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Franchise Systems in Distress

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I. INTRODUCTION

Franchise and distribution systems face historic financial pressures. Credit is scarce. Sales are slumping, making credit ever more dear. Bankruptcies are increasing and we expect many more will follow. One article quotes American Bankruptcy Institute and International Franchise Association data to claim that there were 14,319 business bankruptcies in 2008 (up 64% from 2007) and that the number of franchised businesses will decline by 1.2% in 2009—a net loss of over 10,000 franchised businesses.

In this environment, those who depend on franchise and distribution systems need to protect those systems to save themselves. This means finding ways to help those system members who can be saved at a time when the resources to do so are increasingly scarce.

Never has careful planning and prudent decision-making been more essential. If you can’t afford to help everyone, who do you help? What are the consequences of helping, both from those you don’t help and from those who fail despite your help? How can you avoid costly mistakes and preventable consequences? This paper discusses tools that can help save distressed franchise and distribution systems and the limits placed on those tools by state and federal law. And it recognizes the need for franchisors and franchisees, manufacturers and dealers, to cooperate in a common effort to survive.

II. FRANCHISE ASSISTANCE PROGRAMS.

You can’t fix a distressed system until you understand why it is distressed. The reasons may be internal: like a flawed business model, poor management, inadequate investment in new products or services, a flagging brand image, poor customer loyalty, poor relationships among system members, falling market share, oversaturation and inadequate unit profitability. The reasons may be external, particularly now: inadequate access to capital, operating in a depressed sector of the economy, technological changes and consumer trends readily come to mind. And of course the reasons can be both internal and external.

The type, scope and duration of the assistance program must address the reasons for the distress – that is obvious – and satisfy a critical internal constraint: what can you afford? Some assistance programs redistribute resources, at least temporarily, from franchisor to franchisee: royalty and debt relief and direct loans are examples. These programs can be expensive; at least in the short run, if you choose to help some system members, must you offer the same

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2 See Emily, Maltby, Dragged into a bankruptcy that isn’t yours, CNNMoney, July 17, 2009 (reflecting on the plight of franchisees of Mrs. Field’s, Dial-a-Mattress, Bally Total Fitness and other systems that have filed for bankruptcy protection within the last year).

3 A solution that costs more in the short run may work better in the long run. Reducing royalties and increasing advertising fees may cut a franchisor’s revenue initially but may enable the entire system to prosper over a longer term.
help to all? Other programs have less impact on cash flow: for example, policies that raise retail
profits by reducing intrabrand competition (MAP programs, internet price advertising policies
and resale price maintenance policies are examples). But federal and state laws regulate some
of these practices, making their true cost harder to calculate.

The first section of this paper examines the legal limits on different types of assistance
programs. This includes federal and state laws that regulate the right to discriminate among
system members, antitrust laws and the common law.

A. Distressed Systems Can Discriminate Among Those Who Receive Help By
Following A Reasonable System-wide Plan.

Systems in distress must use their resources wisely. Most systems include members who can
survive without help, members who need help to survive and members who will fail anyway.
Most laws that prohibit discrimination aim at uneven practices used to support actual or
constructive termination or nonrenewal. While a failed system member can allege that denying
it assistance amounted to constructive termination, we found no cases that supported this
argument when the franchisor or grantor followed a system-wide plan that tried to direct
resources to those for whom they were most likely to make a difference.

   a. The Robinson-Patman Act. Although not intended to do so, the Robinson-Patman Act presents an obstacle to franchisee
      and dealer assistance programs. Enacted during the Great Depression, the Robinson-Patman Act tried to level the playing field by limiting the ability of large companies to obtain price and
      other concessions beyond the reach of their much smaller competitors. It bars sellers from discriminating in price between at least two purchasers of goods of like grade and quality where
      the effect may be to substantially lessen competition or tend to create a monopoly. "Price" includes terms of sale that affect the buyer's cost of obtaining the goods. But the statute also
      bars indirect ways by which the strong may extract other concessions that enable them to outcompete their weaker rivals, without requiring proof of injury to competition, and these strict
      liability provisions pose the greatest risk to programs that try to help distressed system members.

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4 "MAP" is an acronym for minimum advertised price. Lawful MAP programs aim to protect the image of a premium
brand by preventing ads that tarnish that image by offering cheap prices. A MAP policy can become illegal if it goes
beyond ad content and effectively controls actual resale prices.


6 15 U.S.C. § 13(a) bars price discrimination, whether direct or indirect. Anything that lowers the buyer's net cost of
purchasing the product is a component of price. See e.g., Sanitary Milk Producers v. Bergians Farm Dairy, Inc., 368
1966), aff'd per curiam, 371 F.2d 428 (7th Cir. 1966) (freight allowance), and Nat'l Dairy Prods. Corp. v. FTC, 412
F.2d 605 (7th Cir. 1969).
Few assistance programs that target distressed, salvageable system members will violate the statutory ban on price discrimination because the prohibition applies only if the effect "may be substantially to lessen competition or tend to create a monopoly." A good faith assistance program aims to save competitors that might fail without help; it promotes competition by helping more competitors to survive. And while discriminatory extensions and denials of credit can violate price discrimination laws, *Whirlpool Corp. v. U.M.C.O Int'l Corp.*, a franchisor or grantor can allocate credit among distressed system members based on the reasonable application of nondiscriminatory credit policies.

But the Act's strict liability sections arguably impose liability regardless of whether the banned activity has an effect on competition, so assistance programs that might fall within them require closer scrutiny. Section 13(c) prohibits unearned brokerage payments. Section 13(d) forbids payments for services or facilities furnished by system members unless the payments are available on proportionally equal terms to all other competing system members. And section 13(e) bans sellers from providing services or facilities to some system members on terms not offered to all system members on proportionally equal terms. A simple way to distinguish between section 13(a) claims that require proof of an injury to competition and sections 13(d) and (e) claims that impose liability without regard to competitive effects is that section 13(a) claims focus on system members' purchases of goods and sections 13(d) and (e) claims focus on system members' efforts to resell them.

There are limits to the reach of these strict liability provisions. Like the rest of the Robinson-Patman Act, they apply only among sellers and buyers of goods. And they do not apply to franchisors or grantors if system members buy their goods from truly independent third parties.

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10 But see Volvo Trucks North America, Inc. v. Reeder-Simco GMC, Inc., 546 U.S 164, 181, 126 S.Ct. 860, 873 (2006)(noting generally that the primary concern of antitrust law is interbrand, not intra-brand, competition, and that the Court has continued to construe the Act "consistently with broader policies of antitrust laws.")
11 Section 13(c) has been called "curious" and little related to the rest of the statute. Philip F. Zeidman, Legal Aspects of Selling and Buying, Second Ed. at 116. It was aimed at powerful chain stores that demanded payments to their wholly owned brokerage houses as another way to best their weaker rivals. Id. at 117. It has been extended to commercial bribery when the recipient receives the bribe without the knowledge of his employer or principal. See e.g., Grace v. E. J. Kozin Co., 538 F.2d 170 (7th Cir. 1976); Stephen Jay Photography, Ltd. v. Olan Mills, Inc., 713 F.Supp. 937, 940-42 (E.D. Va. 1989), aff'd, 903 F.2d 988 (4th Cir. 1990). It should have no application to the kinds of assistance programs we are discussing.
12 But regardless whether or not a court requires a showing of "injury to competition" for §§ 13 (c), (d) and (e), a plaintiff bringing a private antitrust action under § 4 of the Clayton Act (15 U.S.C. § 15) must be able to show an "antitrust injury" resulting from the alleged violation. An "antitrust injury" is "an injury the type the antitrust laws were intended to prevent. See e.g. Maddaloni Jewelers, Inc. v. Rosex Watch U.S.A., Inc., 354 F.Supp.2d 293, 305 – 310 (S.D.N.Y.2004); Tubby's #14, Ltd. v. Tubby's Sub Shops, Inc,2006 WL 3556199 (E.D. Mich 2005). See also J. Truett Payne Co. v. Chrysler Motors Corp., 451 U.S. 556, 562, 101 S.Ct. 1923 (1981)(a plaintiff must prove more than a violation of the Robinson-Patman Act, and "must make some showing of actual injury").
13 See 15 U.S.C. § 13(c), (d), (e).
Courts have not yet applied sections 13(c), (d) or (e) to assistance programs for financially distressed systems, but the credit cases decided under section 13(a) offer some insights. \(^{15}\) In each of them, the court stated that it would not apply the Act against a business that made credit decisions based on a nondiscriminatory credit policy applied to individual system members with reasonable business judgment. But an "assistance program that rewards only the strongest system members, who do not need it to survive, is likely to be unmasked as illegal price discrimination."\(^{16}\) The lesson of these credit cases is that system members must have the ability to qualify for the program, but the Act does not protect those who could have qualified but don't because of how they operated their business.

The credit cases can be distinguished as forms of "price" discrimination under section 13(a), which does not create strict liability or require that pricing programs be available on a "proportionately equal" basis as do sections 13(d) and (e), so assistance programs that fall within sections 13(d) and (e) entail more risk. This includes programs in which the franchisor or grantor either pays the system member for performing services that promote the resale of its products or performs those services itself. But it should not include programs that help improve the general economic health of distressed system members and do not constitute some form of promotional allowance.

A variety of assistance programs pose little risk of price discrimination. Where consumer demand no longer supports the same number of system members, consolidations and unit closures will rebalance supply with demand. Franchisors and suppliers can facilitate these transactions by repurchasing excess inventories, financing consolidations and even contributing toward the purchase price. Reducing royalty or renewal fees, increasing advertising, deferring a restructuring debt, re-training and help with financial management are other forms of assistance that present little risk of price discrimination.

b. **Petroleum Marketing Practices Act ("PMPA").**\(^{17}\)

The PMPA regulates the termination and nonrenewal of franchises that sell or distribute motor fuel. It does not regulate assistance programs. But programs that discriminate against individual franchisees can be evidence of intent to injure the disfavored franchisees. While constructive termination attacks rarely succeed under the PMPA, a discriminatory assistance program that causes excluded franchisees to fail is more vulnerable to those kinds of claims. Assistance programs that pass muster under the Robinson-Patman Act should not violate the PMPA, either.

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\(^{14}\) See e.g., *Acme Refrigeration of Baton Rouge, Inc. v. Whirlpool Corp.*, 785 F.2d 1240, 1243 (5th Cir. 1986), cert. denied, 479 U.S. 848 (1986) (applying the rule to a non-controlled affiliate).

\(^{15}\) *Bouldis*, 711 F.2d 1319 (Plaintiff complained that franchisor's credit assistance programs were not available to it but the court found no price discrimination because Suzuki determined eligibility based on a nondiscriminatory credit policy that considered credit history, net worth, capital, cash position, personal guaranty and overall dealership success). See also *Thomas J. Kline*, 878 F.2d 791; *Carlo C. Gelardi Corp.*, 502 F. Supp. at 647 ("a manufacturer is free to extend different terms to competing purchasers so long as it makes its decisions in a non-discriminatory manner, i.e., the same standards of creditworthiness must be extended to all applicants for credit . . . .").

\(^{16}\) *Craig*, 515 F.2d at 222; *Whirlpool Corp.*, 748 F. Supp. 1557.

"The PMPA is primarily concerned with attempts by franchisors to discriminate against a particular franchisee or to extract an unfair concession based upon the franchisor's superior bargaining power."\(^{18}\) It "was intended by Congress to protect franchisees only in situations where the franchisor acts with evil motive or discriminates selectively against franchisees with the intent to terminate or to nonrenew the franchise."\(^{19}\) Constructive termination claims rarely succeed.\(^{20}\)

An assistance program that targets salvageable distressed system members is not prohibited. But denials of assistance have been used as evidence to support a wrongful termination or nonrenewal claim. *Serianni v. Gulf Oil Corp.*\(^{21}\) shows how. Gulf Oil declined to renew Serianni's retail franchise because Serianni failed to buy enough motor fuel. The franchisor had been paying two of Serianni's local competitors a 2\% rebate, but not Serianni. So Serianni argued that the minimum purchase requirement was unreasonable as long as Gulf Oil was subsidizing his competitors. Gulf Oil moved for summary judgment but the court held that a reasonable jury could decide that the minimum purchase requirement was either unreasonable or that Serianni's failure to satisfy it was beyond his control while Gulf Oil subsidized his competitors.

Courts will scrutinize assistance programs to see whether they are thinly veiled attempts to injure particular excluded system members. System-wide programs that set nondiscriminatory standards to qualify for help should pass that scrutiny unless they are applied in an arbitrary way that discriminates against a particular system member.

c. **Automobile Dealer Franchise Act ("ADFA").**\(^{22}\)

The ADFA does not regulate assistance programs. Case law suggests the Act would not prohibit assistance programs that exclude some system members through nondiscriminatory eligibility standards applied in good faith.

The ADFA aims to address the unequal bargaining power between automobile manufacturers and their dealers to protect dealers from unfair termination and other coercive practices.\(^{23}\) It creates a remedy if the manufacturer fails "to act in good faith in performing or complying with any of the terms or provisions of the franchise, or in terminating, canceling, or not renewing the franchise."\(^{24}\) Good faith "has a limited and restricted meaning. It is not to be construed liberally."\(^{25}\) A dealer must demonstrate the manufacturer's lack of good faith in "the context of

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\(^{18}\) *King Serv. Inc. v. Gulf Oil Corp.*, 834 F.2d 290, 294 (2d Cir. 1987).

\(^{19}\) See also *Palmieri v. Mobil Oil Corp.*, 529 F. Supp. 506, 511 (D. Conn. 1982).


\(^{25}\) *Autohaus Brugger, Inc. v. Saab Motors, Inc.*, 567 F.2d 901, 911 (9th Cir. 1978).
actual or threatened coercion or intimidation.\textsuperscript{26} There must be evidence of a wrongful demand by the manufacturer that would result in penalties if the dealer does not acquiesce.\textsuperscript{27}

The AFDA does not bar assistance programs that try to help some but not all system members.\textsuperscript{28} In Capital Ford, a dealer challenged a Ford price assistance program that included a published schedule of available assistance. Dealers could appeal for more assistance than stated on the schedule if the corresponding sale was large enough or was to a large customer.\textsuperscript{29} Ford enforced the program strictly, and the plaintiff-dealer was never able to qualify for additional assistance through the appeal process.\textsuperscript{30} The court held that Ford’s process for awarding additional assistance did not violate the AFDA because there was no evidence of coercion or that Ford adopted or applied it in bad faith.\textsuperscript{31}

d. \textbf{The Sherman Act}.\textsuperscript{32}

The Sherman Act prohibits unreasonable restraints of trade. System-wide assistance programs may be used without violating the Act to enhance brand image, help save financially distressed system members and generally enable the system to compete better with its interbrand rivals. But programs adopted at the behest of competing system members present a high risk because they will be scrutinized as possible cartel-like agreements among competitors to restrain competition.

Franchisors and grantors sometimes try to help increase the profitability of system members through programs that enhance demand for the products they sell or that reduce or eliminate price competition among system members. The Sherman Act tests these programs under the rule of reason, barring them only when the anticompetitive effects unreasonably exceed the pro-competitive effects of the program.

Advertising programs that leave buyers and sellers free to determine actual sale prices do not violate the Sherman Act. Minimum Advertised Price (MAP) policies try to enhance brand image by barring ads that emphasize cheap prices and position the product as a commodity item. Co-op advertising policies operate similarly by subsidizing only ads approved by the franchisor or grantor, usually ads that use MSRP or the like. What separates these programs from more highly scrutinized resale price maintenance programs is the ability of buyers and sellers to agree on prices other than those advertised.\textsuperscript{33} When MAP policies eliminate this "price-finding"

\textsuperscript{27} Id.
\textsuperscript{29} Id.
\textsuperscript{30} Id.
\textsuperscript{31} Id. at 1567.
ability, they become vulnerable to attack. Co-op advertising policies are safe to use when they are truly voluntary and system members are free to run separate, unsubsidized ads that promote whatever price they wish.

Forbidden fruit for nearly 100 years, resale price maintenance programs (not so affectionately called resale price fixing) have gained attention since the Supreme Court decided Leegin Creative Leather Products, Inc. v. PSKS, Inc. No longer does federal law find such agreements per se illegal. Still, they remain far from a safe choice as federal courts struggle to apply the new rule and Congress considers legislation to repeal Leegin. And Leegin does not control state law. But if your system happens to affect commerce only in those states that recognize Leegin as the law, resale price maintenance programs can help franchisees and dealers maintain a higher profit margin by eliminating intrabrand price competition that can become a destructive "race to the bottom." Of course, if you adopt such a program because your competing system members pressured you to do so, you can expect to be attacked for joining a horizontal price fixing cartel, for which jail time remains a possibility if the attack comes from the government.

2. State Laws.


Most states have adopted their own versions of the federal Robinson-Patman Act and the Sherman Act. A few states ban resale price fixing explicitly. In most other states, courts are directed either to follow federal precedent or to strongly consider doing so. Some of those states banned resale price fixing by adopting the Supreme Court's original 1911 ban as the correct interpretation of their state's "Little Sherman" Acts and may not abandon their ancient precedents for the Court's recent 5 – 4 ruling.

The result is uncertainty from state to state, making it most prudent for now to follow pre-Leegin precedent in designing assistance programs that affect resale prices. So what we have said about those federal statutes applies as well to their "little" state analogs, with the caveat mentioned earlier about uncertainty over how state courts will respond to Leegin. This means that system-wide assistance programs that set nondiscriminatory rules for eligibility and apply those rules with reasonable business judgment should not violate these "little" state statutes, unless they (a) amount to resale price fixing agreements, (b) are disguised horizontal cartel

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34 See e.g. FTC Action [1997 to 2001 Transfer Binder], Trade Reg. Rptr. CCH ¶ 24,746, Sony Music Dist. Inc., DKT C-3971(Aug. 30, 2000); See also Campbell v. Austin Air Systems, Inc., Trade Reg. Rptr. CCH ¶ 75,023 (W.D.N.Y. Sept. 29, 2006).
35 See Supra note 9.
37 The federal statutes just discussed and the state law discussed below apply to ad hoc decisions involving individual system members as well as to regional and system-wide changes. Disparate treatment of individual system members is a frequent litigation trigger, for example.
arrangements or (c) fall within the state equivalents to sections 13(c), (d) or (e) of the Robinson-Patman Act.

b. **State Anti-discrimination Laws.**

State franchise and dealer statutes that prohibit discrimination can apply more broadly to assistance programs than the Robinson-Patman Act, the Sherman Act, or their "little" state analogs. Some state statutes prohibit discrimination among franchisees explicitly. Others build the concept into their definitions of "good cause," "just provocation," substantial changes in competitive circumstances and similar standards for assessing franchisor and grantor actions. These statutes are not limited to relationships between buyers and sellers of "like goods or commodities," to plaintiffs who suffer "antitrust injury" or to unreasonable restraints of trade within defined product and geographical markets. But in the end, they should not prohibit a nondiscriminatory program applied with reasonable business judgment. For example, these laws should not affect an assistance program that enables financially distressed system members to consolidate with or be acquired by other members, or close, before falling even deeper into debt. Such assistance strengthens the entire system by rebalancing supply to meet reduced demand, enabling system members to operate more profitably.

Indiana offers a good case study because it explicitly prohibits the broadest range of discrimination. The Indiana Deceptive Franchise Practices Act states:

> It is unlawful for any franchisor who has entered into any franchise agreement with a franchisee who is a resident of Indiana or a nonresident operating a franchise in Indiana to engage in any of these acts and practices in relation to the agreement:

> (5) discriminating unfairly among its franchisees, or unreasonably failing or refusing to comply with any terms of a franchise agreement.

Yet even this far-reaching language should not keep distressed systems from adopting system-wide assistance programs that leave out those who either don't need help or are beyond salvaging.

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41 For examples of generally applicable relationship laws, see Ark. Code Ann. § 4-72-204(a)(1), (2); Iowa Code § 523H.7; and Wis. Stat. §§ 135.02(4)a, 135.03 & 135.04. For examples of state motor vehicle statutes that prohibit discrimination in various forms that might affect assistance programs, see Ga. Code Ann. § 10-1-662(a)(9); Nev. Rev. Stat. § 482.36385(2); Ohio Rev. Code § 4517.55(B)(5); Wash. Rev. Code § 46.96.185(1); and Wis. Stat. § 218.0116(1)(i)(a). For similar language in other special industry laws, see Idaho Stat. § 23-1328A (Wine); Mich. Comp. Laws § 445.1457a (farm and utility equipment); Idaho Stat. § 28.24-140D (farm equipment); Wash. Rev. Code § 19.98.009-.210(1) (farm implements and machinery); Va Cod. § 59.1-352.9 (farm machinery); Minn. Stat. § 325E.062 (farm equipment); Ark. Code § 4-72-310 (farm equipment); Mo. Rev. Stat. § 407.1323 (recreation vehicles); Tenn. Code. § 47-25-1909 (motorcycles and off-road vehicles); Md. Code Com. Law § 19-103 (equipment); Mo. Rev. Stat. § 407.898 (outdoor power equipment); Cal. Bus. & Prof. §§ 22901-22925 (equipment); Iowa Code § 322F.2, et seq. (equipment); Neb. Rev. Stat. § 87-704 (equipment); and Minn. Stat. § 325E.0682 (heavy and utility equipment).

42 Ind. Code § 23-2-2.7-2(5).
Canada Dry Corp. v. Nehi Beverage Co. shows the limits of Indiana's anti-discrimination statute. The parties signed a franchise agreement that stated: "Nehi intends, subject to further review with Canada Dry, to introduce Ginger Ale as a soft drink in the Spring of 1978." But Canada Dry never let Nehi begin selling Ginger Ale as a soft drink due to concerns about Nehi's ability to do so. So Nehi alleged unfair discrimination under the Indiana statute, complaining it was the only bottler among nine Midwestern bottlers offered the right to sell Ginger Ale as a soft drink that was denied the opportunity to exercise that right. The jury found unfair discrimination and awarded Nehi $200,000. The Seventh Circuit reversed, holding the evidence of discrimination was insufficient as a matter of law.

We conclude, however, that Nehi failed to introduce sufficient evidence for the jury to find that Nehi established a prima facie case of discrimination. Discrimination among franchisees means that as between two or more similarly situated franchisees, and under similar financial and marketing conditions, a franchisor engaged in less favorable treatment toward the discriminatee than toward other franchisees. Thus, proof of "discrimination" requires a showing of arbitrary disparate treatment among similarly situated individuals or entities. This principle is supported by the very authorities which Nehi itself has cited in favor of its position.

Nehi introduced no evidence of more favorable treatment of similar bottlers under similar marketing conditions either as to the soft drink program or as to termination of the franchise agreement. For example, Nehi did not show whether it was as qualified to enter the soft drink program as the eight bottlers who were offered such a program; nor did it demonstrate that it was more qualified than bottlers who were also not offered the program, of which Canada Dry asserts there were at least fifteen.

Canada Dry and similar decisions leave plenty of room for systems to help distressed-but-salvageable system members without requiring those programs to include system members who either don't need help or are likely to fail even with help.

Wisconsin provides a good example of a state anti-termination statute that incorporates anti-discrimination concepts into its definition of "good cause." While the Wisconsin Fair Dealership

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43 723 F.2d 512 (7th Cir. 1983)
44 Id.
45 723 F.2d at 521 – 522.
Law\textsuperscript{47} may require notice before implementing an assistance program that disadvantages ineligible participants, it should not preclude the same types of system-wide assistance programs that would pass muster under the federal and state regulatory schemes discussed previously in this paper.

The WFDL defines "good cause" to encompass discrimination among system members. Section 132.05(4)(a) defines "good cause" as:

\begin{quote}
Failure by a dealer to comply substantially with essential and reasonable requirements imposed upon the dealer by the grantor, or sought to be imposed by the grantor, which requirements are not discriminatory as compared with requirements imposed on other similarly situated dealers either by their terms or in the manner of their enforcement;\textsuperscript{48}
\end{quote}

The WFDL also bars changes in competitive circumstances (a) without good cause, notice and a chance to cure if the changes are to the competitive circumstances of a dealership agreement and (b) without 90-days notice if the changes do not alter the dealership agreement but still impede the dealer's ability to compete in a substantial way.\textsuperscript{49}

As interpreted, the WFDL could delay but should not prevent a distressed system from adopting assistance programs that help fewer than all system members. The good cause definition itself recognizes the right to make rational distinctions among system members, and if a new program based on those rational distinctions competitively disadvantages a system member without breaching the dealership agreement, the WFDL requires only that the disadvantaged system members receive 90-days' written notice before it is implemented in the areas that affect them.

Two cases illustrate these principles. The first is \textit{Remus v. Amoco Oil Co.}\textsuperscript{50} Amoco began a program that offered customers a discount if they paid cash and encouraged its dealers to charge credit card customers the true cost of credit sales. The system-wide change applied to all Amoco dealers but it affected more adversely those dealers who depended more on credit card customers. Remus claimed the new program discriminated against him and the class he represented. The Seventh Circuit held that such system-wide changes do not violate the WFDL:

\begin{quote}
The statute may go somewhat further than we have suggested and protect dealers against new competition that has substantially adverse although not lethal effects..... what most dealers fear more than anything else is that the franchisor will increase the amount of intrabranch competition by placing new outlets, whether franchisee or franchisor-owned, too close to the existing outlets for comfort. But even if the Wisconsin Fair Dealership Law is designed to give franchised dealers in
\end{quote}

\textsuperscript{47} Wis. Stats. § 135.

\textsuperscript{48} Wis. Stat. § 135.02(4)(a).

\textsuperscript{49} Compare Wis. Stat. §§ 135.03, 135.04, with Jungbluth v. Hometown, Inc., 201 Wis. 2d 320, 548 N.W. 2d 519 (1996).

\textsuperscript{50} 794 F.2d 1238 (7th Cir. 1986).
Wisconsin some protection against such moves by franchisors (an issue we need not decide), this cannot help Remus. Amoco did not increase the number of dealers or open up new company-owned stations. Far from stepping up the competitive pressure on its dealers it unbundled its cash and credit card pricing in order to make it easier for them to respond to competition from dealers in other brands of gasoline.\footnote{Id.}

The second example is \textit{Wisconsin Compressed Air Corp. v. Gardner Denver, Inc.}\footnote{571 F. Supp. 2d 992 (W.D. Wis. 2008).} It creates a trap for the unwary, but ultimately allows systems to make changes that adversely affect some system members in substantial ways as long as (a) the changes don't breach the dealer agreement, (b) the disadvantaged dealers receive 90-days' advance notice, and (c) the changes are not made because of dealer deficiencies.

Gardner Denver granted Wisconsin Compressed Air Corp. a nonexclusive right to sell in a primary area of responsibility. Later, the grantor bought a competitor and inherited its dealers, one of whom competed with Wisconsin Compressed Air Corp. in Wisconsin. Gardner Denver allowed the new dealer to sell both product lines, but not Wisconsin Compressed Air Corp. This placed its original dealer at a serious competitive disadvantage. Litigation followed.

For the first time, 22 years after Remus, a court scrutinized the statutory regulation of "changes in competitive circumstances." The court concluded "that a grantor 'substantially changes' a dealer's circumstances by allowing or engaging in any 'intrabrand' competition likely to have a serious effect on a dealer's ability to continue to compete in that market."\footnote{Wis. Compressed Air Corp., 571 F. Supp. 2d at 1002 (citation omitted).} Adding the new dealer did that, which triggered a close examination of some odd differences between Wisconsin Statutes section 135.03 (which prohibits substantial changes to the competitive circumstances of the dealer agreement) and Wisconsin Statutes section 135.04 (which requires a 90-day notice and 60-days to cure "any claimed deficiency" before making a "substantial change in competitive circumstances" without limiting "competitive circumstances" to those found in the dealer agreement). Adding the second dealer did not breach the dealer agreement because it was nonexclusive. But it seriously hurt the original dealer's ability to compete because only the new dealer could sell the entire Gardner Denver product line. Did that give the disfavored dealer the right to cure under Wisconsin Statutes section 135.04? "No," answered the court, because the grantor did not appoint the new dealer to address the original dealer's deficiencies; the grantor merely thought the new dealer would do a better job. Still, the change in competitive circumstance was substantial, so the disfavored dealer was entitled to 90-days' notice before the appointment took effect.

These cases teach several lessons. Systems can adopt assistance programs that place some system members at a competitive disadvantage. It is safer to do so if the right to make such changes has been reserved in the parties' agreement. At least make sure the change doesn't breach that agreement. Then, define the program in a nondiscriminatory way, and apply it consistently. In Wisconsin, at least, notify system members 90-days in advance, and do not assert dealer deficiencies as the reason for the assistance program.

\footnote{Id.}
c. **Other State Statutes.**

As a last statutory resort, system members unable to qualify for an assistance program may invoke state deceptive and unfair trade practice statutes. Practically every state has one. These efforts usually fail. In *McLaughlin Ford, Inc. v. Ford Motor Co.*, the court held that a nonconsumer dealer could invoke the statute but still had to prove that unfair or deceptive methods of competition had a "potential effect on the general public." Adding an encroaching new dealer failed to satisfy that standard. *Accord, D & K Foods, Inc. v. Bruegger's Corp.*, rejecting claims under the Washington Consumer Protection Act and the New Mexico Unfair Trade Practices Act, in part, because the public interest was insufficiently at stake. (But the court refused to dismiss an alternate claim based on the covenant of good faith and fair dealing.)

d. **Common Law.**

The final limitations on assistance programs come from the common law. Our focus here is on the lessons taught by the lender liability cases that arose from recessions past. In those cases, lenders became involved in their borrower's efforts to adapt to financial distress. When those efforts failed, the borrowers (or their other creditors) accused lenders of using their leverage to pillage the borrowers' assets. Franchisors and suppliers often have similar leverage over system members in financial distress. When assistance efforts fail, some financially distressed system members (or their other creditors) will raise a similar complaint: we needed a life preserver and you tossed us an anchor. While the lender liability decisions display an array of legal theories, most involve a few common scenarios.


55 473 A.2d 1185 (Conn. 1984).

i. Misuse of Control.

By far the biggest risk involves exploiting control over system members in a way that a judge or jury considers unacceptable in hindsight.57 Use and misuse of control create a spectrum of risk. At the lower end is the creditor that merely exercises veto power over a borrower's major decisions to protect its loan or receivables.58 Toward the upper end is the creditor that insinuates itself so deeply into the debtor's business that it effectively dictates day-to-day operational decisions and, in egregious cases, manipulates those decisions to make the system member buy even more of its products and pay for them by robbing Peter (other creditors) to pay Paul (the controlling creditor).59 Theories that depend on abuse of control include instrumentality theories,60 agency theories,61 inadvertent agency and partnership theories,62 fraud and negligence theories,63 and duress theories.64 Control-based liability can arise under tax law, securities law, and CERCLA, as well.65 Control of a debtor also can extend the bankruptcy preference period from 90 days to one year.66 Control also can lead to rulings that the system member's personnel actually are employees of the franchisor or supplier.67

ii. Broken Promises and Other Misrepresentations.

Another important source of common law claims involve promises and representations. Broken promises to lend or provide other assistance create breach of contract and promissory estoppel.

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61 See A. Gay Jenson Farms Co., supra at note 56; and In re Atl. Fin. Mgmt., Inc., 784 F.2d 29, 31-32 (1st Cir. 1986).


claims. Rosy portrayals of the debtor's financial condition may become actionable when another creditor or investor relies on them. The logic of Central States Stamping would apply to a franchisor that vouches for a financially distressed franchisee's creditworthiness to someone who extends credit to the franchisee based on the credit reference. A list of possible misrepresentations would be endless. The simple lesson of these cases is say what you mean, do what you say, and confirm it in writing to avoid misunderstandings.

iii. Interference Theories.

Tortious interference with contract or with a prospective contract is another source of risk. A manufacturer's comments about a troubled dealer can cause lenders and other creditors to withhold or withdraw credit. This risk is particularly great when the dealer's financing comes from a system affiliate because even though a subsidiary ordinarily cannot conspire with its parent, either of them can interfere with the performance of the other's contracts or prospective contracts with dealers. Interference claims also arise when a financially troubled dealer wants to sell its business to the highest bidder but the manufacturer prefers another suitor or a lower price.

iv. Deepening Insolvency.

Deepening insolvency has become a catchy label for taking a bad situation and making it worse. Normally, it is raised by creditors or by passive investors whose stock has become worthless. As such, it is a type of derivative claim, which means the claimant stands in the shoes of the debtor. This is important for two reasons. It means that agreements that allocate risk between a financially troubled dealer and the assisting manufacturer or lender are likely to bind the third party creditor who steps into the system member's shoes. It also means the assisting manufacturer or lender is more likely to be able to prevail with defenses based on the business judgment rule and the in pari delicto doctrine.

69 See e.g., Cent. States Stamping Co. v. Terminal Equip. Co., 727 F.2d 1405 (6th Cir. 1984).
70 See e.g., supra note 59.
72 See e.g., Se. Distrib. Co., supra note 59.
73 The seminal decision is Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340 (3d Cir. 2001). But the theory has been rejected by other courts. Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168 (Del. Ch. 2006) and In re SI Restructuring, Inc., 532 F.3d 355 (5th Cir. 2008). And the Third Circuit later limited it to a damage theory. In re CitX Corp., 448 F.3d 672 (3rd Cir. 2006).
74 See CitX Corp. v. Detweiler, supra note 73.
75 See e.g., R.F. Lafferty & Co., supra note 69; Trenwick Am. Litig. Trust, supra note 69.
B. **Creating An Assistance Program: Practical Ideas.**

1. **What or Who is the Problem?**

Start broadly. Get a view from outside the system looking in. Ask customers. Ask system members. Ask system management – at every level. Don't assume you know the problem; it could be you, and you may be the last to realize that.

2. **Consider all Possible Solutions.**

Almost any problem can be solved in more than one way. Consider all of them. Some will cost more, others less. Some will create more legal risk, others less. Some will have business consequences among system members that are not immediately obvious. Just as you sought broad feedback to help identify the problems, solicit broad feedback in considering solutions. Involving system members in a collaborative effort to identify and help solve the root problems will reduce the risk of litigation later. But beware of involving system members in decisions that might violate antitrust law if those decisions are deemed to have resulted from the pressure of system members.

3. **Check Your Agreements and Policies.**

Make sure your franchise or dealer agreements (and policies that could be considered binding) are flexible enough to accommodate the solutions you are considering. If they aren't, make sure future versions are. Meanwhile, including system members in the brainstorming and problem-solving process may become your most valuable currency for negotiating the necessary accommodations. True, some subjects should be off limits or addressed delicately because they raise antitrust and securities law concerns. Groups of system members should not discuss among themselves ways to avoid competing with one another or pressure franchisors or manufacturers to adopt "protective" anticompetitive restraints, like punishing price cutters or "poachers" who sell to customers of other system members. Nor should publicly traded companies share with system members information material to stock prices before that information becomes public. But there remains ample room to vet ideas for improving the system. Doing so builds trust and no system stays healthy without mutual trust. Because many franchise and distribution agreements fail to anticipate the kinds of changes and assistance programs that may be necessary, the ability to implement them may depend on how much franchisors and system members trust one another. Mutually developed, voluntary programs may be more effective than autocratic solutions that stretch contract terms beyond their intended scope.

4. **Check Compatibility with Applicable Law.**

a. System-wide changes that help all system members pose little risk, unless you are considering resale price maintenance. Better advertising, better products,

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MAP programs, temporary relief from fees and other expenses—these potentially help all system members. But some system-wide changes may be too expensive to offer to everyone.

b. If you need to limit more costly programs to those for whom they will do the most good, use objective standards to decide who will be eligible. Don't start by selecting the individual system members you want to help and then make rules that exclude everyone else. Consider starting with standards like those used in good credit policies to make credit decisions. Then add important strategic considerations; not every system member occupies a point on the map of equal strategic importance, for example.

c. Heed the lessons of the lender liability cases. Do not try to control the day-to-day business decisions of system members. If your assistance plans call for financial or management advice, that advice should come from qualified independent advisors. Leave the choice of advisors to system members; if you recommend some advisors, make it clear that system members may select others, requiring only that they be reasonably acceptable to you.

5. Use An "Assistance Agreement."

Think of an assistance agreement as a "mid-nuptial agreement" signed just before the troubled couple meets the marriage counselor. Everyone knows the relationship is in trouble and may fail. The franchisor or manufacturer is willing to help if the system member wants help and is willing to agree about the consequences of failure. The goal is to negate arguments that the franchisor or manufacturer controlled the assistance process or forced the system member to do anything. Here are some recommendations and cautions:

• If the system member wants help, ask him or her to ask for it, in writing.

• Require the system member to sign an assistance agreement before you begin to help. The system member should consult his or her own attorney before signing.

• The assistance agreement should describe the system member's financial troubles and explain why he or she believes the franchisor's or manufacturer's assistance will help. This may negate later allegations of coercion and improper motives. It also supports the business "judgment rule" and "in pari delicto" defenses if creditors or investors later bring derivative claims.

• The assistance agreement should restate that the system member has asked for help and is entering into the agreement free of coercion, preferably with the advice of counsel. The system member should not accept such language unless it is true.

• The assistance agreement should recognize that the business may fail despite the efforts to help and that its failure should not be held against the assisting party for trying to help.

• The assistance agreement should contain explicit covenants (a) not to sue, (b) barring any recovery for lost profits, deepening insolvency, debts to other creditors or other forms of incidental or
consequential damages, and (c) requiring the system members' principals to indemnify the assisting party if anyone sues it as a result of its effort. The system member should insist on at least some reciprocity, such as holding the franchisor or manufacturer responsible for negligence, actions that go beyond merely offering advice, and intentional torts. A mutual release or covenant not to sue may be appropriate depending on the extent of the ongoing business relationship.

- The assistance agreement should make clear that the system member will always have the last word in running its business and in deciding whether to take your advice, and that the assisting party's role is merely advisory. Include a statement that under no circumstances will you become involved in the day-to-day management of the system member and that you will have no power to write checks, hire or fire, or prefer one creditor over another. This is important for the system member, too, in case the franchisor or manufacturer becomes coercive.

- The assistance agreement should state what help you will provide and what you will not provide. The goal is to prevent any promissory estoppel claims. It also makes sure both parties know what they can expect.

- If you will be extending credit as part of the assistance plan, make sure that you are as secured as possible (which may include getting personal guarantees) and that you create only those powers necessary and typically used by lenders to protect their interest in the loan. System members should be wary of personal guarantees if none are in place because personally guarantying a failing business may end up forcing a personal bankruptcy as well.

- The assistance agreement should disavow any intent to create a partnership, agency or any other relationship by which you and the franchisee or dealer could be responsible for one another's debts or obligations.

- The assistance agreement should contain a carefully written integration clause to eliminate any alleged side deals or extraneous promises. The system member should make sure that every important representation or promise is stated clearly in the agreement because an oral assurance may not be enforceable.

A short sample form of assistance agreement is attached as Appendix A for reference purposes only.

6. **Behave Prudently.**

Remember that great documents and careful planning mean little if your behavior conflicts with your commitments. Those who communicate with system members need to understand their limited roles. They need to watch what they say and who they say it to. Possible
misimpressions and misstatements need to be corrected promptly, in writing. Those who communicate with distressed system members need to remember that they are players in a drama that may get replayed in front of a jury. Their mantra should be "speak carefully and document defensively." Here are a few do's and don'ts about communicating with financially distressed system members and their creditors:

- Everyone who communicates with a financially distressed system member should do so respectfully, noncoercively, and in an advisory capacity. Sensitive subjects should be confirmed in writing, along with a reaffirmation that the system member is the one who must make final decisions concerning any advice or recommendations. This is good advice for system members as well. The potential is high that the business will fail, leaving many debts unpaid. Anticipate future litigation by documenting important conversations and events.

- Avoid communicating with other creditors. If you must do so, be careful not to vouch for the system member's financial condition. If you think something you did or said might be construed as a credit recommendation, quickly disavow the implication, in writing.

- The admonition not to communicate with other creditors includes your financing/floor planning affiliates. It may be tempting to communicate about the competence of the system member's personnel or business plan, or for the franchisor or grantor to seek information about the system member's creditworthiness, etc. But any communication with a lender creates the risk of an interference claim if the lender later declines or withholds credit. If the lending affiliate needs information about the system member's status within the system, it should make that request of the system member, who, in turn, should make that request of you. In other words, the communication should be through the system member and not between you and the system member's lender.

- Do not make any promises or give any assurances that might not be fulfilled. This applies to possible replacement system members. The choice of a replacement system member may be up to the bankruptcy court, not you. System members should be wary of promising, personally, to pay creditors, for doing so could create personal liability if the creditor relies to its detriment on your promise.

- Avoid making defamatory statements to third parties about the system member or its financial condition. System members should heed the same advice to avoid incurring personal liability in future litigation.

III. OTHER RESPONSES TO THE INABILITY OF FRANCHISEES AND DEALERS TO MEET THEIR DEVELOPMENT SCHEDULES, SALES TARGETS AND OTHER GOALS.
It is axiomatic that franchisors need their franchisees to remain in compliance and pay all amounts owed to the franchisor timely and in full. This section addresses both familiar and innovative examples of what some franchisors are doing or could do in terms of a “give” to their franchise system as a whole or to targeted franchisees in peril in order to help preserve the whole. The franchise community is well aware of this with a recent proliferation of writings on the topic.  

A. **Addressing Systemwide Economic or Operational Failures.**

No franchisor wants to admit a system-wide economic or operational failure, or a potentially fatal flaw in its system or business model. In fact, many franchisors cannot own up to such a failure or flaw in private, much less openly and creatively address such a failure or flaw in public or with franchisees. Many times franchisors wait until litigation or franchisee desperation to act. However, it is the authors' belief that franchisors can and should take action before it is too late.

1. **Permanent Modifications.**

There are numerous ways to permanently modify the system or some material aspect to the system to improve the future of the franchisor and its franchisees. Some examples include:

   a. **Royalty Fee Reductions.**

   The most common method for franchisors to gain a little franchisee goodwill is to temporarily reduce or defer royalty payments. Of course, many times temporary royalty relief (and especially royalty deferral) is just a temporary stop gap and does not effect real change or assistance.

   Although drastic, there are more than likely a number of franchise systems that are prime targets for permanent fee readjustments either because the original fee structure was set without much thought, the competitive market has shifted or the unit economics require adjustment. Perhaps a six percent royalty made sense in 1998, but today it does not. Perhaps the franchisor copied its main competitor's fees, but has since discovered the competitor was not as healthy as it appears. Whatever the reason, to the extent a franchisor has the contractual and other wherewithal to make a material, permanent fee change, such a move could have a materially beneficial impact on existing franchisees.

   Franchisors may be reluctant to consider a permanent fee adjustment for existing franchisees, and may instead want to have a right to re-trigger the original rate due to a change in the economy or the system that breeds much better systemwide results. Another option is to phase in or phase out revised royalty fee structures in a graduated manner. This can provide the franchisees with the relief they need (if not perhaps as quickly as some may desire or need),

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while softening the impact to the franchisor’s bottom line to the extent the franchisor is already near its own safe working capital limits for meeting its own fixed and other recurring costs.

There are also a number of factors that could inhibit or hinder fee reductions. Many franchisors have lender obligations that will not permit fee reductions, or fixed overhead costs that take precedence. Some franchisors believe something must be done, but feel hamstrung by loan covenants and are reticent to approach lenders for fear of repercussions as well as added oversight or attention.

b. **Marketing Fee Reductions.**

More or better marketing is not a panacea, but franchisors that have perhaps been married to an outmoded or inefficient franchisor-driven marketing program can many times drive change by making material changes to the marketing program. Perhaps a focus on national television is no longer merited due to store count losses or lack of geographic coverage. Perhaps a franchisor prepared print marketing program is no longer viable, and the internet is a more potent use of dollars for your system.

For franchise systems that are especially insular, new blood or new marketing ideas (from the franchisees or outside the system) can drive sales and franchisee enthusiasm and while scary to many franchisors, permanent or temporary plans to dismantle Ad Funds or other franchisor-driven marketing collection mechanisms can sometimes allow franchisees to use and spend money in ways that work best in their individual markets.

Franchisor (with input and buy-in from franchisees) might consider increasing marketing fees or reallocating royalty amounts to marketing to drive sales or reinvigorate the franchisee and customer base. Any formal increase would likely need written approval from the franchisees unless the franchisor had contractual increase rights, but franchisees are generally in favor of additional advertising if they are in general agreement with the strategy and implementation.

c. **Reduce Renewal Fees.**

Renewal fees can be an extra, needed source of income for mature franchisors that may not be selling new franchises at the rates sold in the past. However, renewal fees can be expected but unwelcome expenses for long time franchisees who have relatively low profit margins, especially multi-unit franchisees who may see a six figure renewal fee allocation in their future along with expensive upgrade requirements. Franchisors who need existing franchisees to develop new units, upgrade existing units or even just elect to renew their existing units may find that the elimination or reduction of renewal fees can be a carrot to entice franchisees to develop or upgrade, even if an elimination or reduction is tied to obligations to use the money to develop new units or upgrade existing units.

d. **Unit Economic Improvements.**

Most franchise systems start and stop due to unit economics. Having the best product or the best service is meaningless if the mandatory and other fixed fees and costs do not allow for franchisee profitability. There are numerous ways to improve unit economics other than through a reduction of franchisor fees. Whether via introduction of new products or reductions in food costs or labor needs, franchisors are paid a continuing royalty in part to innovate and stay current.
i. Franchisor Food or Service Cost Reductions.

Many franchisors receive significant revenue through the sale of products or services to the franchises. Many times the sales price is well above costs and serves both as a profit center for the franchisor and a source of ire for the franchisees. Franchisors normally have the ability to adjust their sales price to bring savings to the system, and while a reduction will have an affect on the franchisor, it is the franchisor’s role to determine whether an adjustment is viable and merited.

ii. Purchasing Cooperative.

Franchisors that maintain a costly purchasing group may discover that outsourcing the purchasing mechanism to the franchisees can be a cost saving for the franchisor and the franchisees if the system has the volume and franchisee dedication necessary to make a franchisee-driven purchasing cooperative work. One recent example is the DineEquity, Inc. purchasing cooperative developed to integrate purchasing activities for the IHOP and Applebee’s brands under the umbrella of a franchisee-led purchasing cooperative.\(^78\)

iii. Lease Modifications.

Commercial lease rates have always fluctuated with the times, and today many franchisees find themselves in leases that were signed at the top of the market. Several franchisors have engaged outside leasing agents to assist franchisees with studying their leases and approaching landlords regarding permanent or temporary lease rate adjustments. Landlords are some of the hardest hit in these times. But many landlords realize that a reduced rate for an ongoing tenant is better than no rate for a location from which a tenant is forced to vacate and for which the landlord may have no viable replacement or a replacement at a rate much lower rate than the negotiated reduced rate with the current franchisee tenant. Landlords will likely be more agreeable to adjusting the terms of leases if franchisors are willing to guarantee a portion of the leases of their franchisees or agree to step in, even if it is for a limited time period or amount of money, but that would be a very important decision to be fully vetted before a franchisor took on such risk.

iv. New Products or Services.

Many times, the best way to generate buzz for a franchise system and create sales (and thereby happier franchisees) is to develop and introduce new products and services. Franchisors must, in these economic times, balance the risk and reward with new products or services that have high development or implementation costs, but whether developed as an add on or new product line, innovation can refresh a franchise system in need of change. In recent times, franchisors have rolled out both positive and flawed product or service innovations. For example, positive results have come from programs such as carside pickup, delivery or catering

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78 See IHOP, Applebee’s parent forms purchasing co-op, LA Business Journal, February 11, 2009. Author Robert A. Lauer was a member of the team that represented DineEquity in the purchasing cooperative transaction.
Negative results have come from programs such as Wifi and computers in units that did not justify the implementation and maintenance costs.  

v. Quality Assurance Programs.

When economic times are hard, franchisors and franchisees can fall into a trap of sacrificing quality for cost reductions. When consumers are being more diligent with their dollars, the supposed cost savings can be easily negated by loss of customers due to negative experiences or even bad press. An economic downturn is actually the best time for franchisors to implement more formalized quality assurance programs to ensure that the brand is properly represented by its franchisees. Franchisors should consider retraining existing quality assurance personnel and setting up announced or unannounced inspections with a focus on identifying and fixing problem areas rather than penalization. This can serve a dual goal of reinvigorating the franchisee’s commitment to quality and proving to the compliant franchisees that the franchisor has a renewed focus on customer service. This also demonstrates to the franchisees that the franchisor is working hard to ensure that laggards in the system will not adversely affect the compliant franchisees’ businesses. The best pressure on a non-compliant franchisee comes from the compliant franchisees in their territory or DMA. For those compliant franchisees, any program that is designed to help them and the System and not penalize them or their fellow franchisees is normally looked upon favorably, and franchisees may ultimately be the franchisor’s greatest ally in implementing these types of quality assurance programs.

vi. Third Party Consultants

Most franchisors are aware of the numerous franchise or industry-specific consultants that assist franchisors with various aspects of their systems. Consultants have different focuses from unit economics to franchisee relationships to marketing to franchise sales. A franchisor needs to vet a potential consultant even more carefully than a potential franchisee.

While certainly an expensive step, franchisors that have engaged large consulting firms (such as the big three of McKinsey, Bain and Boston Consulting Group) and tasked them with studying the financial model both from the franchisor standpoint (by increasing venues through proprietary products or new lines of business) but also the unit economics level (by additive offerings or reducing or eliminating fixed or variable costs). While the bigger consulting groups may at times focus too much on numbers and not fully grasp the intangibles that make a “brand” special, a detached third party evaluation can be extremely eye-opening and valuable, especially to a previously insular franchisor that has always focused on the product or service and the “experience” but may not have drilled down into the numbers.

2. Negotiate or Announce?

79 Several casual dining chains (including Applebee’s and Outback) have instituted carside pickup programs that have helped drive incremental sales by enabling units to reach new customers that were perhaps not in position to dine-in a particular evening but were in position to pick up a non-fast food dinner on the way home.

80 Schlotzsky’s is one concept that was at the forefront of Wifi and computers in units, but it is highly questionable whether the initial and continuing costs justified the initial media attention obtained and customer interest generated, especially since Wifi and other similar initiatives later become commonplace and must cheaper to implement.
Franchisors considering permanent changes to their system have to decide whether to unilaterally decide upon and implement the changes, or discuss and negotiate the changes with their franchisees. While franchisee advocates may posit that a unilaterally decided and implemented program is doomed to fail, there is no right answer or method. This is because many times the franchise systems most in need of a material change have the worst relationships with their franchisees. An open forum on potential systemwide changes in such systems could breed chaos or consternation when franchisee ideas are not adopted or the nature of the changes are not fully embraced. Conversely, franchisors who make unilateral systemwide changes could face backlash from their franchisees, particularly if the change is unsuccessful in driving additional revenue. Franchisors must carefully document their actions to counter any franchisee claims that the franchisor was not acting reasonably in the exercise of its discretion.

For example, in the Sizzler International case, Sizzler, with some input from its franchisee organization, made the decision to change its buffet court and grill marketing concept. Sizzler determined that its buffet court was a poor revenue-generator, even though it had a high sales volume. The grill marketing concept generated more revenue than the buffet court. Based on this information, the franchisor decided to reorient its marketing emphasis on the grill concept instead of the buffet concept. However, Sizzler never issued a directive to its franchisees on the use of the buffet court and grill marketing concept, and never adopted another marketing concept. The system's franchisee organization supported the franchisor's decision to emphasize the grill marketing concept since the buffet concept produced higher food costs, lower average checks and operating difficulties. A large, terminated franchisee sued Sizzler for breach of its license agreement and for breach of the implied covenant of good faith and fair dealing due, in part, to alleged dishonesty in the decision-making process.

In granting Sizzler summary judgment as to the franchisee's claims for breach of the license agreements and breach of the implied covenant of good faith and fair dealing, the court discussed the propriety of Sizzler's actions. The franchisee claimed that Sizzler breached various provisions of the license agreements which gave the franchisor discretion by acting dishonestly and outside of accepted commercial practices. The court "decline[d] to second-guess the result [the franchisor] reached, as long as the decision making process was honest or was within accepted commercial practices," even if the decision ultimately had a detrimental affect on franchisees' businesses. There were no provisions in the license agreements that required the franchisor to use the buffet court concept over the grill marketing concept, and the

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82 Id.
83 Id.
84 Id.
85 Id.
87 Id.
88 Id.
89 Id.
court found that the franchisor had good cause for deciding to undertake the reorientation and that the franchisee failed to present a triable issue of fact as to whether the franchisor breached the implied covenant of good faith and fair dealing by such exercise of its discretion.\textsuperscript{90} Of course, whether or not Sizzler's actions were legal, the question remains whether its actions were prudent or appropriate for the franchise system.

Another example of announce and then negotiate occurred with the Schlotzsky's chain\textsuperscript{91}, which in 2003 announced plans to move to a new prototype that incorporated new menu items that required new FF&E and additional training. Schlotzsky's sought out existing franchisees to test the new concept and developed a series of incentive programs to drive interest and adoption, but ultimately the concept changes were too little too late for Schlotzky's, and were largely abandoned following a 2005 purchase out of bankruptcy when the new owners decided a "back to basics" approach to the menu was more viable for the system.

The Hot n' Now franchise system provides another example of a system that was forced to litigate a claim involving a unilaterally implemented change made without franchisee input. In Loehr and D.L. Operating Inc. v. Hot 'N Now, Inc., et al.\textsuperscript{92}, fast food franchisees alleged that their franchisor had destroyed the franchisee's business by materially altering the franchise system's fast food concept. The franchisees asserted a claim for breach of contract and breach of the implied duty of good faith and fair dealing. The franchisees claimed that the franchisor constructively modified the terms of the franchise agreement and caused the franchisees' businesses' demise.\textsuperscript{93} Citing the standard that a party with discretion must exercise its discretion reasonably and with proper motive, the court found that ultimately, whether the franchisor acted reasonably was a question most properly resolved by a jury.\textsuperscript{94} The court denied the franchisor's motion for summary judgment as to breach of the franchise agreement and breach of the implied covenant of good faith and fair dealing,\textsuperscript{95} and the franchisor ultimately settled, but given the current (non) status of the Hot n' Concept, it is another example where unilateral franchisor action may not be a prudent approach.

3. \textbf{Addressing Development Schedule Defaults.}

   a. \textbf{Development Period Amnesty.}

Several systems have declared amnesty periods for development schedules, either by simply extending out a development period within a development schedule or extending the entire development period for a stated period of time with promises to re-evaluate. Formal amnesty programs are a bit unique in that franchisors generally have to grow to prosper, and permitting a

\textsuperscript{90} Id.

\textsuperscript{91} Author Robert A. Lauer was in house franchise and litigation counsel for Schlotzsky's, Inc. before and during the bankruptcy filing. The Schlotzsky's franchise system was later sold at auction, and by all accounts has weathered the storm and come out much better than prior to the bankruptcy.

\textsuperscript{92} Bus. Franchise Guide (CCH) ¶ 11,352 (S.D. Fla. 1998).

\textsuperscript{93} Id.

\textsuperscript{94} Id. (citation omitted).

\textsuperscript{95} Id.
systemwide halt to development is considered a fairly drastic act. However, given the scarcity of credit, and the woes that many existing franchisees may face with their operating units, development amnesty can be a pragmatic tool to allow franchisees to focus on their existing units and use their capital wisely.

b. **Tying Amnesty to Other Compliance or Existing Unit Upgrades.**

Franchisors who consider development schedule amnesty should strongly consider whether conditions should be set for the amnesty participation. Perhaps the franchisee must otherwise be in compliance with the development agreement and any existing franchise agreements. Perhaps the franchisee should provide a general release, or agree to re-allocate funds to some amount of existing unit upgrades. However, if the goal is to provide assistance and relief to franchisees, the conditions should not provide a material disincentive to a franchisee interested in the relief.

c. **Ability to Purchase Extensions.**

Many franchisors are not in a position to permit systemwide amnesty and need to be able to consider less onerous options. Many franchisors have built into their agreements rights for franchisees to purchase development schedule extensions for development lapses not due to force majeure. Whether or not the franchisor has this type of provision in its development agreement, franchisors may want to provide franchisees the option to purchase development extensions at a price that provides some revenue but is also palatable to franchisees who would prefer the peace of mind of remaining in compliance with their development schedule but also want to wait to develop until the economic and lending landscape is more advantageous.

d. **Ability to Relinquish or Buyout Development Agreement Obligations.**

To the extent that franchisees are under economic stress and/or have become disenchanted with the franchise system, franchisors who want to spur growth could elect systemwide or targeted plans to offer franchisees the ability to relinquish their remaining development rights (and obligations), or even buy out their remaining development rights. Franchisees may desire the freedom and peace of mind associated with the relinquishment or buyout of rights, and franchisors may desire the ability to re-sell the remaining portion of the territory to a newer, more highly motivated and/or capitalized franchisees. In some cases, a new franchisee may also be a prospective purchaser of the existing franchisee’s units—a win/win for all in many cases.

4. **Addressing Declining Sales.**

Section 2.A. above discussed permanent modifications, but there are temporary measures in every franchisor’s toolbox to combat declining sales, and these measures can come in the form of Band-Aids or shots of adrenaline.

a. **Royalty Relief or Deferral.**

Royalty relief is simply the reduction or waiver of amounts to be paid for a period of time. Royalty deferral is the postponing of all or a portion of the amounts to be paid, and can be
accompanied by a promissory note (with or without interest), and a security agreement or other forms of guaranty. As with development schedule amnesty programs, franchisors can set a number of conditions, from franchise agreement compliance to reallocation of amounts for advertising to complex or simple repayment plans.

Royalty relief can come in many forms, including royalty deferral in the form of a "line of credit" to the "drawn down" (i.e., a right to relief exercised) by a large, multi-unit franchisee as and when its compliance with its lender covenants were in jeopardy. In one instance, the franchisor was able to obtain personal guarantees from a principal and provide rather unique and helpful assistance to a large franchisee that needed assistance.

b. **Unit Upgrade Initiatives.**

Franchisors that have older units in the system are always looking for ways to motivate franchisees to update and upgrade units, especially where older form franchise agreements may not provide for upgrades outside of a formal transfer or renewal.

Franchisors have used royalty "deferral" to cause franchisees to use the deferred amounts on upgrades. However, sometimes franchisors purchase upgraded FF&E or co-sign loans or leases as an alternative to fee reductions. This approach may be worthwhile for a franchisor that has a strict no deferral or relief policy, but believes it is necessary to prompt franchisees to act or even fund franchisees to act in terms of upgrades and other modifications that will benefit the franchisees and the system as a whole.

c. **Marketing Incentives.**

Marketing can be a saviour for some systems. One only needs to think of Jared and the Subway system as an instance in the franchise world where a focused and successful marketing campaign helped refocus and reinvigorate a franchise system. Franchisors have unlimited means by which to use a combination of creativity and money to drive systemwide sales. Similar to unit upgrade incentives, franchisors can incentivize additional marketing spending through a number of means, from additional franchisee control or input over marketing campaigns to borrowing against an Ad Fund for targeted marketing efforts to dollar for dollar (or similar) matching programs for incremental advertising dollars spent or sent to the marketing fund.

d. **Quality Assurance Reviews and Assistance/Mystery Shopping.**

As discussed in Section III.A.1.d.v. above, franchisors who lose sight of customer service and during hard economic times and focus on cost savings without ensuring quality and service are maintained are fighting a losing battle. Developing and implementing internal or third party quality assurance programs or even mystery shopping programs that are designed to focus on improvement vs. penalization can be in reality inexpensive means to improve franchisee morale and systemwide goodwill.

e. **Financial Audit and Operational Audits.**

Franchisors who believe that all of their franchisees are fully reporting gross sales and are paying full royalties and advertising amounts due are either new to franchising and have very few franchisees or are naive. As an unfortunate byproduct of these economic times,
franchisees may have incentives to consider underreporting of sales and/or shortcuts on operations (such as under staffing or under portioning of product), especially if the franchisor has historically been lax with inspections or audits.

Whether conducted by internal staff or third party auditors or inspectors, financial and/or operational audits and inspections can be effective tools for rooting out fraud and discovering “found money” for the franchisor.

B. Disclosure Law Ramifications of Permanent and Temporary Modifications

Of course even franchise systems in distress sell franchises to new franchisees or to existing franchisees desiring to develop new units. Thus, the question becomes to what extent does a franchisor or a franchise system in distress have an obligation to disclose the nature and scope of the distress. To what extent does a franchisor in distress that is offering assistance programs to existing franchisee have to disclose the assistance programs in its franchise disclosure document?

1. General Overview.

The Federal Trade Commission’s Trade Regulation Rule entitled “Disclosure Requirements and Prohibitions Concerning Franchising” ("FTC Rule") requires franchisors to provide full presale disclosure to prospective franchise purchasers by furnishing a Franchise Disclosure Document ("FDD"). The FTC Rule is applicable in all 50 states, but does not require any filing or registration of the disclosure document with federal authorities.

Fifteen states have franchise registration and/or disclosure laws that are generally applicable to most U.S. franchise programs. These states are: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington and Wisconsin. The requirements of the state laws vary from mere filings to actual registrations involving a comprehensive review process. Most states that require franchise registration require the franchisor to complete the registration process prior to initiating any franchise offering activity within the state.


Interestingly, the financial condition of a franchisor can sometimes be buried within an FDD, and a franchisee may have difficulty piecing together the truth about a franchisor’s financial health and well being from the sometimes hundreds of pages of FDD disclosures, particularly if the franchisor entity is a dedicated franchisor subsidiary with financial statements that do not show the whole picture or the franchisor is not tied to a public company that produces non-franchise related reports.

Franchisees typically need to look outside the FDD and talk to other franchisees regarding the financial health or well being of a franchisor or franchise system since financial information or


\[97\] Oregon and South Dakota only require delivery of a disclosure document.
other information that may reflect distress may only be indirectly referenced in, among other places of the FDD, (a) a State Cover Page Risk Factor that the Franchisor may include (or be required to include by a state examiner) in the FDD (RED FLAG—a “going concern” statement); (b) Item 3 litigation disclosures reflecting a rocky past and numerous pending matters; (c) Item 4 bankruptcy disclosure regarding parents or affiliates; (d) an Item 19 financial performance representation that does not reflect strong performance (although most franchisors that cannot show strong performance would not include a financial performance representation); (e) an Item 20 chart reflecting an inordinate number of closures, non-renewals or terminations, or even transfers; and (f) Item 21 financial statements reflecting poor performance or performance trending downward. A diligent franchisor that is in distress but still offering and selling franchises should in good conscience ensure that its current plight is not misrepresented in the FDD, and is instead addressed head on even if with descriptions of plans to rectify the situation.

Although outside the scope of this paper, a franchisor in distress will also need to consider when the distress rises to the level of a material change under applicable law that would require the franchisor to amend its FDD and re-disclose active franchisee prospects. Perhaps the franchisor’s accountant has issued warnings, the system’s main distributor has cancelled the distribution agreement, perhaps a large number of termination or closures has occurred, a substantial number of franchisees are not in compliance with system standards or the historical performance reflected in an Item 19 financial performance representation has so drastically changed in the interim period so as to make the representation misleading. Franchisors in this position will need to be constantly evaluating their status and their disclosure to ensure that the franchisor is not adding new liability and new problems on its already full plate.

3. Application to Assistance Programs.

A franchisor that is no longer offering or selling franchises should not have any franchise disclosure obligations arising from the identification, selection and implementation of assistance programs designed to assist existing franchisees. But if a franchisor is concurrently offering and selling new franchises while also implementing an assistance program designed to assist existing franchisees, the franchisor needs to consider the extent to which the program will be available to or otherwise affect a new franchisee coming into the system and, at a minimum, ensure that the franchisor’s FDD and agreements provide the franchisor authority and flexibility with respect to implementing and modifying fees and agreement terms and modifications.

For example, a franchisor that charges a 5% royalty in its current FDD but has formally announced a plan that royalties will be reduced to 3% for a minimum of one year should at a minimum consider disclosing the change and confirming its application (or non-application) to new franchisees. Also, a franchisor that has set financial performance quotas based on dollar figures that are no longer being satisfied and has re-set quotas for existing (and future)

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98 See 16 C.F.R. § 436.7(b) (2008); Franchise Commentary to North American Securities Administrators Association, Inc. 2008 Franchise Registration and Disclosure Guidelines (April 27, 2009) (text at www.nasaa.org/Industry_Regulatory_Resources/Franchise/). Although definitions and interpretations vary, the original FTC definition of material change and the commonly referenced test is “any fact, circumstance, or set of conditions which has a substantial likelihood of influencing a reasonable franchisee or a reasonable prospective franchisee in the making of a significant decision relating to a named franchised business or which has any significant financial impact on a franchisee or prospective franchisee.”
franchisees should consider disclosure of the re-set. Franchisors have begun to use some fairly novel disclosures designed to both protect the franchisor and warn the prospective franchisee. For example, a warning/modification announcing that the franchisor and its franchisees have experienced unusually greater hardship in locating sites for units over the past X months and therefore the franchisor has temporarily extended the periods of time that developers and franchisees have to select sites, begin construction and open units under their development agreements and franchise agreement. One well known brand has for several weeks had to make specific, additional disclosures regarding the number of units that have been sold but have never opened in accordance with their requirements under the franchise agreement.

In sum, for franchisors in distress and/or considering assistance programs, a necessary and prudent focus on the existing system and existing franchisees does relieve the franchisor of its disclosure obligations to its future franchisees.

IV. FRANCHISEE DIVORCE – WORKOUTS/UNIT CLOSURES.

Franchise divorces are some of the most complex and difficult aspects of a franchise practice, but they are also an area where creativity and perseverance can lead to (mostly) positive results for all parties when the future seems to only foretell animosity, litigation and potential bankruptcy. There are no readymade short cuts to a successful franchise divorce workout, but this section first outlines several potential scenarios and best practices for a successful franchise divorce workout. Thereafter, this section outlines key issues to consider with respect to a unit closure if the parties cannot complete a workout, or the situation has deteriorated to the point unit closure is the only viable option.

A. Default Notice and Failure to Timely Cure.

In order to have any leverage in the workout, a franchisor may need to issue a default notice for any then existing material defaults and, as applicable, provide the contractual or statutory time to cure the defaults. The default notice, and especially the potential for action following a failure to timely cure, is normally an impetus for the franchisee to come to the bargaining table and the workout partners to understand the seriousness of the situation and the need to find a resolution.

1. Defaults that Seed a Franchise Divorce Workout.

There are myriad ways that franchisees can find themselves in financial or operational difficulty, and then fall behind in compliance with their franchisors and face default and potential termination. In many instances, the nature of their difficulties and the resulting defaults will help guide the franchisor, the franchisee and potential workout partners (from lenders to landlords to vendors to government tax agents to employees to prospective transferees) regarding the structure of a potential workout and resolution. We note below several of the defaults that are most prevalent in workout situations.

a. Non-Payment of Fees.

It is axiomatic that franchisees are required to pay franchisors fees for the continuing use of trademarks and the system, and if a franchisee does not timely pay its fees, it will be subject to default and potential termination. Some systems make it almost impossible for a franchisee not to pay because they control the billing and accounting, but in most systems the franchisees still
control the funds they pay to the franchisor either by sending a check, commencing a wire
transfer or funding an account for ACH credits and debits by the franchisor.

The non-payment of the fees is also generally the easiest default to cure if the franchisee has
the money available, or can readily obtain it. Of course, while there are certainly instances of
franchisees (or their owners and guarantors) withholding payments as a means of defiance
when the funds are available, more often the franchisee is having to decide whether to pay the
franchisor, some of all of its other creditors or satisfy its own household needs. Decisions a
franchisee makes at the onset of its difficulties with respect to the recipient(s) of its funds can be
determining factors as to whether a workout will be viable. While every case is different,
workouts can be made infinitely more difficult if the franchisee has not paid its taxes, especially
its employee withholding taxes, property taxes (if applicable) or its equipment taxes.

b. Poor Operations.

Franchisees that are simply poor operators and that cannot be rehabilitated are many times
most ripe for a workout that involves a new transferee. It is sometimes far easier to paint the
post-workout picture to workout partners when a unit that is at X volume and losing money can
be compared to similarly situated units at Y volume and making money, with the main difference
the quality of the operator. In some cases, that lackluster operator is open to a workout
because they are tired or under water and just want to be able to exit; at other times that
operator is the last person to realize they are the problem — and instead lashes out at everyone
else for causing their problems.

c. Illegal Transfer.

It is the authors’ experience that there are a significant number of unapproved transfers in the
franchise community that go unnoticed until some other default occurs. While many franchisors
would tell you that strong evidence of an illegal transfer is one of the best defaults a franchisor
can have in its pocket, many times that illegal transfer can complicate a workout where different
assets and aspects of the franchised business are held in different affiliated or unaffiliated
entities and the workout becomes about unravelling the who, what and when of the past for the
franchisor and other workout partners. Consider an instance where the franchise is in the name
of an individual who long ago exited the relationship, the lease is held by an undisclosed entity
with a series of unknown investors/owners, there is a separate phantom management company
that is the operator with different investors/owners and the permits are still held by the original
franchisee who long ago exited.

d. Lender or Lessor or Vendor Defaults.

Sometimes franchisors are the last to know that a franchisee is in financial difficulty. Some
franchisees will make their payments to their franchisors for fear of losing the franchise, but then
refrain from making payments to lenders or lessors or vendors. Many franchisors have
relationships with these third parties (especially vendors) and hear about the failures from the
third party, and not their franchisee.

Franchisors that believed they had a compliant and relatively healthy franchisee can find
themselves in workout situations with lenders or landlords who have not been paid, and either
want the franchisor to come in to save the day by buying out the loan or lease, or “place”
someone else in the location. Franchisees who try to hide these ticking time bombs from the
franchisor can many times do themselves a disservice by not involving the franchisor earlier,
because not having this franchisee on the franchisor’s radar beforehand can sometimes cause franchisors to not grasp the gravity of the situation or have already occupied themselves with other matters that were first in line and not be able to move quickly enough.

B. Termination Notice.

The issuance of a default notice is sometimes not enough to persuade the parties to focus on a workout. In those instances, franchisors must actually force the issue by exercising rights to terminate (assuming all conditions to termination are satisfied). While termination cannot be taken lightly, in those instances where the franchisor knows that a workout is the preferred resolution, the franchisor will have concurrently prepared a deferral agreement or temporary operating agreement to submit to the franchisee under separate cover immediately after issuance of the termination notice.

C. Franchise Divorce Workout Frameworks.

Deciding whether to pursue a franchise divorce workout in a pre-termination or post-termination context is never an easy decision. In most instances, franchisors who find themselves with a franchisee in default and struggling to timely cure can either (1) move to terminate; (2) elect to extend the cure period, especially if the workout blueprint allows for the retaining of the franchisee through a full or partial cure; (3) extend the cure period with a condition that the only remaining cure is an approved sale of the franchise, especially if the workout blueprint reveals a viable unit but a need for a new franchisee; or (4) do nothing and hope the cure comes in time.

In reality, franchisors that are loath to terminate a defaulting franchisee due to the potential loss of an open unit or the potential for litigation will many times simply refrain from taking action after a cure period runs. Although discussed in greater depth in Section 2 of this paper, franchisors need to take into consideration that waiting too long without formal action (either termination, extension, acknowledgement of cure, etc...) could adversely affect their ability to terminate or obtain injunctive relief if necessary to enjoin operations after a termination, by providing the franchisee an argument for a waiver, estoppel or laches argument.

Accordingly, the authors believe that franchisors need to take some type of action, but the franchisor will need to factor in both business and legal issues and repercussions, as well as the emotions involved with a termination event, before making a decision.

1. Business Issues with Pre-Termination vs. Post-Termination Franchise Divorce Workouts.

The first business decision in a franchise divorce workout is to determine which route will provide the best opportunity for a successful workout. This is of course not an easy decision, and can be driven in part by legal risks associated with the route that provides the best opportunity. However, there are a number of business-centric questions a franchisor can ask itself to help guide its decision-making process:

- Has the franchisor defaulted this franchisee repeatedly over the years, such that another default will simply fall on deaf ears and termination is the only viable option?
- Are franchisor/franchisee emotions so raw that a termination will cause the franchisee to irrationally oppose any workout?
• Does the franchisor believe that litigation is imminent if a termination notice is sent, or that there is franchisor exposure for potential claims if the franchisee elects to oppose the workout and seek redress through litigation?

• Does the franchise believe that all workout partners will act with the necessary urgency outside of termination, or potentially use a termination event to foreclose and attempt to stem losses by pursuing other options that do not involve a continuation of a unit?

• Does the franchisor believe that the unit must stay open during any workout, or would all parties be best served by a temporary closure and re-opening under new ownership or management?

• Can the workout include the franchisee retaining some interest in the franchise as means to recoup investment, including as a minority owner, an operator or advisor?

2. **Regulatory Issues with Post-Termination Workouts.**

A franchise divorce that occurs in the pre-termination context will not directly trigger registration and disclosure issues with respect to the existing franchisee. However, if the franchisor pursues a workout in a post-termination framework, the franchisor needs to take care to not inadvertently create new franchise registration or disclosure issues in connect with the existing franchisee.

In most cases, a post-termination franchise divorce workout will attempt to keep the unit open during the workout, and therefore many times you see one of two key post-termination structures, namely either a deferral of post-termination obligations so that a sale can occur during the deferral period or a new temporary license so that a sale or other disposition can occur during the term of the temporary license.

Besides the options of a deferral vs. a temporary license, there are regulatory issues to consider, namely whether the entry into a deferral or temporary operating agreement constitutes a new franchise sale to any existing franchisee or otherwise triggers disclosure or relationship law issues under a state franchise registration and disclosure law. This is especially important for a franchisor that may not be actively offering and selling franchises, and may not have an active franchise disclosure document or active state registrations.

It is the authors’ position that the entry into this type of agreement in settlement of a dispute does not constitute the offer or sale of a new franchise, on the basis that this is a forbearance of rights under a prior, terminated agreement, but franchisors should consider taking action to hedge against an argument that the disclosure and/or registration laws apply.

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99 Regulatory issues with respect to a new purchaser are outside the purview of this paper, but any successful workout will need to factor in the franchisor’s ability to comply with applicable franchise registration and disclosure obligations to the new franchisee.
Of note, there is a Minnesota case applying California law that is generally on point and favorable to the franchisor in this scenario. In Adcom Express, Inc. v. EPK, Inc., Adcom terminated the franchise agreement and sought a judgment declaring the termination to have been lawful. Soon afterwards, Adcom and the former franchisee entered into an interim agreement for operations during the pendency of the lawsuit. The agreement contained a general "no creation of franchise" disclaimer and also had an at will termination right. Later, the franchisee argued that Adcom violated California's franchise law by failing to register the interim agreement and issue an offering circular in connection with the registration. The district court concluded that the agreement was not a franchise agreement. The appellate court did not directly answer the question, instead stating only: "Even if we were to hold that the interim agreement constituted a franchise agreement, summary judgment is appropriate: appellants have not pointed to evidence in the record showing that they suffered damages caused by Adcom's violations of California franchise law or that Adcom's alleged violations were willful." Thus, the case is favorable for a franchisor considering a workout, but not dispositive.

Starting with the premise of the application of California law for ease of reference, even if a franchisee takes the position that the interim agreement is an offer or sale of a franchise under California law, there is still an argument that the grant was exempt as a settlement of a pending dispute. Cal. Corp. Code section 31018 addresses the "sale" or "offer" of a franchise and clarifies that the "sale" or "offer" of a franchise does "not include the renewal or extension of an existing franchise where there is no interruption in the operation of the franchised business ... provided, that a material modification of an existing franchise, whether upon renewal or otherwise, is a "sale" within the meaning of this section. If the franchisee argues a new franchise, a franchisor can still argue that at worst it is a renewal or extension of the prior franchise, there is no interruption of business and that even if there are changes in the term and royalty fee or other potentially material modifications of an existing agreement, Cal. Corp. Code section 31125 provides an exemption in the case of "a resolution of a bona fide dispute between the franchisor and the franchisee or the resolution of a claimed or actual franchisee or franchisor default". The exemption is available as long as "[t]he franchisee receives the complete written modification at least five business days prior to the execution of a binding agreement, or providing that the franchisee may, by written notice mailed or delivered to the franchisor or a specified agent of the franchisor within not less than five business days following the execution of the agreement, rescind the agreement to the material modification." Thus, if a franchisor can make sure the franchisee has the interim agreement for at least 5 business days, a franchisor can lay the groundwork for an exemption defense.

There are numerous exemptions at the federal and state levels that could also potentially be applicable here from a defensive standpoint if the offer/sale argument is later raised, but the first

101 Cal. Corp. Code § 31018. See MZ Ventures, LLC v. Mitsubishi Motors Sales of America, Inc., Bus. Franchise Guide (CCH) ¶11,692 (CD. CA 1999) (finding that, where the parties entered into an "interim" agreement prior to executing a Dealer Agreement, the Dealer Agreement materially modified the Interim Agreement, thereby constituting a "sale" within the meaning of Section 31018).
103 Id.
step is understanding and addressing the issue, which can be difficult when workout discussions are moving at the speed of light and the framework continues to evolve through the discussions.

D. **Initial Workout Offer/Agreement.**

In most cases the key document(s) for any such structured workout will involve (1) an initial confidential settlement proposal outlining the proposed workout structure and terms; (2) a form of settlement and deferral agreement or settlement and temporary operating agreement that (as applicable) extends a cure period, defers action on a termination or provides a temporary operating period post-termination, all in order to continued operations and effect a sale. There are several key business and legal terms that any franchisor contemplating such an arrangement must consider.

1. **Term.**

If there is one theme in this section, it is that it is imperative that all parties adopt and maintain a true sense of urgency. Therefore, pre-termination cure periods or sale periods and post-termination temporary operating periods need to remain short albeit reasonably attainable if all parties are focused and diligent. Depending on the complexity of issues (especially tax or lender issues), 30 to 90 days would be the norm for an initial term, with renewal rights at the franchisor's option if the parties are continuing to be diligent in working on a sale.

2. **Lender, Vendor and other Creditor Relationships.**

In many instances, the single greatest impediment to a successful workout is the lack of information regarding the franchisee's lender, vendor and other creditor relationships. It is nearly impossible to structure a settlement if you don't know the parties, cannot talk to the parties or have incomplete information on what the parties have or claim in terms of secured rights, liens and other interests. A workout agreement needs to provide that the franchisor and other interested parties are free to discuss the workout and share information regarding the franchisee and its situation, or else landmines may appear as the parties are nearing the finish line. Similarly, a franchisor that does not have express contractual or other written consent to talk to lenders, vendors and other creditors risks tortious interference or other tampering claims from the franchisee if the workout is not culminated.

3. **Forwarding Looking Compliance (or waiver therof).**

A workout agreement must discuss what is expected of the defaulting franchisee during the deferral period. For instance:

- Must they pay full or partial amounts going forward, maintain insurance and other permits and otherwise comply with operational terms?

- Are there financial concessions that the franchisor (or other workout parties) are willing to forgo and permit to be rolled up into a closing, such as back royalties or rent?

- Must the franchisee provide certain initial information or documentation to the franchisor?
4. **Transfer Process.**

In many workout scenarios, there is an absolute need to find a qualified buyer. The franchisee in some cases is incapable or incompetent in terms of finding a buyer, and whether by contract or circumstance it falls to the franchisor to locate qualified buyers. However, franchisors must take care not to promise too much to the franchisee or potential candidates, and franchisors must retain their full rights to review all prospects, and should confirm upfront in the workout agreement whether candidates will be subject to initial fees, transfer fees, standard guarantees, existing negotiated terms and other seemingly secondary terms and conditions that can crater workouts at the eleventh hour.

5. **Interim Management.**

It is not uncommon to have a franchisee effectively “checkout” during a prolonged workout period and allow operations to falter. Franchisors need to have the contractual flexibility to take over interim management, provide assistance (at the franchisor’s or franchisee’s cost) or even require or authorize a potential third party purchaser to assume interim management before the workout is completed.

6. **Release.**

Franchisors that act outside the four corners of their franchise agreements to help facilitate a workout need to take care not to cause more harm than good to themselves. A franchisee who is ready to close may be convinced by a franchisor to stay open for a sale, and incur additional expenses in doing so—only to find no buyer and ultimately close, blaming the franchisor for the additional time, effort and heartache associated with the failed workout. It is crucial that a workout agreement provide for a general release as a condition to the entry into the deferral agreement, a waiver of future damages related to franchisor’s actions taken during the workout period to facilitate the workout and a final release to be issued after the workout sale or disposition has occurred.

7. **Additional Security / Stipulated Judgment for Amounts Due.**

There are numerous ways for a franchisor to attempt to protect itself from simply increasing their accounts receivable and other out-of-pocket damages during the workout process. While the decision to enter into a workout scenario necessarily has a risk/reward component and is rarely the case that the franchisor comes out whole following a franchise divorce workout, franchisors can always assess the parties involved in the workout and seek protections, indemnities or even stipends to fund a workout.

Franchisors can seek to secure past due and future amounts owed through new or renewed personal guarantees, new or renewed and perfected security interests, assignments of interests in leases and assets and even through letters of credit. However, in many cases, personal guarantees may already be in place and effectively worthless, security interests and conditional assignments of assets unavailable due to the existence of prior secured liens by lenders and landlords and letters of credit impossible to secure or fund.

A stipulated judgment for the past amount due that can be enforced if the workout agreement is breached or the workout fails to close can be a powerful tool. While the stipulated judgment is not foolproof, it will put the franchisor ahead of the game in terms of other unsecured lenders and provide faster means to secure amounts due than a traditional lawsuit if there are monies to
be had, especially from a personal guarantor who may have conceded that a franchisee entity is headed to bankruptcy but is loath to consider personal bankruptcy.

E. **Unit Closures.**

While admitting failure on a global, regional or even unit basis is never easy for franchisors or franchisees, the closure of units is sometimes the only or best scenario for a franchise system. There are many instances where brands have effected closures of stores for a number of reasons. Closures of franchised stores raise additional issues, especially in mom and pop franchise systems where there may only be one or two units operated. In those instances, a unit closure constitutes a career change. Still, it is sometimes necessary and there are a number of ways for a franchisor to facilitate closures in a manner that is for the good of the system and that minimizes the negative affect on the closing franchisees.

1. **Voluntary Resignation for Some Units.**

There are a number of mature franchise systems that have units and franchisees that have not stayed current, whether in terms of location (think about a franchise in Central Detroit) or remodeling (think the 1983 prototype). Franchisees that may only be breaking even and that may own their property or have other items paid off may only be in business due to their continuing franchise obligations. To the extent that a transfer is not viable, a program that enables franchisees to voluntarily resign their franchises and commit not to compete may help thin a franchise system. While the franchisor may be reluctant to permit closures and the resulting loss of royalty streams, a voluntary resignation before financial ruin and potential litigation may have some appeal.

Franchisors in a unique situation of overpopulation could also follow the lead of car markers and other business that have downsized through early retirement programs. While a franchisor would likely have to be in dire straights to consider offering incentives for franchisees to leave (and I think many franchisors could never imagine such a scenario), it is conceivable that a franchisor would offer to repurchase assets or inventory in order to retake the site or the territory.

In addition, while outside the purview of this paper, multiple programs that have been undertaken to incentivize early termination programs in connection with area representative or three tier system.

2. **Nonrenewal for Some Units.**

Depending on the terms of a franchisor’s franchise agreements, and subject to applicable state law requirements, franchisors can also effectively weed and feed the system through the targeted exercise of nonrenewal rights. While a franchisee that actually reaches a renewal (especially for a 10 or 20 year agreement) is to be commended and is likely a survivor, there are certainly others that as noted above may be ready to move on or are stuck in their ways or have not remained current with the system, and may be ripe for nonrenewal.

3. **Other Options.**

A forced sale or closure are of course not the only options in a workout or unit closure scenario.
a. Relocate Units.

Sometimes the location of a unit is the main culprit for a distress franchisee. In those instances, a workout can be focused around a relocation of one or more units. Of course, in such instances, the landlord may be the most difficult aspect of the workout discussions.

b. Consolidate Multiple Units.

Franchisees that have development rights and an entire territory may find themselves having overbuilt the territory cannibalizing their own sales and jeopardizing the whole system due to the performance of a couple of units. In these instances, while the franchisor may need to accept fewer royalties from fewer units, the most viable workout would entail a culling of a single franchisee’s units for the betterment of the franchise as a whole.

V. MARKET WITHDRAWAL.

As they ride out the current economic storm, many franchisors and other grantors may consider dropping their struggling brands and product lines. As they do, they also may consider ending or altering relationships with system members who offer those products and brands. But before acting, suppliers and grantors must determine whether their contracts or applicable state laws limit their ability to terminate or substantially alter those relationships. State dealer and franchise laws can come into play even when the supplier’s reason for the change is to stem the tide of economic losses.

Suppliers must also think about whether different dealers should receive different treatment in a market withdrawal situation. That decision may depend upon the applicable contract and state law, as well as individual circumstances (including the issues discussed in Section II.A.2.b. above).

A. General Overview in Light of Recent Decisions.

Market withdrawal and resulting dealership and franchise termination issues have been thoroughly discussed and debated for many years. Recent cases involving market withdrawal show that this issue is still open to debate, and there may be different results under different state laws.

1. Brand Discontinuance as Market Withdrawal.

Many anti-termination statutes prohibit termination or substantial change without prior notice and a showing of "good cause." There is no uniform definition of "good cause." Some laws

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specifically say that good cause exists if the supplier leaves the market or discontinues a product line, but others define "good cause" primarily in terms of the system member's status or performance and say nothing about a franchisor's or grantor's status or its economic challenges. As a result, if a supplier decides to stop making a product or marketing a brand, it may have good cause to terminate its dealers and franchisees in some states, but not in others, even if the reason is the same for all.

Recent cases demonstrate why the wording of the law can be important. For example, the Arkansas Supreme Court recently ruled that a supplier's decision to discontinue a particular brand of farm equipment was not "good cause" to terminate its franchisees under Arkansas franchise law. The Fourth Circuit came to the same conclusion at the end of 2007 when Volvo decided to stop selling its "Champion" brand of earth-moving equipment. In those cases, the suppliers decided to discontinue selling certain brands of products, but planned to continue to sell similar products under different brand names. Both courts read the Arkansas franchise law very literally and based their decisions on a definition that limits "good cause" to a list of eight specific events, none of which included a supplier's decision to stop selling a product line. The

Just a few months after the Larry Hobbs decision, the Seventh Circuit Court of Appeals found that a supplier had good cause to terminate dealers under Maine's franchise law under similar circumstances when it stopped selling the "Samsung" brand of construction equipment, even though it sold similar equipment through Volvo dealers under its "Volvo" brand name. The

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106 See e.g., the Arkansas Franchise Protection Act, Ark. Code Ann. § 4-72-204(a)(1), Wis. Stat. § 135.02(4) discussed below.

107 Larry Hobbs Farm Equip., Inc. v. CNH Am., LLC, No. 08-1056 2009 WL 153357 (Ark., Jan. 22, 2009). However, the same court found no liability for termination based on rebranding a product or ceasing to use a brand name under the Arkansas Farm Equipment Franchise Protection Act, § 4-72-309, because the law only precluded attempts or threats to terminate, cancel or fail to renew, and not actual terminations, cancellations or nonrenewals. Larry Hobbs, 2009 WL 153357 at *4-5.

108 510 F.3d 474 (4th Cir. 2007).

109 Under Arkansas franchise law, Arkansas Code section 4-72-202(7), good cause is defined as:

(A) Failure 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, which requirements are not discriminatory as compared to the requirements imposed on other similarly situated franchisees, either by their terms or in the manner of their enforcement; or (B) The failure by the franchisee to act in good faith and in a commercially reasonable manner in carrying out the terms of the franchise; or (C) Voluntary abandonment of the franchise; or (D) Conviction of the franchisee in a court of competent jurisdiction of an offense, punishable by a term of imprisonment in excess of one (1) year, substantially related to the business conducted pursuant to the franchise; or (E) Any act by a franchisee which substantially impairs the franchisor's trademark or trade name; or (F) The institution of insolvency or bankruptcy proceedings by or against a franchisee, or any assignment or attempted assignment by a franchisee of the franchise or the assets of the franchise for the benefit of the creditors; or (G) Loss of the franchisor's or franchisee's right to occupy the premises from which the franchise business is operated; or (H) Failure of the franchisee to pay to the franchisor within ten (10) days after receipt of notice of any sums past due the franchisor and relating to the franchise.

Maine law specifically stated that good cause to terminate a franchise exists "when the manufacturer discontinues production or distribution of the franchise goods."

The FMS court rejected the dealer's argument that Volvo's "mere rebranding" of its Samsung excavators with only "modest design changes" was not actually a discontinuation of the franchise good. The court held that since the statute defined "franchise" in terms of a trademark license and the agreement authorized the dealer to use only the Samsung trademark, discontinuation of the Samsung-brand line of excavators was a discontinuation of the "franchise goods" under the statute.

2. Is There an Implied Right to Withdrawal?

While recent cases focused on whether the state termination laws specifically included a supplier's decision to discontinue a brand or product line within the law's definition of "good cause," other courts have found that a supplier's financial problems can be considered in the "good cause" analysis even if the statute does not explicitly say so. Unlike the Fourth Circuit and Arkansas Supreme Court, the Seventh Circuit and Wisconsin Supreme Court held that there is an implied right to substantially alter or even terminate a dealership based on the grantor's own economic circumstances, even though "good cause" is defined in the statute only in terms of the dealer's status or actions.

For example, in Morley-Murphy Co. v. Zenith Electronics Corp., the Seventh Circuit held that a supplier would have good cause to terminate its Wisconsin dealers as part of its overall effort to change its distribution system to stem large financial losses, even though Wisconsin's Fair Dealership Law ("WFDL") defined "good cause" only as a dealer's contract breach or bad faith and said nothing about a supplier's financial circumstances.

In that case, a manufacturer of consumer electronics argued that it had to terminate its dealer network and convert to one-step distribution in order to adapt to market changes (the rise of large discount consumer electronics retailers like Sears and Best Buy) and stem the tide of substantially declining sales. The Seventh Circuit agreed that one had to "strain" to interpret the WFDL as permitting dealer terminations based on a grantor's decision to restructure. But the court noted that the Wisconsin Supreme Court previously had found that a supplier could substantially alter its method of doing business with dealers to accommodate its own economic problems, as long as the changes were essential, reasonable and nondiscriminatory. Relying

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112 FMS, 557 F.3d at 762.
113 Id. at 764.
114 142 F.3d 373.
115 The Wisconsin Fair Dealership Law defines "good cause" as "(a) Failure by a dealer to comply substantially with essential and reasonable requirements imposed upon the dealer by the grantor, . . . which requirements are not discriminatory as compared with requirements imposed on other similarly situated dealers either by their terms or in the manner of their enforcement; or (b) Bad faith by the dealer in carrying out the terms of the dealership." Wis. Stat. Ann. § 135.02(4).
116 See Morley-Murphy, 142 F.3d at 377 (citing Ziegler Co. v. Rexnord, Inc., 147 Wis. 2d 308, 433 N.W.2d 8 (1988)). In Ziegler, a manufacturer proposed to stem financial losses by nonrenewing its dealer agreements and offering dealers positions as independent sales agents paid by commission instead. The Wisconsin Supreme Court held that the manufacturer's economic circumstances could constitute good cause for the proposed changes, but only if the
on that case, the Seventh Circuit held that the WFDL's "good cause" requirement would be met so long as (a) the termination is part of a system-wide change, (b) there is an objective need for the change, a proportionate response to that need, and (c) the change is implemented in a nondiscriminatory manner.\footnote{Morley-Murphy, 142 F.3d at 377-378.}

Unless the economy quickly improves, we are likely to see more market and product withdrawal cases like these, and it is unclear whether other courts will follow the more strict reading of "good cause" under franchise and dealer laws, or whether they will decide that there is an implied right to end business relationships based on a franchisor's or grantor's own economic circumstances, even if the law does not specifically say so.

3. **Reasons for the Withdrawal Do Matter.**

Courts often seem influenced by the reasons for the market withdrawal and whether the supplier is really getting out of that business. If a supplier decides to get out of the business for its convenience (rather than economic necessity), or if it continues to sell the same products under a different brand name, there is more risk that a court will find that the supplier does not have "good cause" to terminate its dealers. But if the supplier is truly exiting the market in an effort to stay afloat or deal with deepening financial loss, courts seem less likely to decide that the termination is improper, that good cause is lacking, or that substantial damage awards to former franchisees or dealers are warranted.

When considering a market withdrawal or product discontinuation, a supplier should be prepared to show that the reasons for the withdrawal or discontinuation are necessary for the business, reasonable under the circumstances and is imposed in a nondiscriminatory manner. System members threatened with termination or nonrenewal should certainly inquire about the reasons for the termination and question how it is being carried out. Open communication amongst the parties concerned with these issues may help avoid unnecessary disputes and costly litigation.

4. **Other System-Wide Changes to Distribution or Methods of Doing Business.**

A franchisor or supplier also may consider substantial changes to their systems or methods of distribution in order to stem financial losses during tough economic times. But they also must be aware that some franchise and dealer laws preclude substantial changes to a franchise or dealership agreement without notice or good cause.\footnote{See e.g., Wis. Stat. § 135.03 (precluding substantial changes to the competitive circumstances of a dealership agreement without a showing of good cause); Ala. Code § 8-21 A-4; Idaho Code § 28-24-104; Iowa Code § 322F.2; La. Rev. Stat. § 51:482i; Mich. Comp. Laws § 445.1457a.}

\begin{itemize}
  \item Changes were essential, reasonable and implemented in a nondiscriminatory manner. The court noted that while the WFDL was intended to afford dealers with substantial protections previously unavailable at common law, "the Wisconsin legislature could not have intended to impose an eternal and unqualified duty of self-sacrifice upon every grantor that enters into a distributor-dealership agreement." Ziegler, 433 N.W.2d at 11.
\end{itemize}
In addition, some changes may be deemed to "constructively" terminate a system member. In that case, the questions concerning whether "good cause" is required for the change, and whether the franchisor's or supplier's own economic reasons constitute good cause, must be addressed, just as they are for actual termination situations.

In addition, as discussed in Section II above, some franchise and dealer laws preclude discriminatory treatment of franchisees and dealers, so any change must be evaluated under those laws as well.

B. Contract Review.

When considering a product or market withdrawal, or when faced with one, the first thing to consider is the franchise or dealership contract. A supplier must review the contract to make sure that a termination or nonrenewal is permitted at the time of the withdrawal. It must also review the contract to make sure it complies with any notice or post-termination obligations. Likewise, franchisees and dealers should review their contracts to determine their own rights and obligations in connection with a market withdrawal.

Contracts sometimes contemplate the possibility of a product or market withdrawal. Other contracts remain silent on the issue. Suppliers should consider including such provisions in their contracts in case a product or market withdrawal becomes necessary. Likewise, dealers and franchisees may want to negotiate terms that give them specific rights under those circumstances.

C. Other State Franchise/Dealer Law Requirements.

1. Notice and Other Requirements Related to Termination/Nonrenewal.

Even if there is no contractual or statutory impediment to product discontinuance or market withdrawal, franchisors and suppliers still must be sure to comply with the notice requirements under state franchise and dealer laws.\(^{119}\)

2. Repurchase Requirements.

Franchisors and grantors considering product discontinuance or market withdrawal also must comply with contractual or statutory obligations to repurchase a system member's inventory and related items.\(^{120}\)


\(^{120}\) Arkansas, California, Connecticut, Hawaii, Michigan, Washington and Wisconsin have repurchase obligations.
3. **Other Requirements.**

Franchisors and grantors considering product discontinuance or market withdrawal also must comply with any other requirements imposed by their contracts or applicable state dealer or franchise laws. In addition, franchisors must consider whether changes need to be made in their own franchise disclosure materials that relate to dealer terminations or nonrenewals.

**D. Other Claims.**

If a franchisor or grantor chooses nonrenewal to implement its market withdrawal, system members may assert claims under their contract or applicable state law, as well as other claims available under the common law, including the following: (1) Fraud/Fraud by Omission; (2) Tortious Interference; (3) Promissory/Equitable Estoppel; (4) Unjust Enrichment; and (5) Recoupment. When the withdrawal spans multiple states, franchisors and grantors often respond that restricting their right to restructure multi-state operations violates the Dormant Commerce Clause of the United States Constitution.

In the *Larry Hobbs* case, the Arkansas Supreme Court avoided the constitutional analysis by noting that the Dormant Commerce Clause issue had not been certified to it. The supplier had argued that by interpreting the Arkansas statute to permit termination as part of a market withdrawal, the court could avoid the prospect of a state-imposed "exit toll" that would raise commerce clause concerns. However, the court said the "exit toll" issue was not within the questions of law they accepted upon certification and therefore declined to address it.

In *Volvo Trademark*, the court rejected Volvo's similar argument and distinguished a prior case from the Fourth Circuit concerning the constitutional question. The Fourth Circuit noted its prior observation that Commerce Clause concerns may have arisen if there had been a ruling that discontinuing a product line wrongfully terminated dependent system members, distinguishing the present case as involving termination of a separate franchise, and that the case before it concerned termination of the franchise itself. Without revealing its analysis, the court simply held that its prior decision was not controlling, and agreed with the district court's conclusion that reading the franchise law to prohibit termination based on discontinuing the brand did not result in a per se violation of the Dormant Commerce Clause, nor did it place an excessive burden on interstate commerce under U.S. Supreme Court precedent.

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121 See e.g., Christianson & Korzenowski, supra note 83, at 25-26; Dady, supra note 83, at 97-100.
124 Id.
125 See Volvo Trademark, 510 F.3d at 483-484 (distinguishing Cent. GMC, Inc. v. Gen. Motors Corp., 946 F.2d 327 (4th Cir. 1991)).
126 Id. at 484.
127 See Volvo Trademark, 510 F.3d at 484, n.7.
E. **Possible Compromises.**

While there are many debates about the propriety and legality of market withdrawals, there is no dispute that litigation about them is time-consuming and expensive. The recent market withdrawal cases are perfect examples: The Larry Hobbs case was initially filed in April 2008, and is still pending. The *Volvo Trademark* case wound its way through the courts for seven years before the Fourth Circuit’s decision and is still pending,\(^{126}\) and the *FMS* case began in 2000 and bounced back and forth between the district and appellate courts until the most recent decision this spring, which once again remanded the case to the district court.\(^{129}\)

One way to avoid expensive arguments is to try to reach a mutually acceptable agreement before the arguments begin. An agreement could include: (1) a buyout package; (2) repurchase of inventory; (3) assistance with sale of business to other franchise dealers or to a third party; (4) compromise on non-compete obligations; and/or (5) other assistance.\(^{130}\)

Based on the cases decided to date, it does not appear that the Constitutional limitations on market withdrawals have been fully explored. It is likely that we may see this issue raised again sometime soon.

F. **Market Withdrawal Checklist.**

Market withdrawals are usually difficult for everyone involved, and there will always be open questions concerning how and when they are appropriate, as well as how they can be implemented in a way that does not lead to disputes. Here is a checklist of things to think about in connection with a proposed market withdrawal.

**Withdrawal Considerations**

- **What Does the Franchise or Dealer Agreement Say About the Right to Terminate or Discontinue a Product, or to Terminate Based on a Product or Market Withdrawal?** Did the franchisor/supplier reserve the right to discontinue products or the entire product line? Did the franchisor/supplier reserve the right to sell all or part of its business or to sell the product line to a new owner? (Note that even a reservation of rights to discontinue a product may not justify termination of an entire dealer agreement.) Are there any long-term contracts involved? Will the withdrawal occur at the expiration of the contract terms? Could the withdrawal breach any contracts?

- **Will the Franchisor/Supplier Permanently Cease Production of the Product?** If so, there is less risk that a franchisee or dealer will complain. But when a franchisor/supplier continues production of the same or similar products, even under a different brand name, the risk of litigation increases.

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\(^{128}\) *Volvo Trademark*, 510 F.3d at 477.

\(^{129}\) *FMS*, 557 F.3d at 765.

\(^{130}\) See Christiansen & Korzenowski, *supra* note 83, at 28-30 (for a good discussion of considerations that may form the basis for offering a buyout package).
- Will the Franchisor/Supplier Continue to Market Similar Products? Similar to the question above: If the franchisor/supplier stays in the same business with similar products (even if it sources them from someplace else, or makes similar products), the risk of a challenge increases. If the franchisor/supplier exits the particular business altogether, the risk decreases.

- What is the Reason for the Discontinuance or Withdrawal? Was the withdrawal decision based on economic reasons, or will it be perceived as a franchisor’s/supplier’s attempt to sell the assets or appropriate the goodwill developed in the marketplace by its dealers or franchisees? If the withdrawal decision was economically motivated, was the motivation to avoid substantial losses, or to make even more money? Discontinuing or selling a profitable product line is more likely to be viewed with suspicion.

- Is the Franchisor/Supplier Selling the Division/Subsidiary/Product Line? If another entity will continue to market the product, there is risk that it will not be deemed to be a market or product withdrawal or good cause for termination of a dealer.

- Will Anything Related to the Products Be Sold, Transferred or Used? For example, is the product mold or other specialized equipment being sold to a third party buyer? Will trademarks, trade names or logos be sold or used? Designs or other intellectual property related to the products? Customer lists? The risk of dealer litigation increases if dealers or franchisees are terminated and the same or similar product will be manufactured and sold by the asset purchaser. This is true even if the product will be marketed under a different brand name.

- Will Dealer Contracts Be Assigned to a Purchaser? If so, are they assignable? The probability of a dispute decreases if the existing dealers or franchisees will be allowed to continue selling the same products under their existing contracts.

- Will Dealers or Franchisees Be Treated the Same? If the withdrawal is complete, and all dealers or franchisees are treated the same in a system-wide, nondiscriminatory manner, the risk of a dispute is reduced. If the withdrawal affects only part of the dealer system or if it affects only some of the dealers or franchisees, the risk of dealer litigation increases.

- Are There Any State Dealer Laws That Govern Market Withdrawal? See discussion above. The wording and interpretation of the specific state laws can become important.

- When Will Dealers or Franchisees Be Told? Again, state law may require that a dealer receive a particular amount and type of prior written notice of termination. Additionally, waiting too long to inform impacted dealers or franchisees can increase the risk that they will claim they should have been told sooner (i.e., before they got into the business, made orders, invested in the product lines, or made other business decisions they otherwise would not have made if they had known about the withdrawal). The risk of claims like misrepresentation and fraud by omission can come into play here.
• **What Were Dealers or Franchisees Previously Told?** Consider whether any communications by the franchisor/supplier could be construed as a definitive "promise" to a dealer about the continuation of the business. Also, are there any communications about the product line that could become the subject of claims of misrepresentation, fraud by omission, promissory estoppel, etc.?

• **How Dependent Are Dealers or Franchisees on this Product Line?** If the dealers and franchisees carry many other brands and are not dependent on this product line for the health of their overall business, the risk of a challenge to a market or product withdrawal diminishes.

• **Would a Buyout Package Be Beneficial?** When a market withdrawal is inevitable, a franchisor/supplier may want to consider putting together a form of "package" to assist impacted franchisees or dealers. The package could address inventory return, sales incentives or other compensation or assistance.

### VI. FRANCHISOR BANKRUPTCY.

#### A. General Overview.

A bankruptcy filing by a franchisor is the ultimate acknowledgment of failure. However, in the right circumstances, it can also be the impetus for change that the system and franchisees sorely need to prosper. Entire papers can and have been written on specific aspects of franchisor bankruptcy, so this Section focuses on providing the key macro level reasons why franchisors in today's economy may find themselves contemplating or forced into bankruptcy, a general overview of bankruptcy options and certain business and legal pros and cons stemming from a franchisor bankruptcy.

1. **Reasons Franchisors Face Bankruptcy.**

The story behind every bankrupt company is different, but most follow fairly consistent themes, and franchisor bankruptcies are no different, except that the cause/affect interplay of franchisors and their independent franchisees is truly unique.

a. **Poor Company and/Franchised Unit Performance.**

While there are numerous reasons that a company and its franchisees may perform poorly, ranging from inferior products or services to ill conceived unit economics to changing customer

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tastes or interests, if company or franchised units perform poorly or close, franchisors will have difficulty selling new franchises, generating new revenues, keeping staff and maintaining morale. While poor company or franchise unit performance does not generally lead to bankruptcy, it can certainly lead to acts, errors or omissions that aid fuel to the fire and set the stage for a franchisor bankruptcy.

b. Inability to Obtain or Pay down Financing Debt.

The authors have seen instances of franchisor bankruptcies based on two completely different franchise models. First, there are examples of franchisors that mixed unit development via company and franchised units, and the core problems that lead to bankruptcy occurred at the company store level (think Bennigans\textsuperscript{132}). Second, there are examples of franchisors that focused on franchise development, and the core problems that lead to bankruptcy occurred at the franchise level (think Schlotzsky's)\textsuperscript{133}. However, in both those instances, the operational issues at the company and franchised levels breed an inability to generate revenues (through company sales or franchise royalties) to satisfy debt services, which at least in the Schlotzsky's case were levels that were set with specific numbers of existing and new franchised units open, operating and paying royalties, and which numbers significantly dropped in the two to three years before bankruptcy.

c. Litigation.

Franchisors will never be able to construct workouts to appease all franchisees in distress, and litigation is a byproduct of franchise systems in distress. While again litigation in and of itself is rarely the main reason for a franchisor bankruptcy, the litigation (and specifically the approaches taken the franchisor and franchisees in such litigation) can expedite a franchisors demise if not handled expertly and efficiently, which of course is much easier said than done. While a specific beat the company litigation is rare in franchise systems, it is not unheard of, and as has become the case more often, a successful claim brought by a single franchisee breeds copycat claims by other (allegedly) similarly situated franchisees. While this type of litigation can many times be the impetus for settlement and change for good in the manner set forth in Section 2 and 3 above, it can also open wounds and expose cracks that only deepen.

2. Types of Potential Franchisor Bankruptcies.

The types bankruptcies available for a franchisor are under Chapter 7 and Chapter 11. The two primary differences between a Chapter 7 bankruptcy and a Chapter 11 bankruptcy are: 1) in Chapter 7 there is an automatic appointment of a trustee and 2) in Chapter 11 bankruptcy, the debtor may develop a plan for either liquidation or reorganization.


\textsuperscript{133} As noted above, author Robert A. Lauer was in house franchise and litigation counsel for Schlotzsky's, Inc. before and during the bankruptcy filing. The Schlotzsky's franchise system was later sold at auction, and by all accounts have weathered the storm and come out much better than prior to the bankruptcy.
a. **Chapter 7.**

A franchisor who files bankruptcy under Chapter 7 elects to liquidate the property of the business for distribution to creditors. The liquidation is controlled by the Chapter 7 trustee, who is either appointed by the U.S. trustee as an interim trustee or elected by the creditors. The role of the trustee is to collect the property of the business and, if applicable, reduce the property to money available for creditors. The court may also authorize the trustee to operate the debtor's business if it is deemed to be in the best interest of the estate. The Bankruptcy Code governs how the property of the business is to be distributed under Chapter 7. The priority claims are paid first, followed by unsecured claims which are timely filed and, lastly, unsecured claims which are untimely filed. A debtor who files under Chapter 7 may elect to convert the case to a Chapter 11 bankruptcy at any time, provided the debtor has not previously converted the case from a Chapter 11 bankruptcy to a Chapter 7 bankruptcy.

b. **Chapter 11.**

In a Chapter 11 bankruptcy, the ultimate goal for the franchisor is to attain court approval of a plan of reorganization which restructures and possibly forgives certain pre-petition debt. The debtor becomes a "debtor in possession" and has all the rights and duties of a trustee, except for compensation. As such, a debtor in possession may operate a debtor’s business in a Chapter 11 case. A trustee is typically only appointed in a Chapter 11 case where there is fraud, dishonesty, incompetence or mismanagement of the debtor's business. As soon as practicable, a debtor in possession must file a plan of reorganization which details how the debtor intends to reorganize the business and treat its creditors. The creditors may then vote in favor of, or against the plan of reorganization. If the plan of reorganization is approved by the bankruptcy court, it becomes a legally binding agreement between the debtor and its creditors.

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146 See 11 U.S.C. § 1121(c).
i. Pre-Pack.

Some franchisors attempt to reorganize through out-of-court workouts with lenders and suppliers. However, a workout is not afforded the same protections as Chapter 11, such as the automatic stay of Section 362 and exemption from certain securities requirements. Therefore, restructuring negotiations that began as workouts often end up in bankruptcy court as pre-packaged plans. A pre-packaged plan is when a Chapter 11 debtor files a pre-negotiated or pre-approved plan of reorganization when the petition is filed. A pre-packaged plan has the advantage of receiving more expedient confirmation from the bankruptcy court because it has already been approved by the creditors.

ii. Auction.

In a Chapter 11 bankruptcy, sales which are not in the ordinary course of business may be by private sale or by public auction. After providing a business justification and giving proper notice, a debtor must decide whether the sale will be by private sale or by public auction. Public auctions are generally favored over private sales because the purchase price is presumed to reflect more closely the true market value of the assets sold.

B. Key Pros of a Franchisor Bankruptcy.

1. Ability to Refocus Franchisor.

Franchisors that are mired in litigation, refinancing, towing the line on debt covenants or other similar ancillary obligations can have a tendency to lose the time or ability to focus on the business and the franchisees. While of course not a cure-all, a reorganization in bankruptcy can (after what would undoubtedly be the biggest distribution—the preparation, filing and aftermath itself) create a new day for the franchisor and the franchisees, and provide the time, ability to focus and in some instances the resources (through new funding or freed up cash) to refocus on the brand and the franchisees, and growth.

2. Potential for New Owners/Management.

While current management is not always the problem, bankruptcy is a means to potentially flush out the old and bring in the new, especially due to the enhanced attractiveness to new buyers and management of having a cleansed company, even if not a cleansed brand. This is particularly true in the private equity world, where there are a number of funds that focus on opportunities among distressed companies due to the ability to cleanse the company and insert professional management to unlock value and opportunities that may not have been recognized or seized by prior management.

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3. **Ability to Dispose of Litigation and Problem Franchisees.**

Perhaps the single greatest aspect of bankruptcy protection for a franchisor is the ability to reshape itself coming out of bankruptcy. Not only can past misdeeds and the potential future litigation arising therefrom be managed and addressed, the executory contract acceptance or rejection phase effectively gives franchisors an ability to remove problem franchisees or units, or even reshape the franchise system. For example, in the Schlotzsky's bankruptcy, Schlotzsky's management elected to reject all then existing third party area developer agreements to effectively resurrect the direct franchisor to franchisee service element and retain the portion of initial fees and continuing royalties that were being paid to area developers. It would be almost unheard of for a franchise system to be able to effect such an important and crucial restructuring in such a manner without creating years of litigation.

C. **Key Cons of a Franchisor Bankruptcy.**

1. **Potential Stigma to Brand.**

The stigma of a franchise system bankruptcy is inescapable, and will not clear quickly or easily. A franchisee desiring to purchase a franchise for a formerly bankrupt system should take extra care and diligence to that the brand is in irreparably harmed in the public's eye, regardless of what strides the restructured entity or brand have taken post-bankruptcy. That said, in this day and age, corporate bankruptcies (including of major "brand names" such as Lehman and General Motors) have become more common place and the authors believe that perhaps the stigma that might have been associated with a bankruptcy five or ten years ago would be less (assuming that the bankruptcy is not accompanied by allegations of fraud, theft or other corporate misdeeds).

2. **Potential Hindering of Franchisee Ability to Raise Funds or Obtain Loans.**

It is ironic that while a franchisor coming out of bankruptcy with new owners, new management and a cleansed company is likely to be a much more viable target for new investment or debt, the franchisor's franchisees may have greater difficulty finding investors or taking on debt regardless of their own operating results and prospects. While a sophisticated franchisee should be able to counteract initial investor or lender concerns with its own financial statements and results, smaller franchisees or even new franchisees will likely have a more difficult time finding investors or convincing lenders to loan funds for growth or working capital.

D. **Affect on and Role of Franchisees and Vendors.**

It is a cardinal rule of bankruptcy that franchisors contemplating bankruptcy cannot telegraph a filing to third parties, and thus the very franchisees and vendors who may be most affected by a bankruptcy are many times the last to know, and the most surprised/angry. That said, franchisors contemplating bankruptcy must be ready to almost immediately get the message out to the franchise and vendor community that (except in extreme circumstances such as Ground
Round and Bennigan’s) it will be “business as usual” and that the franchisor has funds to provide service to franchisees, pay vendors, run advertising and otherwise conduct business. This is particularly true for franchise wide distributors or vendors who serve company units and franchise units. Of course, it is not always “business as usual”.

Franchisees and vendors that are part of a franchise system in bankruptcy will undoubtedly have hundreds of questions, and in many cases will not receive timely or adequate answers from the franchisors. It is imperative that franchisees and vendors seek assistance from competent bankruptcy counsel to preserve and protect their rights. While vendors have means to seek protection to the extent the vendors are providing ongoing products or services, franchisees may feel particularly helpless. However, franchisees and vendors are typically creditors who can obtain a seat at the table in deciding the bankrupt franchisor’s fate, as well as their own fate when it comes to the acceptance or rejection of their contracts with the bankrupt franchisor.

VII. CONCLUSION

During the initial drafting of this paper, the economy, stock market and even the real estate sector were showing some signs of life. However, these signs of life are not likely to have an immediate impact on the multitude of franchisors and franchisees that continue to struggle on a daily basis—credit is still scarce, customer investment portfolios are still down well below their highs several years ago, unemployment rates remain stubbornly high and concerns about job security abound. There will continue to be fallout for a number of years—the status quo is not an option for many franchise systems.

While this paper makes clear there are no silver bullets, the authors hope this paper provides franchise systems in distress with a plethora of tools to consider, including key legal, regulatory and practical ramifications of using these tools. Of course, with so many tools available, it is crucial that franchise systems in distress vet, select and implement an option that works for the particular franchise system (and not just the tool that worked for a competitor). Without attempting to distil this entire paper into one long sentence, in this environment, this means: (1) balancing the potential for short term gains vs. the burden of new, long term legacy costs; (2) involving franchisees in the vetting, selecting and implementing process (or else even the best of the available options runs the risk of failing at the implementation stage); (3) keeping all eyes and minds wide open to possibilities that might never have been considered before, (4) maintaining realistic expectations of success (and failure); and (5) embracing sacrifice for the long term good. The economy will rebound some day, franchise systems in distress need to do what is necessary to make sure they are around to enjoy it.

See Craig Tractenberg, Franchisees Unite to Purchase Franchisor, LNJ’s Franchising Business & Law Alert, Volume 10, Number 12 (September 2004). In Ground Round, the franchisor closed its offices and company owned units without notice, causing the franchisees to fend for themselves. The franchisees ultimately banded together to by the franchise assets out of bankruptcy and created a franchisee-run system.

See Emily, Maltby, Dragged into a bankruptcy that isn’t yours, CNNMoney, July 17, 2009 (reflecting on the plight of franchisees of Mrs. Field’s, Dial-a-Mattress, Bally Total Fitness and other systems that have filed for bankruptcy protection within the last year.)
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