ actions violated the territorial restrictions in the franchise agreement and also took money out of the pockets of other Manpower franchisees. It ultimately concluded that Mancan-Columbus’ actions demonstrated “a lack of commitment to the franchise relationship and destroyed one of its essential objects.”

E. Damage to Franchisor’s Reputation

Courts also tend to agree that when a franchisee’s conduct or breach causes damage to the franchisor’s reputation and goodwill the conduct or breach is material and justifies termination. For example, a number of courts have held that a franchisee’s conviction of, or guilty plea to, criminal charges or other unlawful conduct involving the franchise constitutes a

46  263 F.3d 296 (3rd Cir. 2001).
47  405 F.Supp.2d 959 (E.D. Wis. 2005).
material breach of the franchise agreement because of the resulting or potential damage to the franchisor’s reputation and goodwill.

In one such case, *Dunkin’ Donuts Inc. v. Gav-Stra Donuts, Inc.*, the court held that a franchisee’s criminal conviction for tax fraud conspiracy arising out of the operations of the franchise constituted a material breach of the “goodwill” and “obey all laws” provisions of Dunkin’ Donuts franchise agreement. In another case involving Dunkin’ Donuts, *Dunkin’ Donuts Inc. v. Panagakos*, the court stated that “no reasonable jury could find that Panagakos’ involvement in a tax evasion scheme intimately connected with the operation of his Dunkin’ Donuts franchise was not a material breach” of the franchise agreement. Likewise, in *Dunkin’ Donuts Inc. v. Panagakos*, the court stated that "no reasonable jury could find that Panagakos’ involvement in a tax evasion scheme intimately connected with the operation of his Dunkin’ Donuts franchise was not a material breach” of the franchise agreement.

Finally, in *Dunkin’ Donuts Inc. v. Chetminal, Inc.*, the court held that the franchisee’s illegal sale of cigarettes to minors was a material breach of the franchise agreement and provided cause for termination.

**F. Failure To Meet Sales Quotas**

Franchisors may be required to demonstrate the reasonableness of performance quotas when terminating an agreement for failure to meet them. There was no question about the reasonableness of performance quotas where a restaurant area developer did its own research and established its own quotas in *Brown Dog, Inc. v. The Quizno’s Franchise Co., LLC*. At the outset of the relationship, Brown Dog was responsible for establishing its own development quotas based on its own market research. Failure to meet the development quota was grounds for termination. After Brown Dog lagged behind schedule for two quarters, Quizno’s notified Brown Dog that it needed to catch up and maintain the schedule. Brown Dog did not catch up and after 90 days, Quizno’s sent Brown Dog a termination notice. Brown Dog argued that it had substantially complied with the development requirement because it was only one or two restaurants behind and that it often caught up to the preceding quarter’s quota. Quizno’s countered that “one is a big number when you have only eight restaurants,” and concluded that Brown Dog did not have enough proposed restaurants in the pipeline to enable the developer to meet the quota.

The court held that the development requirement was an essential and reasonable requirement of the contract under section 135.03 of the Wisconsin Fair Dealership Law. Brown Dog’s failure to meet the quota for six quarters was a failure substantially to comply with the

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agreement. Because proper notice was given and the quota requirement was not discriminatory, termination of the marketing agreement was proper.

Franchisors may more easily justify termination for failure to meet performance goals when there is evidence of efforts to consult with the franchisee about its shortcomings. A distributor's failure to meet six out of seven mutually agreed-upon performance goals justified transfer of the product line to another distributor under the South Carolina Unfair Trade Practices Act (SCUTPA) in *Richland Wholesale Liquors v. Glenmore Distilleries Co.*\(^5^3\) There was no evidence of malice where the manufacturer met with the distributor on multiple occasions to discuss its concerns over dwindling sales, gave written notice six months before making its final decision, and re-purchased all inventory from the terminated distributor.

The manufacturer had also consulted with the distributor in *L-O Distributors, Inc. v. Speed Queen Co.*\(^5^4\) The parties had a distributorship agreement pursuant to which L-O Distributors was to devote its best efforts to promote sales of defendant Speed Queen products. The agreement provided that it could be terminated "by either party at any time for any reason upon giving ten (10) days notice of same by certified mail to the other party, which termination shall be effective ten (10) days from the date of mailing said notice."

L-O Distributors performed poorly under the agreement. Speed Queen advised L-O Distributors how to correct its deficiencies, but to no avail. Speed Queen sent L-O Distributors a notice of termination citing L-O’s overall poor performance as the reason for termination. Speed Queen listed four specific actions that L-O Distributors could take to rectify its deficiencies. Speed Queen later advised L-O Distributors that it had failed to correct the alleged deficiencies and that its distributorship would be terminated.

L-O sued under the Wisconsin Fair Dealership Law, contending that: (i) it had substantially met its sales goals, (ii) Speed Queen lacked good cause to terminate the distributorship because of L-O’s substantial compliance with the agreement, (iii) the requirements imposed by the Speed Queen were discriminatory, and (iv) Speed Queen had an ulterior motive for the termination and actually wanted to divide L-O’s territory in half.

The court rejected all of the distributor's arguments, finding that L-O’s declining market share and failure to meet sales quotas evidenced its poor performance. L-O had fulfilled only two of the four cure requirements. The requirements were not discriminatory because Speed Queen had terminated six other distributorships for failure to achieve market share growth in their respective territories, and Speed Queen had a clear policy of terminating distributorships that failed to increase their market share. Speed Queen had complied with all notice requirements and thus the termination was proper.

Termination of a dealer agreement was found to be without just cause where a manufacturer failed to establish the reasonableness of its sales objectives in *Newell Puerto Rico, Ltd. v. Rubbermaid Inc.*\(^5^5\) The dealer had an agreement for the exclusive distribution of the Rubbermaid houseware product line in Puerto Rico and the U.S. Virgin Islands.

\(^{53}\) 818 F.2d 312 (4th Cir. 1987).

\(^{54}\) 611 F. Supp. 1569 (D. Minn. 1985).

\(^{55}\) 20 F.3d 15 (1st Cir. 1994).
Rubbermaid gave notice of termination based on the dealer’s failure to achieve assigned sales objectives and based on its competing manufacture and distribution of similar products.

The Puerto Rico Dealer’s Contract Act prohibits a supplier from unilaterally terminating a distribution Agreement with a dealer or refusing to renew an agreement upon expiration without “just cause.” “Just cause” is defined as nonperformance of any of the dealer's essential obligations under the contract, or any action or omission that adversely and substantially affects the interest of the principal or grantor in promoting the marketing or distribution of the merchandise or service. The dealer alleged that Rubbermaid had made direct sales to the retailers, imposed unreasonable sales quota, reclassified some of its houseware products to take them out of the agreement, and delayed and refused to service orders placed by the dealer. The evidence showed that Rubbermaid hampered the dealer’s ability to compete by also selling its products through another store, and that Rubbermaid’s assigned sales objectives were not reasonable for the Puerto Rican market. At trial, the jury found for the dealer, concluding that the termination was without just cause, and the Court of Appeals affirmed.

G. Under-reporting

Courts will generally find under-reporting of sales to be a material breach. Deliberate falsification of data will be recognized for the serious violation that it is, while potentially unintentional under-reporting may be excused as immaterial. Franchisors must be mindful of their own accounting and be prepared to provide reliable proof of the alleged under-reporting. The franchise agreement at issue in Dunkin’ Donuts v. Chyi Liu provided that an intentional under-reporting of gross sales and falsification of financial data were good cause for termination of the agreement. The agreement required the franchisee to report weekly gross sales accurately and to preserve all accounting and supporting documents. Dunkin’ Donuts discovered that Liu had under-reported gross sales in 1990. Dunkin’ Donuts met with the franchisee and advised him that it was terminating the agreement. Liu refused to vacate the store and Dunkin’ Donuts then sued to end the franchise agreement, alleging that Liu had under-reported sales and committed tax fraud.

While suit was pending, Liu fell behind on payments required under the franchise agreement. Dunkin’ Donuts sent a Notice of Default and Notice of Cure letter, Liu failed to cure and Dunkin’ Donuts terminated the agreement.

Liu counterclaimed for breach of the implied covenant of good faith and fair dealing, claiming that Dunkin’ Donuts’ computer auditing program was unreliable, and contending that Dunkin’ Donuts desire to resell Liu’s store at a profit was the motivating factor behind termination. Liu failed to produce evidentiary support for these allegations. The court concluded that based on Liu’s failure to make timely payments and the under-reporting of gross sales, there was no dispute that he had materially breached the contract and Dunkin’ Donuts had the right to terminate the franchise agreement.

The intentional under-reporting of merchandise sales is a material breach that goes to the essence of the franchise agreement, according to the U.S. District Court for the Eastern District of New York in The Southland Corp. v. Richard Froelich. The court declined to follow

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a magistrate judge’s recommendation and granted Southland’s request for injunctive relief. The 7-Eleven franchise agreement included a clause requiring notice and opportunity to cure before termination. Southland’s investigation of Froelich’s business revealed intentional under-reporting of merchandise sales at Froelich’s store. Southland sent Froelich a non-curable Notice of Termination. The court found that Froelich’s admitted failure accurately to report and deposit receipts and failure to report accurately the actual retail selling prices of merchandise were both material breaches of the franchise agreement. Southland was not required to give Froelich a chance to cure, the court concluded, because the intentional understating of merchandise sales, for any reason, was fraudulent conduct that went to the very essence of the contract.

The Jackson Hewitt franchise agreement at issue in Jackson Hewitt v. Greene provided that the franchisee’s under-reporting by 2% or more its Gross Volume of Business (GVB) was good cause for termination without a notice to cure. Jackson Hewitt terminated the franchise agreement, asserting that Greene had underreported in two ways: first, by claiming that franchise customers were his own preexisting clients, and second, by improperly deducting from GVD certain compensation payments to employees. Greene admitted to the misclassifications but blamed them on Jackson Hewitt’s software. The court rejected this argument and held that Greene had the duty to avoid misclassifications.

The court found that because Greene had miscalculated by 2% or more on two or more occasions, Greene was in violation of the agreement and subject to termination. The court rejected the franchisee’s contention that the contract clause was vague, noting that the Greene’s conduct harmed Jackson Hewitt precisely in the manner the clause was meant to prevent. The court also rejected Greene’s argument that the compensation payments were “indirectly included” in the reports submitted to Jackson Hewitt, and that Jackson Hewitt would have found them if it had looked. The court found that the franchisee’s discounting practices used to determine compensation payments led to the under-reporting, and granted Jackson Hewitt’s motion for summary judgment.

In a particularly egregious case of under-reporting, a franchisee claimed that a notice of termination was ineffective in The Southland Corp. v. Mir. Southland sued Mir for fraud and sought seizure of Mir’s inventory pursuant to a security agreement. Southland gave notice of termination of Mir’s franchise agreement without opportunity to cure. Southland alleged that Mir systematically perpetrated fraud against Southland through the improper use of money orders in a scheme designed to misrepresent and conceal store revenues. To disguise the discrepancy between actual money orders sold and the number reported, Mir falsified records. Mir conceded these were valid grounds for termination, but claimed that Southland should have given it an opportunity to cure.

The franchise agreement required that Southland give 30 days notice of termination, except for certain instances in which Southland had to give only 72 hours notice. One instance giving rise to termination on 72 hours notice was the franchisee’s failure properly to record, deposit, deliver, or expend and report receipts or to deliver invoices or other reports of purchase. The franchise agreement provided Mir the right to cure before expiration of the notice period for termination.

The court applied the common law principle that “unless a contract provision for termination for breach is in its terms exclusive, it is a cumulative remedy and does not bar the ordinary remedy of a termination for a breach ‘material, or which goes to the root of the matter or essence of the contract’.” The court held that Southland did not need to give Mir time to cure the breach, because the alleged “mail order” scam to misrepresent gross sales was a substantial breach that went to the “root of the matter or essence of the contract.”

A franchisee’s under-reporting was unquestionably good cause for termination in Dunkin’ Donuts of America v. Middletown Donut Corp. Dunkin’ Donuts notified Middletown that its franchise agreements were to be terminated due to intentional under-reporting of gross sales. During the eighteen-month period before suit, Middletown had intentionally underreported sales by approximately $98,000. The termination notice provided an opportunity to cure the alleged breach by making prompt payment of the amounts claimed due. Middletown made no attempt to do so. Middletown claimed that he did not underreport and did not breach his franchise obligations in any way. The trial court concluded otherwise and determined that Middletown was “guilty of unconscionable cheating” by deliberately failing to keep the financial records, so that he could underpay franchise fees, advertising fees, and rental override charges and evade both state and federal taxes. The court found it indisputable that Middletown’s underreporting was good cause for termination under both the NJFPA and common law. The Supreme Court of New Jersey upheld the trial court’s substantive ruling that Dunkin’ Donuts had a right to terminate the franchise agreement for underreporting, but remanded on damage issues.

H. Franchisor Market Withdrawal

In Ray Skillman Oldsmobile & GMC Truck Inc., v. General Motors Corporation, the court denied GM’s motion to dismiss, leaving open the question of whether termination of one product line was good cause for termination of a dealer agreement. Skillman had separate agreements with GM for each product line. In December 2000, GM notified all dealers that it would be phasing out its Oldsmobile division to improve GM’s overall competitive position. GM offered its dealers a buy out program, which the vast majority of dealers accepted. Skillman did not. In October 2004, GM notified Skillman that it would not renew its Oldsmobile Dealer Sales and Service Agreement upon expiration in 2005.

Skillman sued GM, alleging that GM engaged in deceptive franchise practices in violation of the Indiana Deceptive Franchise Practice Act. The Act prohibits franchise agreement terms that permit “unilateral termination of the franchise if such termination is without good cause or in bad faith,” or that allow “[a] franchisor to fail to renew a franchise without good cause or in bad faith.” Franchisees injured by such contract provisions have a right to sue the franchisor. Skillman argued that GM could not terminate the franchise agreement except upon breach by Skillman, or if GM withdrew entirely from the market, which Skillman defined as “the automobile market.” GM argued that its withdrawal of the Oldsmobile line was based on a legitimate business reason because the line was no longer competitive. According to GM, this business reason qualified as good cause for non-renewal. The court stated that “[i]t seems unlikely that a franchisor is committed by law to continue to make and sell each product line in perpetuity regardless of profitability and market changes.” Nevertheless, GM was not

\[60\] 495 A.2d 66 (N.J. 1985).


\[62\] Ind. Code §§ 23-2-2.7-1(7), (8).
withdrawing from the market entirely, it was just discontinuing the Oldsmobile brand. Whether GM's decision to discontinue that one line of cars constituted "market withdrawal" and thus "good cause" could not be decided at the pleadings stage.

In another automobile dealer case, Stadium Chrysler Jeep, L.L.C. v. DaimlerChrysler Motors Company, there were mixed results following the manufacturer's termination of one line of vehicles. The dealer's agreement with DaimlerChrysler Motors Company (DCMC) provided that it would terminate without notice on the discontinuation of the production or distribution of all vehicles listed on the Motor Vehicle Addendum. DCMC discontinued the Plymouth brand and created a compensation plan for terminated Plymouth dealers. Pursuant to section 13.4 of the New Jersey Franchise Practices Act (NJFPA), discontinuation of a brand of cars is deemed to be a termination of the motor vehicle franchise. The statute further states that a franchisor can delete models if that deletion does not result in the termination, cancellation or discontinuation of a brand of new motor vehicles. Where termination occurs "as a result of a termination or cessation of a part of the franchisors' business operations throughout the United States, which is not any part of any change in the ownership, operation or control of all or any part of the franchisor's business," the NJFPA imposes repurchase obligations on the franchisor.

DCMC argued that what it had done qualified as a cessation of its business operations under section 13.2 of the NJFPA. The court disagreed, concluding that "cessation of business operations" is not the same as "termination of a brand or line," and thus defendants' actions fell under section 13.4, not 13.2. The court declined to follow the holding in Freedman Truck Center, Inc. v. General Motors Corp., in which another New Jersey federal court held that the NJFPA did not impose liability on a franchisor who "makes a non-discriminatory product withdrawal over a large geographic area," because that case was decided before significant amendments to the statute took effect. The court granted the dealer's motion for summary judgment on its NJFPA claims.

Conversely, DCMC's conduct did not violate the Automobile Dealer's Day in Court Act (ADDCA), and the court granted DCMC's motion for summary judgment on those claims. The ADDCA requires actual or threatened coercion or intimidation in connection with termination or non-renewal. The dealer argued that "through unilateral, illegal impositions of the onerous and financially punitive Discontinuance Agreement, which has cut off Dealer's sales of Plymouth new vehicles, DCMC has seriously hampered Dealer's business and has wrongly obviated the DCMC's obligations to compensate the franchisees for termination, to the dealers detriment," and that DCMC "has conducted a substantial and comprehensive effort to coerce Plaintiffs into accepting inadequate payment for the unlawful termination of their franchise." The court found no evidence to support the dealer's claims. There was no evidence that DCMC had used the threat of termination against the dealer to make it do something, and DCMC had given franchisees a choice of compensation packages.

The manufacturer's motivation for market withdrawal is significant, as Harter Equipment, Inc. v. Volvo Construction Equipment North America illustrates. Harter had an agreement to sell and service Samsung equipment, which had been assigned to Volvo Construction Equipment North America (Volvo). The agreement provided that Samsung could change,
modify, or discontinue the production, sale, design, or specifications of any product at any time.
In 1991, Volvo ceased production of the Samsung line of excavators and other equipment. Volvo sought Harter’s consent to amend the dealer agreement to delete the discontinued equipment and represented that, if consent was not given, Volvo would not renew the agreement. Harter would not agree without additional conditions, which Volvo rejected. When Volvo did not renew the agreement, Harter sued for violations of the NJFPA.

Volvo moved for summary judgment, arguing that the decision to withdraw from the market by ceasing production of the Samsung line of equipment was non-discriminatory market withdrawal, which entitled them to terminate the dealer agreement. Harter contended that the withdrawal was not motivated by economic necessity as required to justify termination. Because Volvo’s motivation for withdrawal was at issue, the federal district court denied summary judgment.

I. Franchisee Insolvency

When determining if a breach is material, courts generally focus on whether the nonperformance defeats the object of the parties in forming the contract. If a party becomes financially unstable or weak, it is more likely that any breach will be deemed material. In Dollar Rent a Car Systems, Inc. v. P.R.P. Enterprises, Inc., defendant franchisee fell behind in payments owed to the franchisor under the parties’ vehicle lease agreements. Dollar notified PRP that the master lease agreements would terminate unless outstanding invoices were paid in full. Dollar withdrew the opportunity to cure after PRP represented that it could not pay the amounts owed and that it might file bankruptcy. Dollar notified PRP that it was terminating the license agreements immediately because of the termination of the lease agreements. Dollar also told PRP that its failure to pay amounts due within three days would constitute additional grounds for termination of the license agreements. PRP was unable to cure the defaults. The court held that the franchisee’s failure to make the required payments was a material breach, and that Dollar was not required to give PRP an opportunity to cure before terminating the agreements.

A licensee’s insolvency was also a material breach of contract in Pat’s King of Steaks, Inc. v. Pat’s International, LTD. International had the exclusive right to use King of Steaks’ trademarks. King of Steaks terminated the agreement based on International’s insolvency and failure to pay taxes. Evidence of International’s insolvency included the fact that International’s creditors placed it in involuntary bankruptcy, and International’s liabilities exceeded its assets by $4.8 million. International’s failure to pay taxes, while not a material breach standing alone, was further evidence of International’s financial difficulties. The court found for King of Steaks and enjoined International from further use of King of Steaks’ trademark.

Even though the franchisor had tolerated certain levels of insolvency among its franchisees, the franchisee that more than doubled its negative net worth in Open Pantry Food Marts of Wisconsin, Inc. v. Howell had become “too insolvent.” Howell’s negative net worth went from minus $25,000 to minus $62,074, justifying the franchisor’s termination on grounds of insolvency. Termination of Howell’s other agreement was not justified on insolvency grounds, however, where allowing Howell to carry the franchise fee as an asset valued at $7,500 made...
Howell solvent. The franchisor typically allowed franchisees to account for franchise fees in this way, and offered no rational basis for not permitting Howell to do the same thing. Howell’s failure to report video game income, however, constituted bad faith and thus the franchisor had good cause for terminating the agreement on this basis.

V. CASES FINDING BREACH NOT MATERIAL AND TERMINATION UNJUSTIFIED

Although fewer and farther between, there are a number of cases in which franchisees and distributors have established that their terminations were unjustified because their conduct did not rise to the level of a material breach. In *Ryko Manufacturing Co. v. Eden Services*, for example, a manufacturer terminated one of its distributors for promoting a competitor’s equipment in violation of the exclusive dealing provisions of the parties’ distributorship contract. The distributor admitted to having provided some of its customers with information and price quotations on at least one competitor’s equipment but argued, among other things, that its conduct did not amount to a material breach of the exclusive dealing provisions of the contract and therefore was not a valid basis for its termination. Apparently there was testimony during the trial indicating that the manufacturer may have anonymously solicited at least some of the competitive information from the distributor and that, despite its contract with other equipment manufacturers, the distributor continued to promote the manufacturer’s products. The jury concluded that the distributor’s conduct was not a material breach of the distributorship contract and that the manufacturer’s termination of the distributor therefore was itself a material breach of the contract. The U.S. Court of Appeals for the Eighth Circuit affirmed.

Volvo did not have good cause for terminating a franchisee under the Arkansas Franchise Practices Act (AFPA) in *Volvo Trademark Holding Aktiebolaget v. Ais Construction Equipment Corporation*. The parties filed cross motions for summary judgment on the issue of whether plaintiff violated the AFPA by terminating the franchise without “good cause.” Defendant Clark was a retail dealer of large earth-moving motor graders who entered into a Distributor’s Sales Agreement with Champion Road Machinery. Pursuant to that agreement, Clark was an authorized distributor of a certain machine. Volvo later purchased Champion Road. In order to promote Volvo’s complimentary products, Volvo decided to use the same dealers for other product lines, which resulted in the termination of some dealers, including Clark. Clark argued that events constituting “good cause” listed in the AFPA were exclusive. Because none of those events had occurred, Volvo lacked “good cause.” Volvo argued that the list was not exclusive and that its reasons for termination constituted “good cause.” Volvo did not contend that the statute was ambiguous. The court found the AFPA to be clear on its face and agreed with Clark’s interpretation. Thus, the court concluded that the termination was without “good cause” and granted the dealer’s motion for summary judgment.

Termination was without good cause in *Subaru of America v. State Board of Vehicle Manufacturers*. Subaru of America had a dealership agreement with Colonial, a licensed motor vehicle dealer. The agreement had a performance addendum, which provided that during the 12 months after the effective date of the agreement, the dealer would make every effort to sell 506 Subaru vehicles. The agreement provided that the dealer’s failure to sell the required number of Subaru vehicles would constitute a material breach of the agreement. The dealership

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69 823 F.2d 1215 (8th Cir. 1987).
70 416 F.Supp.2d 404 (W.D.N.C. 2006).
was unable to meet the required quota. Subaru gave the dealership two options, and refusal to implement either would lead to termination of the franchise. Subaru also told the dealership not to proceed with construction of a new showroom. Subaru later issued a Notice of Intention to Terminate the Dealership Agreement.

Under the Board of Vehicles Act, a manufacturer cannot terminate a franchise agreement with a dealer if the manufacturer’s actions in whole or in part caused the dealer to be unable to comply substantially with the reasonable and material requirements of the franchise. The dealer argued that he was unable to meet the sales quota because Subaru did not provide sufficient inventory. Between Sept 1, 1998 and Aug 31, 1999 Subaru allocated 366 vehicles while demanding that dealer sell 506. The court found that Subaru failed to prove that lack of commitment, rather than lack of inventory, caused the dealer to miss the sales quota.

The Act also required that the manufacturer give notice to the dealer of the material breach and provide time to cure. Subaru did not notify the dealer in writing of its intent to terminate the franchise agreement for failure to meet the sales quota until 14 months after the dealer had missed the target. The court also found that Subaru had violated the statute because the termination was not fair or effected with “due regard to the equities of the dealer.” Subaru allowed and approved the dealer’s facility renovations knowing that the dealer had failed to meet the sales quota. Subaru also threatened the dealership by giving the dealer two options to avoid termination. A manufacturer may not coerce a dealer to its prejudice by threatening termination under the Act. The court concluded that Subaru’s termination of the franchise was without just cause and was unfair and done without due regard to the dealer’s equities.

A dispute over the amount owed by a Century 21 franchisee led a jury to conclude, and the appellate court to affirm, that Century 21 lacked reasonable cause to terminate the franchise agreement under the Virginia Retail Franchise Act in G.M. Garrett Realty v. Century 21 Real Estate Corp. Garrett admitted that it owed fees to Century 21, but disputed the amount that Century 21 said was owed and challenged the franchisor’s accounting. Century 21 claimed that Garrett’s admission that it owed fees amounted to reasonable cause for termination under the Act. The court concluded that Century 21 failed to distinguish between “just cause” and “any cause.” The jury was justified in finding the termination to be unreasonable since Garrett disputed the amount due, had continued to pay certain sums to Century 21 during the term of the agreement, and had engaged in continued negotiations with Century 21 to determine the correct amount owed.

In Dunkin’ Donuts Inc. v. Gav-Stra Donuts, Inc., the court rejected the franchisees’ argument that the franchisor materially breached the franchise agreement by approving a corrupt vendor and failing to assist them in litigation against a co-franchisee. The court concluded that, “[e]ven if there were glitches in the provision of assistance by Dunkin’ Donuts to defendants, there is no evidence they went to the heart of the contract so as to excuse defendants’ contractual obligations.” See also Dunkin Donuts of America, Inc. v. Minerva, Inc. (franchisor lacked “good cause” to terminate).

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VI. FRANCHISOR OBJECTIVE MEASURES FOR JUDGING MATERIALITY

A. Typical Contract Provisions That Build In Materiality

Franchise agreements typically have built-in materiality provisions. For example, agreements often have two-tiered termination sections. Certain defaults give rise to the franchisor’s right to terminate only after an opportunity to cure the default. By giving the franchisee an opportunity to cure, the franchisor has built in a mechanism to prevent termination for a breach that the franchisee could have remedied and thereby preserved the parties’ bargain. Other defaults, such as insolvency, certain fraudulent acts or a felony conviction, give rise to the immediate right to terminate without the opportunity to cure. Most agreements also have provisions that allow a franchisor to terminate immediately, without giving the franchisee an opportunity to cure, when the franchisee has committed the same breach on multiple occasions. For example, it is common to see a provision that allows a franchisor to terminate immediately without an additional opportunity to cure, when a franchisee has had multiple monetary defaults within a 12-month period.

B. Internal Policies And Procedures Used To Evaluate Materiality

It is important that franchisors have internal procedures in place that help avoid termination for immaterial breaches. As a threshold matter, franchisors should implement policies and procedures to ensure that new franchisees are well-qualified. A discerning approach to franchise sales will help to avoid some of the common problems that lead to franchise terminations. Franchisors should also provide for routine and meaningful communication with franchisees. This will enable franchisors to spot problems early on and allow a greater chance for solving those problems.

Franchisors should have procedures in place for formal communications with franchisees as well. For example, franchisors should routinely inspect their franchisees’ operations. By doing so, a franchisor can provide feedback on operational shortcomings before a franchisee is ever placed in default. By providing feedback to the franchisee, the franchisor gives the franchisee an opportunity to fix the problem. If the franchisor advances the franchisee to the default stage on a standards issue, it should typically be after the problem has been identified through the inspection process and the franchisee has failed to remedy the situation after having had the opportunity to do so.

Audit procedures are another mechanism many franchisors have in place that serves as a check on materiality of a franchisee’s breach. A franchisor will typically not terminate a franchise for under-reporting, for example, until it has audited the franchisee’s operations.

Franchisors should have standardized procedures in place relating to default and termination that they follow consistently with all franchisees in the system. A haphazard and inconsistent approach to default and termination decisions will invite challenges to those decisions. Standardized written communications are a critical part of the termination process. Franchisors should work closely with counsel before taking steps to terminate a franchisee and should be consistent in determining when to place a franchisee in default and when to terminate a franchise agreement.
VII. FRANCHISOR MATERIAL BREACH GIVING RISE TO FRANCHISEE RIGHT TO TERMINATE THE RELATIONSHIP

There are circumstances in which a franchisor’s material breach will give a franchisee the right to terminate the franchise relationship. A plaintiff franchisee was entitled to rescind its franchise agreement because of the franchisor’s material breaches of contract in *BJM & Associates, Inc. v. Norrell Services, Inc.* The court in *BJM & Associates* concluded that the franchisor, Norrell’s, failure to provide the franchisee, BJM, with the required four direct mailings per year was a material breach, even though Norrell had furnished other methods of advertising. By failing to provide the four direct mailings, Norrell had transferred that cost to BJM, contrary to what the agreement required. Norrell’s operation of a similar type of business within BJM’s protected area was also a material breach. The court rejected Norrell’s breach of contract counterclaims. The evidence did not support claims that BJM had failed to pay required liquidation fees and had operated an “off-the-books” business.

Similarly, in *Travelodge Hotels, Inc. v. Honeysuckle Enterprises, Inc.*, the court found there was a genuine issue of material fact whether the franchisor had failed to place the franchisee on its reservation system and whether that failure was a material breach that excused the franchisee from performing its obligations to pay. The franchisee claimed that Travelodge’s salesperson represented that, if it converted its hotel to a Travelodge franchise, it would have access to Travelodge’s central reservation system, which would bring it “at least 15 percent reservations,” and that it entered the franchise relationship because of that representation. The franchisee further claimed that Travelodge failed to place it on the central reservation system and that the failure to do so was a material breach of the parties’ License Agreement. The court denied Travelodge’s motion for summary judgment on its claims against the franchisee for unpaid fees and liquidated damages for premature termination of the License Agreement. It concluded that the parties’ License Agreement contemplated the franchisee’s “participation” on the reservations system, that there was a factual issue whether the franchisee in fact was ever included on the reservations system, and that, if Travelodge materially breached the License Agreement by failing to include the franchisee on the reservations system, the franchisee would be excused from its obligations to pay fees to Travelodge.

In contrast, in *Dunkin’ Donuts Inc. v. Gav-Stra Donuts, Inc.*, the court rejected the franchisees’ argument that the franchisor materially breached the franchise agreement by approving a corrupt vendor and failing to assist them in litigation against a co-franchisee. The court concluded that, “[e]ven if there were glitches in the provision of assistance by Dunkin’ Donuts to defendants, there is no evidence they went to the heart of the contract so as to excuse defendants’ contractual obligations.”

VIII. PRACTICAL TIPS FOR EVALUATING THE MATERIALITY ISSUE

As the above discussion demonstrates, the question of materiality is highly fact specific. So how can a franchisor or franchisee best judge whether a particular violation or default is sufficiently material to justify termination or non-renewal?

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75 357 F.Supp.2d 788 (D.N.J. 2005). This case was subsequently tried to the court, which found that the evidence established “without question” that Travelodge had placed Honeysuckle on its reservation system and that Honeysuckle’s claims to the contrary were “contrived.” 2005 WL 3164205 (D.N.J. November 10, 2005).

An obvious starting point is to examine the terms of the franchise agreement. If the franchise agreement expressly states that a requirement or default is material, then a court generally will find that the requirement or default is in fact material for purposes of termination or non-renewal.

The parties should also consider whether the requirement at issue was something that they separately discussed and/or negotiated before entering the franchise agreement. If the parties separately negotiated the requirement, it likely will be considered material and any deviation from its terms will constitute a material breach. Similarly, if the requirement was something that the franchisor refused to negotiate, it likely will be considered a material requirement and any deviation from its terms will therefore be a material breach.

Repeated or multiple violations of a franchise agreement will likely be deemed a material breach or default unless the franchisor has condoned the violations or failed to enforce the requirements for a period of time. Therefore, the parties will need to consider how both sides have treated the particular requirements at issue during the course of their relationship in determining whether a violation is material.

The parties will also want to determine or evaluate how the franchisor has treated the subject requirement with respect to other franchisees. If the franchisor has waived the requirement or responded more leniently for violations committed by other similarly situated franchisees, it is less likely that the requirement or default will be deemed material for purposes of the termination or non-renewal.

IX. CONCLUSION

Because serious and sometimes costly consequences are at stake, franchisors must carefully consider the materiality issue before terminating a franchise agreement. In doing so, franchisors must be knowledgeable of both statutory and contractual requirements for termination, and must consider the unique facts of each franchisee’s situation and relationship with the franchisor. Franchisors will benefit from having a consistent, standardized approach to the default and termination process that enables the franchisor to identify problems early on and ensures an even-handed, defensible approach to termination decisions.
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