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The Soul of Franchising

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Who Owns the Goodwill in a Franchise?

Michael R. Gray
Nicole Liguori Micklich
Types of Goodwill

By authorizing the franchisee to use its trademarks and to sell its products or services, the franchisor is *essentially* lending its national goodwill to the franchisee.

National Goodwill
Types of Goodwill

. . . . The franchisee—by investing his or her time, effort and capital—generates local goodwill, further bolstering the reputation of the national product or service.

Local Goodwill

New Management coming soon...sorry for the inconvenience.
Types of Goodwill

- Corporate/Institutional
  - The Marks
  - The System
  - Marketable
  - Distinct from an individual

- Personal/Local
  - Skills
  - Knowledge
  - Efforts
  - Training
  - Character, Reputation
Value of an Intangible Asset

• Business goodwill is an intangible asset
• It might be the most valuable asset of a franchised business
• It can affect the business’ fair market value
• Consider Coca-Cola
Value of an Intangible Asset

- The goodwill of a franchise is the result of combining all of the various assets of the franchisor and the franchisee used to produce income
Value of an Intangible Asset
Value of an Intangible Asset

• Goodwill encompasses value from other intangibles:
  – trademarks
  – operating systems
  – business acumen
  – market presence
Valuing Goodwill

There is no asset on a company's balance sheet that wreaks more havoc on valuation and good sense than goodwill

- Prof. Aswath Damodaran, NYU Stern School of Business
Valuing Goodwill

- Valuation under GAAP
- Valuation under Cost, Income, and Market Approaches
- Valuation of Trademarks
Valuation under GAAP

• Two-step goodwill impairment test
  – Step 1: Determine if impairment is present
  – Step 2: Estimate the value of business goodwill in order to measure the amount of impairment

• The impairment loss, if any, must be timely recognized
Valuation Under Cost, Income, and Market Approaches

• Cost, or “book value,” approach
  – Valuing the balance sheet assets; or
  – Calculating the replacement cost of the balance sheet assets minus liabilities
Valuation Under Cost, Income, and Market Approaches

• Income or “capitalization of earnings” approach
  – assumes that the earnings of a business constitute an annual percentage return on the value of the business, or, that the present discounted value of the business’s earnings into the future is the current business value
Valuation Under Cost, Income, and Market Approaches

• Market, or “comparable sales,” approach
  – examines the recent sales of similarly situated businesses
  – utilizes actual prices, as opposed to estimates
Valuation of Trademarks

1. Profit Split Method
2. Selling-Price Differential Method
3. Econometric Method
4. License Agreements to determine and appropriate royalty rate
Valuation of Trademarks

1. Profit Split Method
   - based on the division of the after-tax operating margin that a licensee would be willing to pay, after taxes, to a hypothetical licensor for the use of a trademark or trade name
2. Selling-Price Differential Method

– determines the incremental price differential attributable to marks and names over unbranded products or services and then splits the premium portion of the price between the hypothetical licensor and the hypothetical licensee.
Valuation of Trademarks

3. Econometric Method
   – purports to derive implied economic values for trademarks expressed as a percentage of sales
Valuation of Trademarks

4. License Agreements Method
   - Determine comparative royalty rate, then:
     1. determine the projected excess earnings for the branded product or service
     2. select an appropriate royalty rate for the license
     3. compute the present value of the royalty payments using a discounted cash flow method
Purchase and Sale

• Real-world buyers often judge the value of a prospective purchase by comparing price to earnings revenues, cash-flow, pay-back period, or other industry specific “rules of thumb”
Damages

• The value of goodwill is the difference between the current market value of the tangible assets of the business and the total value of the business
State Statutes

• Statutes requiring franchisors to pay franchisees fair and reasonable compensation for inventory upon termination:
  – Arkansas, California, Connecticut, Hawaii, Iowa, North Dakota, Washington, Wisconsin
Federal Acts

• What we’re watching:
  – H.R. 3196 (2015-2016)
PMPA

- Courts are inconsistent
Goodwill in Common Franchise Disputes

- Termination
- Non-Renewal
- Non-Compete Covenants
- Territories

- Trademark Infringement
- Franchise Innovation
- Antitrust, Tying
- Vicarious Liability
Termination

• Who owns the goodwill at termination?
• Most franchise agreements state that all goodwill developed by the franchisee belongs to the franchisor
• Courts have traditionally enforced this provision in favor of the franchisor
Termination

• Franchisor – Post-term use harms goodwill
• Franchisee – No longer using mark – own local goodwill
• The “franchise package theory”
  – “A product and its name are inseparable.”
    • *Jack Walters & Sons, Corp. v. Morton Buildings, Inc.*, 737 F.2d 698, 704-705 (7th Cir. 1984)
Non-Renewal

• Few states require compensation for goodwill when franchisor declines to renew
  – Arizona (Auto Dealerships)
  – Washington
Transfer/Sales

• Common law remedies
  – The transfer/Repurchase Dichotomy
  – Franchisor cannot limit the sale price of a franchise without a legitimate business interest
• *Frank Coulson, Inc.-Buick v. General Motors Corp.*, 488 F.2d 202, 206 (5th Cir. 1974)
Non-Compete Covenants

• Franchisors: Necessary to protect the goodwill and customer base associated with trademarks
• Multi-factor analysis
Non-Compete Covenants

- Geographic and temporal reasonableness
- Scope of restricted activities
- Circumstances and context in which they are to be enforced
Non-Compete Covenants

• Who owns the returning customer base?
• Franchisor: Trademark?
• Franchisee: Ongoing relationship?
• Prior operation at the same location may open the door for prior independent goodwill argument
Territorial Disputes

“Apparently I performed so well, my parents decided to have another and start a franchise.”
Territorial Restrictions

• Whether a franchisor can open a nearby location
• Contract language generally controls
• “Local” goodwill
• Good faith and fair dealing
Trademark Infringement

• Franchisors: Use of trademarks by former franchisees can cause confusion and damage the franchisor’s goodwill

• Franchisees: Immediate cessation of the use of a trademark could cost the franchisee customers – local goodwill
Trademark Infringement

• Proof necessary for Trademark infringement:
  1. that it has a protectable mark;
  2. franchise agreement was properly terminated,
  3. continuing use without consent; and
  4. unauthorized use creates a likelihood of consumer confusion
Trademark Infringement

• Most post-termination actions are routine
Trademark Infringement

• One court took a different path: What effect would loss of goodwill have on a franchisee if an injunction is granted?

• “If it is enjoined...defendant is likely to lose many of the readers and advertisers it has attracted during its eight years [of operation] as well as the goodwill defendant has cultivated.”

Franchise Innovation

• “work for hire” or “innovation assignment”
• *all* goodwill developed by the franchisee using the Franchisor’s marks inures exclusively to the benefit of the franchisor
Franchise Innovation

- Hot-N-Ready® – developed by Little Caesar franchisee
- Pre-made pizzas ready for pick-up/special equipment
- Rolled out to system
- Franchisee sued for damages-Lost:
  - “[T]he rights in the “Hot–N–Ready” phrase and the goodwill that inures as a result of the use of the phrase became the property of [Little Caesar] upon its use by the franchisee.”
  - *Pinnacle Pizza Co. v. Little Caesar Caters., Inc.*, 598 F.3d at 980–81 (8th Cir. 2010)
Antitrust, Tying

• Franchisor: A franchise is an integrated system that includes the trademarks, underlying products, and the franchisor’s goodwill

• Franchisee: The three components of the franchise system are severable
Antitrust, Tying

- Mercedes Benz cases: Can dealers sell non-MB parts?
- 9th Circuit: Restrictions necessary to protect high standards and the goodwill of the trademark and brand
- 4th Circuit: There a less restrictive means available to ensure quality control over parts and customer satisfaction
Vicarious Liability

• Franchisors who exercise “excessive” control over day-to-day operations of its franchisees may be found liable for the acts of the franchisee or the franchisee’s employees.
Vicarious Liability

- Franchisors claim that the need to ensure uniformity and protect the goodwill associated with their marks and brand justify the level of control over franchisee operations and should not result in liability for all purposes.
Vicarious Liability

• What controls are necessary to protect the goodwill of the brand?
  – Approving franchise locations
  – Advertising/use of trademarks
  – Controlling products/services
  – The “Deliverable”
Vicarious Liability

– A Franchisor that exerts control in excess of that necessary to protect its trademark and goodwill is at risk
  • Employment policies and procedures
  • Employee scheduling, compensation, supervision
  • Blanket authority to modify any aspect of manual

– A franchisor that controls the instrumentality that causes harm is at risk
Is there room for both sides to own some goodwill?

- Depends on the language in the franchise agreement--drafted by the franchisor
- Historically franchisors have been very stingy in this regard
Is there room for both sides to own some goodwill?
Is there room for both sides to own some goodwill?

• Should franchisors and franchisees examine the notion of goodwill at the outset of the relationship and acknowledge the intangibles contributed by the other?

• Who has negotiated a goodwill provision?
  – Result?
WHO OWNS THE GOODWILL IN A FRANCHISE?

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I. INTRODUCTION

The concept of customer goodwill is vital to any franchise. But how goodwill is defined depends on who you ask in the franchise food chain. Black’s Law Dictionary defines goodwill as “[a] business’s reputation, patronage, and other intangible assets that are considered when appraising the business, especially for purchase; the ability to earn income in excess of the income that would be expected from the business viewed as a mere collection of assets.”\(^2\) Indeed courts have identified the main characteristic of a franchise to be “the license given to the franchisee to trade upon and exploit the franchisor’s goodwill during the course of the franchise relationship.”\(^3\) This view, emphasized by franchisors, contends that customer goodwill is goodwill for the franchise’s mark, not for the individual franchisee’s business using said mark.\(^4\)

However, Black’s definition of “personal goodwill” aligns more with how franchisees view goodwill, “the goodwill attributable to an individual’s skills, knowledge, efforts, training or reputation in making a business successful.”\(^5\) This definition furthers the concept that while a franchisee does benefit from the goodwill associated with the franchisor’s mark; a franchisee also builds upon and develops its own goodwill through its local position and celebrity, reputation for skill, and level of customer service.\(^6\) Indeed, some courts have explicitly recognized the goodwill established by individual franchisees. In LaGuardia Ass’n v. Holiday Hospitality Franchising, Inc., the court found that a franchisee generates local goodwill through “investing his or her time, effort, and capital.”\(^7\) These differing views on how to define goodwill and who owns it in a franchise relationship have created a diverse landscape of opinions and case law.

II. TYPES OF GOODWILL

Lawyers and accountants know that their businesses benefit from institutional goodwill associated with their firm’s ability to effectively service clients. Like doctors, architects, and engineers, lawyers and accountants also develop professional practice goodwill. This goodwill relates both to the skills and abilities of the individual members or employees of the practice and the reputation, success rate, and operation of the enterprise as a whole. Franchisees can benefit from a similar institutional goodwill, or the goodwill of the “system,” and also from a more personal goodwill.

\(^1\) The authors wish to acknowledge and thank Caitlin R. Miles of Gray Plant Mooty and Jaime S. Paoletti of Garcia & Milas, P.C., for their significant assistance and contributions to this paper.

\(^2\) Goodwill, BLACK’S LAW DICTIONARY (10th ed. 2014).


\(^4\) Id.

\(^5\) Personal Goodwill, BLACK’S LAW DICTIONARY (10th ed. 2014).

\(^6\) W. Michael Garner and Elliot R. Ginsburg, Nailing the Blob of Mercury: Goodwill in Franchising, 33 FRANCHISE L.J. 149, 150 (Fall 2013) (quoting Justice Story, PARTNERSHIPS § 99 (7th ed. 1881)).

\(^7\) 92 F. Supp. 2d 119, 125 (E.D.N.Y. 2000).
The notion that customer goodwill provides value to a trademark has been a tenet of trademark law for more than 50 years. To be valid, a trademark assignment must include an assignment of the goodwill associated with the mark. The trademark provides assurance to consumers who purchase goods or services in reliance on that assurance. Thus, the right to use the franchisor’s marks is a critical element of the modern franchise agreement. Franchisors have characterized this right as a license, a lease, or a loan. Franchisees often view the right as an opportunity, the foundation for an investment, and a tool through which equity is accrued, business developed, and relationships built.

Comparably, franchisees believe that by developing customer loyalty for their specific business, they too develop their own goodwill. But definitions of basic goodwill, including the definition provided by Black’s Law Dictionary, do not include the word—or even the concept—of loyalty. That said, however, the notion of “personal goodwill,” like the concept of local goodwill, provides an opportunity for franchisees to claim ownership interest in the personal goodwill they develop at their franchised location and to demand compensation for that goodwill when the franchisor refuses to renew or sells the location to another franchisee at the end of the franchise relationship.

Most franchise agreements provide that any equity in goodwill belongs to the franchisor, as does anything else the franchisee develops in connection with the franchised business. Nearly twenty years ago, in Dunkin’ Donuts of America, Inc. v. Middletown Donut Corp., the New Jersey Supreme Court enforced a provision in the franchise agreement requiring the franchisee to assign its lease to the franchisor upon termination. The New Jersey Supreme Court reversed the lower court’s decision to force the franchisor to compensate the terminated franchisee for the value of its franchise. Neither the lower court nor the New Jersey Supreme Court distinguished clearly between the goodwill associated with the trademark, the franchisor’s goodwill, and the local goodwill or the goodwill personal to the terminated franchisee.

Similarly, in divorce proceedings involving franchisees, courts have held that any goodwill that existed in the franchised business belonged to the franchisor. In In re Marriage of Ziegler, the husband was a successful State Farm agent. The evidence demonstrated that the husband controlled the operation of the agency. Noting the absence of any evidence that the location or the operation of the agency enhanced the agency’s earnings capacity, the trial court held that any goodwill that did exist belonged to State Farm and the appellate court affirmed. The appellate court analyzed the State Farm system and determined that:

If Mr. Ziegler terminates his relationship with State Farm, he may retain his office and sell other companies’ insurance, but he cannot solicit business from State Farm’s existing policyholders. Whether they would then seek out another State Farm agent . . . or stay with Mr. Ziegler . . . is speculative. Because State Farm

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10 Id.
retains the expectation of continued public patronage, any goodwill attached primarily to State Farm, not its captive agency.\textsuperscript{12}

Although most franchise agreements provide that the equity and goodwill belong to the franchisor, courts have also acknowledged the concept of "local goodwill" established by franchisees. For example, in LaGuardia Ass'n v. Holiday Hospitality Franchising, Inc., the court observed that the "hallmark of a franchise relationship" is the exchange of goodwill:

By authorizing the franchisee to use its trademarks and to sell its products or services, the franchisor is essentially lending its national goodwill to the franchisee. . . . The franchisee—by investing his or her time, effort and capital—generates local goodwill, further bolstering the reputation of the national product or service.\textsuperscript{13}

In LaGuardia, the court granted a permanent injunction barring the termination of two airport hotel franchise agreements and held that the franchisees had established that they would sustain irreparable injury in the absence of injunctive relief.\textsuperscript{14}

In the context of divorce proceedings, courts have also recognized a difference between corporate and personal goodwill. In Brave v. Brave, for example, the Alabama Supreme Court held that for goodwill to be considered marital property, it must be a business asset with value independent of the presence or reputation of a particular individual.\textsuperscript{15} In explaining the difference between corporate and personal goodwill, the court quoted Taylor v. Taylor, a Nebraska Supreme court case, and stated:

[Where goodwill is a marketable business asset distinct from the personal reputation of a particular individual, as is usually the case with many commercial enterprises, that goodwill has an immediately discernible value as an asset of the business and may be identified as an amount reflected in a sale or transfer of such business. On the other hand, if goodwill depends on the continued presence of a particular individual, such goodwill, by definition, is not a marketable asset distinct from the individual. Any value which attaches to the entity solely as a result of personal goodwill represents nothing more than probable future earning capacity, which, although relevant in determining alimony, is not a proper consideration in dividing marital property in a dissolution proceeding.\textsuperscript{16}]

\textsuperscript{12} Id. at 698.

\textsuperscript{13} 92 F. Supp. 2d 119, 125 (E.D.N.Y. 2000) (internal citations omitted).

\textsuperscript{14} Id. at 131.

\textsuperscript{15} 433 S.W.3d 227, 232–33 (2014).

\textsuperscript{16} Id. at 232 (quoting Taylor v. Taylor, 250 S.W.3d 232 (2007)).
As these cases amply demonstrate, courts treat the concept of goodwill and its ownership very differently depending on the factual and procedural circumstances. This results in varying outcomes and somewhat inconsistent results.

III. VALUING GOODWILL

Professor Aswath Damodaran of the NYU Stern School of Business wrote in a December 2012 blog post:

There is no asset on a company’s balance sheet that wreaks more havoc on valuation and good sense than goodwill. The first problem with goodwill is that it sounds good, and when something sounds good, people feel the urge to pay for it. The second problem is that, notwithstanding claims to the contrary, it is not an asset but a plug variable that measures everything and nothing at the same time.\(^\text{17}\)

Capturing this same notion that goodwill is an asset that “measures everything and nothing at the same time,” Bruce Schaeffer wrote in May, 2013 that “too often, all intangibles are listed under ‘Goodwill.’”\(^\text{18}\) Schaeffer says that intangible assets “have become the most valuable assets of the 21st Century surpassing the value of hard assets such as factories and equipment as the embodiment of wealth.”\(^\text{19}\)

In franchising, there are various situations that might require valuation of franchisee goodwill when determining the value of the entire franchised business. These situations include litigation, transfers, mergers and acquisitions, tax matters, death, succession, divorce, and bankruptcy.

For example, allocation of the goodwill value in the purchase price of a franchised unit can be important for tax purposes. In 1982, the United States Claims Court held that a franchisor could not amortize, for income tax purposes, written franchise agreements. The franchisor failed to prove that the franchise agreements had ascertainable value separate and distinct from the trademark and the goodwill of the trademark.\(^\text{20}\)

In a more recent California case, the court held that a hotel franchisee was entitled to a property tax refund because the tax assessor improperly assessed the hotel’s intangible assets.\(^\text{21}\) The tax assessor had determined that the management of the hotel and the franchise fee paid by the hotel owner captured the entirety of the intangible asset of goodwill.\(^\text{22}\) The

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\(^{19}\) Id.


\(^{22}\) Id. at 908.
franchisee argued that the tax assessor erred in assessing the value of the hotel because the assessor failed to fully identify and remove the value of intangible assets from the valuation. The court recognized that:

[Intangible assets like the goodwill of a business, customer base, and favorable franchise terms or operating contracts all make a direct contribution to the going concern value of the business as reflected in an income stream analysis and have a quantifiable fair market value that must be deducted from an income stream analysis prior to taxation.]

The court concluded that the assessor's approach was a violation of California law because it failed to attribute a portion of the hotel's income stream to activity directly attributable to the value of intangible assets, including, specifically: the value of the hotel's workforce, the hotel's leasehold interest in an employee parking lot, and the hotel's agreement with a golf course operator. The value of those intangibles should have been deducted prior to assessment. The case demonstrates one circumstance in which the franchisee's personal and local goodwill was attributable to the franchisee without regard to whether the franchisor claimed sole ownership of the goodwill associated with the business.

A. Valuation Under GAAP

How goodwill is valued under generally accepted accounting principles (GAAP) has also varied over time. "GAAP does not prescribe a fixed set of rules, but rather represent the range of reasonable alternatives that management can use." Prior to 2001, goodwill was amortized. Then, in June, 2001, the Financial Accounting Standards Board (FASB) issued Statement No. 142 indicating goodwill should no longer be amortized. In a summary of the statement, FASB acknowledged that "[a]nalysts and other users of financial statements, as well as company management, noted that intangible assets are an increasingly important economic resource for many entities and are an increasing proportion of the assets acquired in many transactions." Therefore, in addressing financial accounting and reporting for acquired goodwill and other intangible assets, Statement No. 142 took a new approach to accounting for goodwill.

Pursuant to Statement No. 142, a two-step goodwill impairment test is now used and must be repeated at least annually. The first step screens to determine if business goodwill

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23 Id. at 896 (quoting Elk Hills Power, LLC v. Bd. of Equalization, 160 Cal. Rptr. 3d 387, 405 (2013)).

24 Id.

25 Id.

26 Ganino v. Citizens Utilities Co., 228 F.3d 154, 159 n.4 (2d Cir. 2000).


28 Id.
impairment is present. The second step estimates the value of business goodwill in order to measure the amount of impairment. The impairment loss, if any, must be timely recognized.

In 2014, however, the FASB issued updates to GAAP that permit privately held companies to amortize goodwill over a period not to exceed ten years. These privately held companies only need to conduct goodwill impairment valuations when there is some triggering event that indicates the recorded or carrying value of the company exceeds its fair market value. The 2014 alternative was created to reduce yearly accounting costs for privately held companies without diminishing the utility of their financial statements.

B. Valuation Under Cost, Income, and Market Approaches

The question of who owns the goodwill comes up often in the valuation of a business. Fair market value is "the price at which property would change hands between a willing buyer and a willing seller, neither under any compulsion to buy or sell and both having knowledge of relevant facts." The willing buyer and seller are hypothetical and are presumed to be dedicated to achieving the maximum economic advantage from the hypothetical sale. The factors to be considered in determining value are: the nature and history of the business; the economic outlook, in general and in the industry; the book value of the interests held and the financial condition of the business; the earning capacity of the business; the existence, or nonexistence of goodwill and other intangibles; past sales of the interests held and the size of the block to be valued; and the market price of previously traded interests of comparable companies engaged in the same or similar lines of business.

The three most acceptable and commonly used valuation methods in business litigation are the cost, income, and market approaches. In the cost, or "book value," approach, the net

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29 Id.
30 Id.
31 Id.
33 Id.
34 Id. at 28.
36 Id.
38 Id. at 9.
worth of a company is determined either by valuing its balance sheet assets or by calculating the replacement cost of its balance sheet assets minus liabilities. An income or “capitalization of earnings” approach assumes either that the earnings of a business constitute an annual percentage return on the value of the business, or, perhaps more accurately, that the present discounted value of all a business’s earnings into the future is the current business value. Finally, the market, or “comparable sales,” approach examines the recent sales of similarly situated businesses. Because the approach utilizes actual prices, as opposed to estimates, the comparable sales method is generally preferred as the most realistic proof of fair market value.39

Although the market approach is generally preferred when determining “fair market value,” valuation specialists must generally consider all three approaches, or explain why one of the approaches was not used.40 However, unlike valuation specialists, real-world buyers often judge the value of a prospective purchase not by any of the three accepted methodologies, but rather by comparing price to earnings revenues, cash-flow, pay-back period, or other industry specific “rules of thumb.”41

Although business goodwill is an intangible asset, it might be the most valuable asset of a franchised business and can affect the business’ fair market value. The goodwill of a franchise is the result of combining all of the various assets of the franchisor and the franchisee used to produce income. Goodwill encompasses value from other intangibles, such as trademarks, operating systems, business acumen, and market presence. Therefore, a well-run franchise could be worth hundreds of thousands of dollars, while the tangible assets within are worth only a fraction of that amount. Take Coca-Cola for example. As of December 31, 2006, Coca-Cola shows balance sheet equity of $16.92 billion, yet, as of September 1, 2007 has a market capitalization of $124.42 billion.42 Effectively, this means that the market has valued Coca-Cola’s intangible assets, which do not appear on the balance sheet, at $107.5 billion, more than six times the book value of the equity.43 The same principles apply to individual franchises.

C. **Valuation of Trademarks**

The allocation of goodwill in franchise transfers is another example of a situation where franchisees often claim ownership in goodwill. In the context of transfers and a franchisor’s right of first refusal, it is important to note that while an arms-length buyer would purchase the franchise, including certain rights to use the franchisor’s trademarks, the franchisor reacquiring the franchise is the only “buyer” who already has greater rights to the use of the trademarks in a location or territory. Indeed, “it is generally conceded that the ownership of all rights in a

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40 Id.

41 See id. at 10.


43 Id.
trademark in a given territory is worth more than the sum of the value of the licensor's interest plus the licensee's interest for the same territory before the merger of their interests.\textsuperscript{44}

On the other hand, franchisors who sell stock or other ownership interests in the system also allocate value to identified intangible assets and unidentified goodwill. When determining the value of franchise rights and the franchise fees they can charge, in addition to demographics and the terms of the franchise agreement, franchise companies look at goodwill and other intellectual property rights.\textsuperscript{45}

There are four basic types of intellectual property: patents, trademarks, copyrights, and trade secrets. A key element of franchise value is the goodwill associated with trademark value. As Bruce Schaeffer explains there are four methods of trademark valuation, as follows:

1. Profit Split Method- this is based on the division of the after-tax operating margin that a licensee would be willing to pay, after taxes, to a hypothetical licensor for the use of a trademark or trade name.

2. Selling-Price Differential Method- this calculates the value of trademarks and trade names by determining the incremental price differential attributable to trademarks and trade names over unbranded products or services and then splits the premium portion of the price between the hypothetical licensor and the hypothetical licensee.

3. Econometric Method- this method purports to derive implied economic values for trademarks expressed as a percentage of sales.

4. License Agreements to determine and appropriate royalty rate. Once such comparable royalty is determined, three steps follow: (1) determining the projected excess earnings for the branded product or service, (2) selecting an appropriate royalty rate for the license, and (3) computing the present value of the royalty payments using a discounted cash flow method.\textsuperscript{46}

From the franchisor's perspective, a trademark is the symbol for goodwill, and, therefore, trademark right values represent the value of goodwill. However, from the franchisee's perspective, the value of goodwill encompasses more than just the value of the trademark and must also take into consideration local and personal goodwill. As such, traditional valuation methods are often used to value goodwill and such methods seek to ascertain not only the value associated with trademark rights, but also the values derived from the unique patronage, reputation, location and skill of a business. Commonly, a market approach is used to measure the value of a small businesses' goodwill. Using the market approach, one subtracts from the total purchase price of the business the total value of all tangible assets, and the net is the value of the goodwill.

\textsuperscript{44} SCHAEFFER & LEVITT, supra note 37, at 10.

\textsuperscript{45} Id. at 14.

\textsuperscript{46} Id. at 11.
D. The Effect of Personal Goodwill on Valuation

Of course, a significant element of goodwill is the going concern value of an open and operating franchised unit. A franchisee with well-trained and well-liked managers and employees has valuable intangible assets beyond physical resources on-hand at the location. One might value the goodwill of a franchised unit with a high going concern value, expectation of future income, and proven ability to attract and keep new customers using a traditional cost approach. Under this approach, the focus would be to estimate the cost in current dollars one would require to recreate the goodwill. Alternatively, the income approach may be an appropriate way to value goodwill. For example, in Estate of Adell v. Commissioner of Internal Revenue, the United States Tax Court found the income approach was the most appropriate method of determining the fair market value of closely held corporate stock where the highest and best use of the business was a going concern and the value of the goodwill associated with the corporate president was at issue.\(^{47}\)

In Estate of Adell, the court was asked to determine the fair market value of the decedent’s 100% equity interest in STN.com, a closely held company that provided cable up-linking services to one client, The Word Network, a religious programming system.\(^{48}\) The decedent and his son, Kevin Adell, created The Word to broadcast religious programs and Kevin used his personal relationships with religious leaders to attain support and programming for The Word, the sole client of STN.com. The decedent was the president and a director of The Word, while Kevin was the treasurer, secretary and a director. Kevin was also the president of STN.com, but had no employment or non-compete agreement with STN.com. Thus, it was clear to the court that STN.com’s success was “heavily dependent” on The Word and The Word was likewise dependent on Kevin’s personal ties with the religious community.\(^{49}\)

The court found that the income approach, and not an asset approach, was the most appropriate method of valuating STN.com’s corporate stock. Despite the fact that STN.com only had one customer, The Word, historical data indicated that STN.com was expected to produce positive cash flows. As part of its decision, the court also analyzed the nature of the company’s goodwill and found that the goodwill associated with Kevin, STN.com’s president, was personal, rather than corporate in nature. In so holding, the court found that Kevin did not transfer his goodwill to STN.Com through a covenant not to compete or other agreement, and stated “Kevin was free to leave STN.Com and use his relationships to directly compete against his previous employer. If Kevin quit, STN.Com could not exclusively use the relationships that Kevin cultivated; thus, the value of those relationships should not be attributed to STN.Com.”\(^{50}\)

Accordingly, the court held that the income approach appropriately included economic charges of $8 million to $12 million in STN.com’s operating expenses to account for the significant value of Kevin’s personal goodwill; goodwill that was unattributable to the company.\(^{51}\)

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47 108 T.C.M. (CCH) 107, at *15 (T.C. 2014).

48 Id. at *2.

49 Id. at *16.

50 Id. at *17.

51 See id. at *18.
E. Current Trends in the Valuation of Franchises

While literature suggests that one of these three business valuation methods should be used to value every business, current trends in franchise law reveal that courts are more likely to apply different valuation methods when considering the value of franchises.\textsuperscript{52} It has been rightly pointed out that "there are many damages and valuation aspects unique to franchises, distributorships and dealerships... the asset is a mere contract right, not outright ownership; a management analysis must take into account two levels of management—both at the franchisor and franchisee level; and, regulation."\textsuperscript{53} "For these reasons, damages practitioners must carefully review the... FDD... to analyze... the risk of termination and/or non-renewal... covenants not to compete... and rights of first refusal and/or approval of subsequent operators."\textsuperscript{54} Inherently, franchise values are affected by franchisor control. On the one hand, a franchisor's right of first refusal or right to consent to a transfer protects the intellectual property of the system and the goodwill associated therewith. On the other hand, such controls reduce marketability, thus requiring valuation discounts to be applied.\textsuperscript{55}

For damages analysis, accounting principles teach us that the value of goodwill is the difference between the current market value of the tangible assets of the business and the total value of the business. There are two traditional methods of franchise valuation: future lost profits and fair market value. In a wrongful termination case, a franchisee can claim future lost profits or fair market value, but not both. As it is defined for accounting purposes, goodwill is an element of both.

It is possible to measure certain breach of contract damages, as well as patent infringement damages, by determining the reduction in goodwill due to the alleged bad act. However, such measurement can prove very difficult, particularly if the plaintiff "catches" the defendant before significant damage to the plaintiff's reputation occurs. Injunctive relief is more common, especially in circumstances where damage to the plaintiff's reputation is imminent if the defendant is not stopped.

Courts have recognized the risks to franchisees when franchisors are allowed to capture all of the goodwill established during the term of a franchise relationship without any compensation to the franchisee. In 1983, the Appellate Division of the New Jersey Superior Court recognized that:

\begin{quote}
Once a franchisee has succeeded by his efforts and capital in establishing a local reputation for the franchise name, he is vulnerable to termination of the franchise, forfeiture of the business good will and the inability to realize the benefits of his business by selling it to another prospective franchisee. Thus, the
\end{quote}

\textsuperscript{52} Nicole Liguori Micklich, Michael W. Lynch, and Ingrid C. Festin, The Continuing Evolution of Franchise Valuation: Expanding Traditional Methods, 32 FRANCHISE L. J. 223, 223 (Spring 2013).

\textsuperscript{53} Bruce S. Schaeffer, Current Damages Issues In Franchise Disputes: Lost Future Royalties and The Value of a Terminated Franchise, in DUNN ON DAMAGES 24 (Issue 7, 2012).

\textsuperscript{54} Id.

\textsuperscript{55} See SCHEFFER & LEVITT, supra note 37 at 12.
reputation and good will of the network, created primarily by the efforts of each of the individual franchisees, passes back to the franchisor without compensation to the franchisee.\textsuperscript{56}

Courts have also held that when the franchise agreement is terminated, any goodwill created by the franchise is extinguished. In \textit{Novus Franchising, Inc. v. Taylor}, the court acknowledged that the franchise relationship obligated the franchisee to develop local goodwill, but determined that the value of that local goodwill was extinguished when the franchise agreement terminated.\textsuperscript{57}

The court has no doubt that much of the success of [the franchised business] stemmed from the business acumen and hard work of [the franchisees]. However, in any arrangement where a noncompetition clause is likely to be enforced—an employment contract for instance—there is an expectation by both parties to the contract that the employee or franchisee will act to promote the greatest gain for herself and for the employer or franchisor. When the contract is terminated and the noncompetition clause is enforced, courts have recognized that there will necessarily be an extinguishment of some good will the employee or franchisee built up on her own. The courts enforce the covenants nonetheless.\textsuperscript{58}

\section*{IV. STATE AND INDUSTRY SPECIFIC LAWS}

Recognizing a desire to protect franchisees against potential abuses and significant losses at the end of the franchise relationship, Arkansas, California, Connecticut, Hawaii, Iowa, North Dakota, Washington, and Wisconsin have enacted legislation requiring franchisors to pay franchisees fair and reasonable compensation for inventory upon termination. However, only a few of these states require that the franchisor compensate the franchisee for its goodwill and only under limited circumstances.

Arkansas provides that for termination without good cause, a franchisor must repurchase certain inventory, supplies, equipment, and furnishings.\textsuperscript{59} Similarly, Connecticut provides that upon termination, a franchisor must offer fair and reasonable compensation for certain inventory, supplies, equipment, and furnishings.\textsuperscript{60} In California, a franchisor must offer to repurchase certain inventory if they the wrongfully terminate or fail to renew, but may offset with sums owed by the franchisee.\textsuperscript{61}

\begin{itemize}
\item \textsuperscript{57} 795 F. Supp. 122, 128 (M.D. Pa. 1992).
\item \textsuperscript{58} \textit{Id}.
\item \textsuperscript{59} \textit{See ARK. CODE ANN. \$ 4-72-209} (West 2014).
\item \textsuperscript{60} \textit{See CONN. GEN. STAT. ANN. \$ 42-133(c)} (West 2015).
\item \textsuperscript{61} \textit{See CAL. BUS. \& PROF. CODE \$ 20035} (West).
\end{itemize}
The legislatures in Hawaii and Washington have taken similar approaches. In Hawaii, for termination, a franchisor must offer fair market value of certain inventory, supplies, equipment, and furnishings. For takeover of the premises of the franchised business, the franchisor must compensate for goodwill. Compensation may be offset by money owed and costs of removing inventory.\footnote{\textit{See} HAW. REV. STAT. § 482E-6(3) (2015).} In Washington, a franchisor cannot refuse to renew a franchise without compensating the franchisee for the fair market value of inventory, supplies, equipment, and furnishings purchased from the franchisor, and goodwill. But the franchisor is specifically excused from compensating a franchisee for goodwill if it gives the franchisee at least one year’s notice of nonrenewal and agrees not to enforce covenants against competition. The franchisor also may offset amounts owed by the franchisee.\footnote{\textit{See} WASH. REV. CODE § 19.100.180(2)(i) (2015).}

In recent years, proposed legislation that would have required franchisors to compensate franchisees for personal or local goodwill, similar to the Washington act, was defeated in Massachusetts, New Hampshire, and Maine.\footnote{See 2011 MA S.B. 73; 2011 MA S.B. 1843; 2011 MA S.B. 1828; 2013 NH H.B. 1215; 2013 ME H.B. 1043.} Earlier acts failed at both the state and federal level.\footnote{\textit{See} e.g. H.R. 4841, 195th Cong. (1998); 1997 GA S.B. 264, Sec. 10-1-912; 1997 SC S.B. 717, Sec. 38-75-150.}

A bill to establish minimum standards of fair conduct in franchise sales and franchise business relationships, known as the Fair Franchise Act of 2015, was introduced in the U.S. House of Representatives on July 23, 2015.\footnote{H.R. 3196 (2015-2016).} The Act recognizes both the goodwill in the franchisor's trademarks and the local goodwill developed by the franchisee. As proposed, the Act would permit termination or cancellation of a franchise by a franchisor, immediately, upon fifteen days written notice to the franchisee, if the franchisee is convicted in a court of competent jurisdiction of an offense that “materially impairs the goodwill value of the franchise or the franchised trademark” and the conviction is no longer appealable.\footnote{\textit{Id.} at Sec. 8 (d)(2)(c).} The Act would also mandate that upon termination of a franchise, for any reason other than the franchisee’s abandonment or election not to renew, the franchisor must “fairly compensate” the franchisee for the fair market value of the franchise including the fair market value of the going concern value and good will of the business, if any, provided that the franchisor would not have to compensate the franchisee for going concern value and good will “if the franchisor agrees in writing not to enforce a covenant which restrains the franchisee from competing with the franchisor in the same or substantially similar business in the same or substantially similar manner at the same location using the same property except the franchisor's registered trademark or trade name” and provided that the franchisor can offset undisputed amounts owed to the franchisor by the franchisee.\footnote{\textit{Id.} at Sec. 9(a).}
Iowa requires a franchisor to repurchase assets from franchisees, but excludes from that requirement assets the franchisee did not purchase from the franchisor or its agents. Iowa also provides that a franchisor may not prohibit a former franchisee from engaging in any lawful business unless that business relies on a substantially similar marketing program or the franchisor offers to purchase the assets of the franchised business for fair market value.\footnote{See Iowa Code Ann. §§ 523H.11; 537A (West 2015).} North Dakota provides that a franchisee upon termination is entitled to the net cost of new and unused merchandise and a percentage of the cost of parts held at the time, plus the costs of their return.\footnote{See N.D. Cent. Code Ann. §§ 51-07-01; 51-20.1-02; 51-20.2-02 (West).}

The Wisconsin approach focuses on the franchisor’s use of its marks on products or goods sold to the franchisee. In Wisconsin, a franchisor must repurchase from a terminated franchisee, at fair wholesale market value, all inventory sold to the franchisee for resale that bears the franchisor’s name, mark, or label.\footnote{See Wis. Stat. Ann. § 135.045 (West 2015).} In 2003, a federal court faced with interpreting the Wisconsin act determined the meaning of the phrase “fair wholesale market value” as the wholesale price of the goods.\footnote{Roedel-Hanson and Assocs., Inc. v. Environamics, Corp., 242 F. Supp.2d 582, 584 (E.D. Wis. 2003).} The result of the finding was that the dealer plaintiff did not establish that the amount in controversy for diversity jurisdiction and the court granted the dealership’s motion to dismiss for lack of subject matter jurisdiction was granted. The dealer attempted to argue that the fair wholesale market value was different than “cost price.” The court was not persuaded and concluded that the Wisconsin Supreme Court would concur. Wholesale, the court noted, refers to the sale of commodities in bulk for resale, not a different, higher value.\footnote{Id. at 585.}

\section{A. The PMPA}

The Petroleum Marketing Practices Act (PMPA) prohibits franchisors from terminating or refusing to renew a gasoline franchise, except under certain circumstances and establishes specific rules for compensating a franchisee when the franchise is terminated or not renewed.\footnote{15 U.S.C.A. § 2801, et seq.} Judicial analysis of the franchisee’s right to recover for lost goodwill under the PMPA is long and inconsistent. In 1978, in Atlantic Richfield Co. v. Razumic, the court acknowledged that the franchisee created goodwill for the franchise, which benefited both the franchisee and the franchisor.\footnote{390 A.2d 736, 742 (Pa. 1978).} By operating a gasoline service station, the franchisee knew that his good service would in many instances produce regular customers, but also realized that much of his trade would be attracted because his station offered the products, services, and promotions of the well-established and well-displayed name “Arco.”\footnote{Id.} The court realized that the arbitrary
termination of such a franchise would essentially allow the franchisor to steal the goodwill developed over time by the franchisee and granted the franchisee a new trial to prove damages.

In 1986, in Bellmore v. Mobil Oil Corp., the Second Circuit Court of Appeals held that the PMPA did not preempt a similar goodwill payment provision in the Connecticut Gasoline Dealer's Act.\textsuperscript{77} In Bellmore, the franchisee rejected a renewal proposal by defendant-franchisor Mobil which nearly doubled the monthly rent for the franchise premises. Mobil thereafter refused to renew the plaintiff's franchise. Bellmore then sought declaratory and injunctive relief under the PMPA, asserting that Mobil violated the Act because its proposal was made neither in good faith nor in the normal course of business.\textsuperscript{76} When that relief was denied, Bellmore amended his complaint to include a claim for the fair market value of his franchise, including goodwill, under the Connecticut Gasoline Dealer's Act.\textsuperscript{79} A jury awarded Bellmore $43,000 on his claims for goodwill under the Connecticut Act. Mobil appealed, contending that the PMPA preempted the Connecticut Act on all issues related to the termination or nonrenewal of petroleum franchises. The Second Circuit affirmed, finding no preemption had been effected by the passage of the Connecticut Act.\textsuperscript{80} The court stated in part:

We cannot accept Mobil's argument that the payment of good will is a remedy or penalty for termination and thus preempted as not the same as the applicable provisions of the PMPA. The good will portion of the Connecticut Act is no more than a recognition of the good will value that Mobil would otherwise receive because of the efforts of the deposed franchisee. This payment of good will is not a penalty, as Mobil asserts, because Mobil is liable for the payment of such good will upon termination or nonrenewal "for whatever cause or reason except voluntary relinquishment or abandonment."\textsuperscript{81}

Conversely, in Millett v. Union Oil Co. of California, the United States District Court for the Western District of California rejected the auto repair franchisees' claims for the goodwill value of their auto repair franchises and granted summary judgment in favor of Unocal, the franchisor oil company. The court held that the PMPA's one year notice requirement was preempted by the 90-day notice requirement in the Washington Franchise Investment Protection Act (the FIPA).\textsuperscript{82} In so holding, the court rejected the franchisee's argument that its auto repair agreements were separate and distinct from the motor fuel franchise agreement and thus outside the preemptive reach of the PMPA. Rather, the court reasoned that the retail franchise was "sufficiently related to the Unocal motor fuel franchises so as to be covered by the PMPA" and determined that lengthening the nonrenewal notice period would "contradict the

\textsuperscript{77} 783 F.2d 300, 305 (2d Cir. 1986).

\textsuperscript{76} Id. at 303.

\textsuperscript{79} CONN. GEN. STAT. §42-133/ (b) (2015).

\textsuperscript{80} 783 F.2d at 305.

\textsuperscript{81} Id. (quoting §42-133(b)).

\textsuperscript{82} 24 F.3d 10, 15 (9th Cir. 1994).
congressional objective of permitting franchisor flexibility to respond to changing market conditions.\footnote{Id.}

In \textit{Lee v. Exxon Co.},\footnote{867 F. Supp. 365, 367 (D.S.C. 1994).} the court considered whether goodwill was part of a sale between the franchisor and the franchisee. Franchisor Exxon conducted a marketing study for a geographic area including franchisee Lee's direct-supplied franchise in Florence, South Carolina. Based on that study, Exxon "made an informed business decision . . . [to] convert all direct-supplied retail sites to distributor-supplied retail sites."\footnote{Id. at 368.} While Exxon decided not to renew its franchise agreement with Lee, it offered to sell back the franchise site to him for the same price as the highest bid Exxon received. Lee chose to exercise this option, but then sued Exxon for alleged violations of the PMPA.\footnote{Id. at 366.} Lee alleged that Exxon made its offer in bad faith, because the selling price included goodwill that he had built up over time as the franchisee,\footnote{Id. at 367.} forcing him to buy goodwill that he had developed himself.\footnote{Id. at 368.}

The court found that goodwill was not part of the sale, and held that a PMPA franchisor is not required to include the goodwill built up by the franchisee in the fair market price offered because the price need only be what a disinterested party would pay.\footnote{Id.} The court noted, "Congress has, through the PMPA, declared that where a franchisor follows the provisions of the PMPA, the franchisor may terminate or non-renew a franchise without incurring any liability to the franchisee, including any payments for loss of alleged goodwill."\footnote{Id. at 369.} The court reasoned that an "actual price, agreed to by a willing buyer and a willing seller, is the most accurate gauge of the value the market places on a good."\footnote{Id. at 368.} The court was cautioned by \textit{Keener v. Exxon Co.},\footnote{32 F.3d 127, 132 (4th Cir. 1994).} that to look at information other than the agreed-upon purchase price "is necessarily speculative." The counter-argument, of course, is that the value of the goodwill should necessarily be included in the purchase price of an arms-length transaction.

\section*{V. GOODWILL IN COMMON FRANCHISE DISPUTES}

The issue of whether goodwill belongs solely to the franchisor or whether a franchisee can develop its own, severable goodwill often surfaces in disputes between the parties. Such disputes include: termination or non-renewal, enforcement of non-compete agreements, territorial restrictions or encroachments on franchise territory, trademark infringement, antitrust
or tying, and vicarious liability. Each dispute will be discussed in turn by looking at how the courts treat the concept of goodwill differently depending on the nature and factual circumstances of the dispute.

A. Termination

If a franchisor improperly issues a notice of default to terminate a franchise relationship, the franchisee may bring a wrongful termination action, request an injunction to prevent the termination, and seek damages.93 Franchisors argue that allowing a terminated franchisee to remain in the same business after termination damages the franchisor’s goodwill.94 Franchisees argue that enjoining termination is necessary to prevent irreparable harm to its goodwill that would result from a wrongful termination.95 Given these competing arguments, the outcomes are somewhat unpredictable. Often, the disparate decisions are the result of the court’s differing treatment of the concept of goodwill ownership.

As mentioned above, most franchise agreements explicitly state that any equity or goodwill developed by the franchisee in connection with the business belongs to the franchisor. Courts have traditionally enforced this provision in favor of the franchisor.96 In Jack Walters & Sons, Corp. v. Morton Buildings, Inc., a building materials franchisee brought suit against the franchisor manufacturer after the franchisor terminated their agreement.97 The franchisor alleged that the franchisee had damaged the franchisor’s customer goodwill.98 The franchisee argued that he only purchased materials from the franchisor and then sold the final assembled products under his own name, thus precluding any claim of harm to the franchisor’s name and trademark.99 The court held that “a product and its name are inseparable.” The franchisee purchased an inseparable franchise package of materials and goodwill and customers purchase the product because of the goodwill associated with the franchisor’s name.100

Other courts have agreed with the “franchise package” theory. In Gorenstein Enterprises, Inc. v. Quality Care-USA, Inc., franchisor Quality Care sued the franchisee Gorenstein after Gorenstein continued to use Quality Care’s trademarks after termination for unpaid royalties.101 Gorenstein filed a counterclaim for rescission and alleged that Quality Care had abandoned the trademark by allowing Gorenstein to continue using it after the agreement

93 2 FRANCH & DISTRIBUTION LAW & PRACTICE §10:37.

94 Nicole Micklich, Who Owns the Goodwill in Franchise Relationships?, THE FRANCHISE LAWYER 15, 16 (Spring 2015).


96 Micklich, supra note 94, at 16.

97 737 F.2d 698 (7th Cir. 1984).

98 Id. at 706.

99 Id at 704.

100 Id. at 704–05.

101 874 F.2d 431, 433 (7th Cir. 1989).
was terminated. Judge Posner found the argument "frivolous" and affirmed that once a franchise is properly terminated, the franchisee is no longer permitted to use the trademark because the franchisor owns the goodwill associated with the mark and has duty to maintain the consistency of the good or service associated with it.

While the traditional view has been that goodwill belongs to the franchisor, some courts have recognized the significant losses a former franchisee may suffer when a franchise relationship is terminated. In *American Standard, Inc. v. Meehan*, the franchisee sought a preliminary injunction preventing termination of the franchise agreement. Although the court denied the request for preliminary injunction for failure to demonstrate a likelihood of success on the merits, the court did recognize that if the contract was terminated, the franchisee would suffer irreparable harm in the form of lost local goodwill that could not be easily recouped. The court found that after almost 30 years as a franchisee, "[the franchisee] ha[d] invested considerable money, time and effort and has established goodwill for both himself and [the franchisor]." In fact, the court found that on the issue of irreparable harm, the balance tipped in the favor of the franchisee. It was only because the court found that the franchisee had "very little likelihood of success" on the underlying contract claim, that the court denied the franchisee's motion for a preliminary injunction preventing the termination.

As these cases demonstrate, the court's view of "goodwill" and its ownership can have a significant effect on the outcome of actions involving a contested termination.

B. Non-renewal

All modern franchise agreements are set for a fixed period of time. In states without franchise relationship laws, the franchisee is often at the mercy of the franchisor when it comes to renewal. A franchisor may choose to not renew the agreement or change the terms, which can significantly impact a franchisee and its investment. While some states offer protection

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102 Id. at 434.

103 Id. at 435.; see also Downtowner/Passport Intern. Hotel v. Norlew, Inc., 841 F. 2d 214 (8th Cir.1988); Burger King Corp. v. Mason, 710 F.2d 1480 (11th Cir. 1983); All Star Championship v. O'Reilly Auto., 940 F. Supp. 2d 850 (C.D. Ill. 2013).


105 Id. at 989.

106 Id.; see also Atlantic Richfield Co. v. Razumic, 390 A.2d 736, 742 (1978) (holding that a franchisee should be able to expect that "his time, effort, and other investments promoting the goodwill of [the franchisor] will not be destroyed as a result of [the franchisor's] arbitrary decision to terminate their franchise relationship. . . . A contrary conclusion would allow [the franchisor] to reap the benefits of its franchisees' efforts in promoting the goodwill of its name without regard for the franchisees' interests.").

107 See also LaGuardia Assocs. v. Holiday Hosp. Franchising, Inc., 92 F. Supp. 2d 119, 124 (E.D.N.Y. 2000) (acknowledging that termination would allow a franchisor to exploit the franchisee's local goodwill and leave the franchisee with little to no means to recoup its investment).

108 Id. at 990.

109 Emerson, *supra* note 95, at 378.
for franchisees in the form of compensation for inventory or supplies, only few require compensation for the goodwill the franchisee has developed in its area.\textsuperscript{110}

At times, franchisees have also been successful in seeking common-law remedies. In \textit{Frank Coulson, Inc. -Buick v. General Motors Corp.}, the franchisee alleged that he was forced to sell his franchise under threats of nonrenewal.\textsuperscript{111} He alleged that the franchisor GM forced the sale of his car dealership because it felt that he was getting too old.\textsuperscript{112} Although the franchisee found a buyer that would pay for both the inventory and the goodwill of the franchise, GM would not allow the franchisee to include goodwill in the sales price.\textsuperscript{113} The court found that not only was the franchisor guilty of wrongfully forcing the franchisee to sell, the franchisor could not limit the sale price of the franchise unless it had a legitimate business interest in doing so. Here, the court found that GM failed to articulate any legitimate interest in forcing the franchisee to exclude the value of goodwill in the sale price.\textsuperscript{114}

C. Non-compete Covenants

Disputes regarding the enforcement of non-compete covenants often highlight the issue of goodwill ownership. Franchisors advocate that non-competes are necessary to protect the goodwill and customer base associated with the franchise and trademarks. Courts evaluate non-compete agreements based on geographic and temporal reasonableness and the circumstances and context in which they are to be enforced. The scope of the non-compete should be reasonably related to the franchisor’s interest in protecting its goodwill and its business’s know-how and not at restricting the goodwill the franchisee has earned on its own.\textsuperscript{115}

The issue of who owns the goodwill often drives the decision in non-compete disputes. For example, in \textit{DAR & Associates, Inc. v. Uniforce Services, Inc.}, a franchisee operated a staffing service under the name of the franchisor.\textsuperscript{116} The franchisee brought a declaratory judgment action against the franchisor arguing that the post-termination covenants were not enforceable.\textsuperscript{117} The court held that the covenants were necessary and reasonable to protect the interests of the franchisor because the franchisee had not developed its own local goodwill; instead, any goodwill claimed by the franchisee was derived from using the franchisor’s mark

\textsuperscript{110} ARIZ. REV. STAT. ANN. § 28-4457 (West); WASH. REV. CODE § 19.100.180(2)(i) (2015); see also Clay A. Tillack and Mark E. Ashton, \textit{Who Takes What: The Parties’ Rights to Franchise Materials at the Relationship’s End}, 28 FRANCHISE L.J. 88 (Fall 2008); see also supra, Part IV.

\textsuperscript{111} 488 F.2d 202, 203 (5th Cir. 1974).

\textsuperscript{112} Id. at 204.

\textsuperscript{113} Id.

\textsuperscript{114} Id. at 206.


\textsuperscript{116} 37 F. Supp. 2d 192, 194 (E.D.N.Y. 1999).

\textsuperscript{117} Id.
and system.\textsuperscript{118} “For DAR [the franchisee] now to use what it has gained from Uniforce [the franchisor] in order to compete against Uniforce would amount to unfair competition and would impede Uniforce's ability to secure another franchise in the territory.”\textsuperscript{119}

Some courts have enforced non-compete agreements even after recognizing that the franchisee was responsible for developing local goodwill. In Novus Franchising, Inc. v. Taylor, the franchisor moved to enjoin a former franchisee from engaging in competitive business in her former locations for two years following termination.\textsuperscript{120} The court stated it had “no doubt” that the success of the franchisee’s business was due to her business acumen and hard work.\textsuperscript{121} Regardless, the court held that the non-compete was enforceable because the franchisor had a protectable interest in the goodwill built up by its franchisees.\textsuperscript{122}

However, in Bandag, Inc. v. Jack’s Tire & Oil, Inc., the franchisor sought to enjoin one of its franchisees who wanted to terminate its franchise agreement and sign on with a competitive tire brand.\textsuperscript{123} The court found that the defendant had developed its own, independent local goodwill by operating in the market for 32 years before becoming a Bandag franchisee. The court denied the franchisor’s request to enforce its non-compete agreement because “[the franchisor] failed to show that [the franchisee’s] post-termination competition will deprive [the franchisor] of customer loyalties it has earned, as opposed to simply maintaining customer loyalties [the franchisee] has earned.”\textsuperscript{124} The fact that defendant had been operating in the market for over three decades before becoming a Bandag franchisee was clearly a deciding factor in determining that injunctive relief to protect franchisor’s goodwill was not warranted.

In Prosperity Systems, Inc. v. Ali, the franchisor sued the franchisee for trademark infringement and breach of post-termination non-compete agreement.\textsuperscript{125} The court granted the

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\textsuperscript{118} Id. at 198–99.

\textsuperscript{119} Id.; see also Giampapa v. Carvel Corp., Bus. Franchise Guide (CCH) ¶ 11,441, at 30,815–17 (D.N.J. June 18, 1998) (“The franchisor has a legitimate interest in protecting the goodwill developed at this store location.”), Jiffy Lube Intern., Inc. v. Weiss Bros., 834 F. Supp. 683, 691–92 (D.N.J. 1993) (“Jiffy Lube not only has a valid interest in protecting the good will it has developed over the years by having its franchisees do business at the Turnersville location, but it also has an interest in being able to place a new franchisee at or near the same location where this good will has been created. A reasonably crafted restrictive covenant is a legally acceptable means of protecting these interests.”).


\textsuperscript{121} Id. at 128.

\textsuperscript{122} Id.; see also Pearte Vision, Inc. v. Adler, No. 1:07CV321, 2008 WL 2704407, at *7 (S.D. Ohio July 3, 2008) (granting Pearl Vision’s preliminary injunction because Pearl Vision was at risk of losing the goodwill built at the current location through Adler’s operation of the franchise).

\textsuperscript{123} 190 F.3d 924, 925 (8th Cir. 1999).

\textsuperscript{124} Id.; see also Hill v. Mobile Auto Trim, Inc., 725 S.W.2d 168, 171 (Tex. 1987) (“[T]here exists not only business goodwill but also franchisee goodwill… Shrewd employers and franchisors… seek to deprive the employee/franchisee of the fruits of his goodwill by requiring that he enter into an agreement containing a restrictive covenant. The covenant is generally unfair to the employee/franchisee, for when that person is placed in the position of being unable to compete with the former employer/franchisor, his personal goodwill is effectively neutralized.”).

franchisor's request for an injunction preventing use of its trademarks, but permitted the
franchisee to continue operating under his own name at the location of the former franchised
business even though the court found that the franchisee had violated the covenant not to
compete.\textsuperscript{126} The court believed it would be unreasonable to enforce the non-compete "at this
time" because "[i]f the court enjoins [the former franchisee] from operating his restaurant under
his own name, he will likely lose his business and be unable, at least for some period of time, to
support himself or his family. Further he has been operating a pizza restaurant at that location
for many years, arguably establishing his own good will with customers."\textsuperscript{127} Again, prior
operation at the same location opened the door for a finding that the former franchisee had
independent goodwill that trumped the franchisor's goodwill—at least at the preliminary
injunction stage.

\section*{D. Territorial Restrictions/Encroachment on Franchise Territory}

Courts also employ a variety of analytical approaches to goodwill ownership in the
context of resolving territorial disputes. In \textit{Camp Creek Hospitality Inns, Inc. v. Sheraton
Franchise Corp.}, the franchisee brought a suit against Sheraton after Sheraton acquired another
hotel in the same vicinity as the franchisee.\textsuperscript{128} Although the franchise agreement did not
expressly prohibit Sheraton from opening nearby locations, the franchisee alleged that the
purchase violated the Sheraton's duty of good faith and fair dealing because the new hotel
would be in direct competition with the franchisee's location and would trade on the goodwill that
the franchisee had developed in the market.\textsuperscript{129} In support of this argument, the franchisee
presented evidence that it could have been more profitable had Sheraton not opened the new
location.\textsuperscript{130} The court reversed summary judgment in favor of Sheraton on several claims and
remanded the case for additional evidence.\textsuperscript{131}

Other courts have concluded that there is no independent cause of action for good faith
and fair dealing under a franchise agreement. In \textit{Burger King Corp. v. Weaver}, Burger King
opened two new franchise locations near two current locations owned by a franchisee.\textsuperscript{132}
Believing Burger King was encroaching on his territory, (and customer goodwill) the franchisee
stopped paying his rent and royalty payments.\textsuperscript{133} Burger King brought a suit to collect payment
and the franchisee brought a counter-suit alleging breach of good faith and fair dealing because

\textsuperscript{126} Id. at *4–5.

\textsuperscript{127} Id. at *5.

\textsuperscript{128} 139 F.3d 1396, 1396 (11th Cir. 1998).

\textsuperscript{129} Id. at 1402–03. Other courts have denied summary judgment motions on behalf of a franchisor based on the
notion that express denial of a territorial interest in a franchise agreement does not necessarily imply a right to open
new franchisees at will regardless of their effect on the franchisee's operations and goodwill. See \textit{Foodmaker, Inc. v.

\textsuperscript{130} 139 F.3d at 1402.

\textsuperscript{131} Id. at 1414.

\textsuperscript{132} 169 F.3d 1310, 1313 (11th Cir. 1999).

\textsuperscript{133} Id.
Burger King had not expressly reserved the right to license new franchises near his locations.134 The court granted summary judgment in favor of Burger King on all counts and held that "a cause of action for breach of the implied covenant cannot be maintained (a) in derogation of the express terms of the underlying contract or (b) in the absence of breach of an express term of the underlying contract."135 Because exclusive territory rights were not given in the franchise agreement, Burger King was able to establish new locations near the franchisee.

E. **Trademark Infringement**

One of the most commonly litigated issues between a franchisor and former franchisee is that of trademark infringement. Franchisors allege that the use of trademarks by former franchisees can cause confusion and be detrimental to the franchisor's goodwill; while franchisees argue that immediate cessation of the use of a trademark could cost the franchisee customers.136 To be successful in a suit for trademark infringement, the movant must show that it has a protectable mark, that the franchise agreement was properly terminated, that the franchisee is continuing to use the mark without consent, and that the unauthorized use of the mark creates a likelihood of consumer confusion.137 Although most franchise post-termination trademark infringement actions are relatively routine, some courts appear to be torn between protecting the franchisor's mark and protecting the local goodwill developed by the franchisee.

In *Dunkin Donuts, Inc. v. Benita Corp.*, the franchisor Dunkin Donuts sued franchisee Benita for trademark infringement after the franchisee continued to use Dunkin’s marks after termination.138 The court found that because the agreement had been terminated, the franchisor no longer had control over the franchisee’s operations nor the ability to ensure quality standards associated with the trademark were being met.139 Because of the lack of control, the franchisee’s use of the marks could cause irreparable harm and customer confusion if the franchisee sold inferior products in association with Dunkin’s marks. These factors all led to the conclusion that an injunction was necessary to protect Dunkin's trademarks.140

The court in *Pappan Enterprises, Inc. v. Hardee's Food Systems, Inc.*141 took it a step further. Hardee’s sought a preliminary injunction against a former franchisee after the

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134 Id. at 1313, 1317.

135 Id. at 1318; see also *Nibeel v. McDonald's Corp.*, No. 97 C 7203, 1998 WL 547286, at *1 (N.D. Ill. Aug. 27, 1998) (holding the implied covenant of good faith and fair dealing cannot modify the express terms of the franchise agreement).

136 Emerson, supra note 89, at 383.


139 Id. at *5.

140 Id. at *5–6.

141 143 F.3d 800 (3d Cir. 1998).
franchisee continued to use Hardee’s marks post-termination. The franchisee filed a counterclaim alleging irreparable harm if the injunction was granted because it would lose the goodwill it had developed with local customers at that location. The court found in favor of Hardee’s, holding that the franchisee could not “lose” goodwill it did not own.” The concept of customer goodwill in the context of trademark law is goodwill for the Mark, not for the specific restaurant.

On the other hand, some courts have taken into consideration the effect that loss of goodwill would have on a franchisee if an injunction is granted. In Computer Currents Publications Corp. v. Jaye Communications, Inc., the court refused to grant an injunction against a franchisee/licensee that published a local computer magazine. The franchisor alleged that the franchisee was infringing and diluting its trademark and damaging the franchisor’s business by using its trademark on the Internet and outside the scope contemplated by the license agreement. The court found any injury to the franchisor to be slight compared to the harm an injunction would cause the franchisee. “If it is enjoined . . . Defendant is likely to lose many of the readers and advertisers it has attracted during its eight years [of operation] as well as the goodwill defendant has cultivated.” Because the court believed the franchisee could not be expected to transition to a new publication overnight and an injunction would cause the franchisee to lose a majority of its readers and advertisers, the injunction was denied.

F. Franchise Innovation

Another area of contention between franchisors and franchisees involving goodwill is that of franchise innovation. If a franchisee successfully develops its own advertising or marketing methods using the franchisor’s marks, who owns the goodwill resulting from the local advertising developed by the franchisee? If a franchisor adopts the franchisee’s methods to benefit the entire franchise system, does the franchisee own that goodwill? Should the franchisee be paid for the new method of promotion?

In most situations, the answer to these questions does not favor the franchisee. It is common to find a “work for hire” or “innovation assignment” type provision in franchise agreements that state all goodwill developed by the franchisee using the Franchisor’s marks inures exclusively to the benefit of the franchisor. In Pinnacle Pizza Co. v. Little Caesar

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142 Id. at 802.

143 Id.

144 Id. at 806; see also Jiffy Lube Int’l, Inc. v. Weiss Bros., 834 F. Supp. 683, 691 (D.N.J. 1993)(“[T]he primary characteristic of a franchise is the license given to the franchisee to trade upon and exploit the franchisor's good will.”).


146 Id. at 686–87.

147 Id. at 689–90.

148 Id. at 690.

149 See, e.g., Pinnacle Pizza Co. v. Little Caesar Enterers., Inc., 598 F.3d 970, 980 (8th Cir. 2010) ("Section V.B of the franchise agreement states: Franchise Owner expressly acknowledges that any and all goodwill associated with said
Enterprises, Inc., a franchisee developed the "Hot-N-Ready" slogan to identify the availability of ready-made pizzas at a discounted price on certain days.\textsuperscript{150} After introducing the slogan and positive results to other franchisees at a conference, Little Caesar decided to implement the program nationally.\textsuperscript{151} Seeing the successful spread of what it believed to be its own concept, the franchisee sued Little Caesar for damages.\textsuperscript{152} Little Caesar counterclaimed alleging breach of the franchisee agreement for contesting that Little Caesar was entitled to all goodwill and marks developed by individual franchisees.\textsuperscript{153} The court agreed with Little Caesar and entered summary judgment in its favor because "[t]he franchise agreement . . . expressly authorizes [Little Caesar's] actions. . . . [T]he rights in the "Hot-N-Ready" phrase and the goodwill that inures as a result of the use of the phrase became the property of [Little Caesar] upon its use by the franchisee."\textsuperscript{154} As the trademark owner, franchisors should make sure that their contracts include a provision giving them ownership rights to any new program, slogan, concept or innovation that is associated with the franchisor's trademarks or system. As the Little Caesar court indicated, these contract provisions are enforceable and are in line with general trademark law.

G. Antitrust, Tying

Disputes between franchisors and franchisees sometimes include allegations that the franchisor is engaging in antitrust tying. Typically, a franchisor argues that a franchise is an integrated system that contains the franchise trademarks, underlying products, and the franchise's goodwill.\textsuperscript{155} In contrast, the franchisee alleges the three components of the franchise system are severable. These were the positions taken in Mozart Co. v. Mercedes-Benz of North America, Inc., where a franchisee alleged antitrust violations because the franchisor only allowed dealerships to sell replacement parts supplied by the franchisor.\textsuperscript{156} The franchisor argued that the tie-ins were necessary to maintain customer goodwill and achieve the high standards expected by its clientele.\textsuperscript{157} The court agreed with the franchisor and held that

\textsuperscript{150} ld. at 972.

\textsuperscript{151} ld.

\textsuperscript{152} ld. at 971–72.

\textsuperscript{153} ld.

\textsuperscript{154} ld. at 980–81.

\textsuperscript{155} Emerson, supra note 89, at 394 n.273 (citing California Glazed Prod., Inc. v. Bums & Russell Co. of Balt. City, 708 F.2d 1423, 1430 (9th Cir. 1983)).

\textsuperscript{156} 833 F.2d 1342 (9th Cir. 1987).

\textsuperscript{157} ld. at 1349.
the tie-ins were necessary to maintain the standards of the franchise and to protect the goodwill of the franchisor that would suffer with sub-par products.\footnote{Id. at 1350–51; see also Pugh v. Mobil Oil Corp., 533 F. Supp. 169, 175 (S.D. Tex. 1982) (holding that even if a provision in the franchise agreement was presumed to create a tying arrangement, Mobil was justified by its need to protect its goodwill and reputation).}

However, the holding in \textit{Mozart} does not bind other courts outside of the Ninth Circuit. In an almost identical case heard the exact same year, the Fourth Circuit Court of Appeals in \textit{Metrix Warehouse, Inc. v. Daimler-Benz Aktiengesellschaft}, rejected Mercedes’ business justification for the use of tie-ins with automobile distributors.\footnote{828 F.2d 1033 (4th Cir. 1987).} The court denied Mercedes’ claim that tying was necessary to protect the goodwill of the franchise and found that less restrictive means were available to ensure quality control over parts and customer satisfaction.\footnote{Id. at 1040–41.}

\textbf{H. Vicarious Liability}

When a court must determine whether a franchisor is vicariously liable for the actions of a franchisee, the primary focus is on the level of control exerted by the franchisor over franchisee operations. Franchisors who exercise “excessive” control over day-to-day operations of its franchisees may be found liable for the acts of the franchisee or the franchisee’s employees. However, franchisors often claim that the need to protect the goodwill associated with their marks and system justifies the level of control over franchisee operations and should not result in liability.\footnote{Vicarious or Derivative Liability, Business Franchise Guide (CCH) ¶ 1280.}

Determining what constitutes necessary control to protect trademark goodwill can be difficult. In a highly anticipated case, the California Supreme Court held that Domino’s was not vicariously liable for the acts of a franchisee’s employees merely because Domino’s managed its franchise system with all the control necessary to operate in a uniform manner.\footnote{\textit{Patterson v. Domino’s Pizza, LLC}, an employee of the franchisee alleged Domino’s was vicariously liable for the sexual harassment she endured by an assistant manager through the doctrine of respondeat superior.\footnote{\textit{Patterson v. Domino’s Pizza, LLC}, 333 P.3d 723 (Cal. 2014).} Patterson alleged that the controls identified in the Domino’s franchise system “protect far more than trademark, trade name, and goodwill, and deprive franchisees of the means and manner by which to assert managerial control.” The court disagreed and instead found that “only if [the franchisor] has retained or assumed a general right of control over factors such as hiring, direction, supervision, discipline, discharge, and relevant day-to-day aspects of the workplace behavior of the franchisee’s employees,” will a franchisor be liable for actions of a franchisee’s employees.\footnote{Id. at 734.} Id. at 739.}
Applying these principles, the court found that although there were many controls identified in the franchise agreement and operations manuals designed to maintain a uniform brand image (goodwill), nothing in the franchise agreement granted Domino's the right to perform any of the functions commonly performed by employers.\textsuperscript{185} In fact, the evidence indicated that the franchisee implemented its own harassment policy and training program and retained the authority to discipline for any violations.\textsuperscript{186} Because Domino's did not retain or assume the right of general control over day-to-day employment factors, there was no basis to find an agency relationship existed.

What is considered "continuing control" has also been an issue for the courts. In \textit{Broock v. Nutri/System, Inc.}, a widower brought a claim against Nutri/System arguing it was vicariously liable for the death of his wife.\textsuperscript{187} The plaintiff argued that his wife joined and participated in the diet program because of the goodwill and marks of Nutri/system and the franchisor-franchisee relationship made the franchisee an agent of Nutri/system.\textsuperscript{188} The court found the allegations by plaintiff to be unsound. Nutri/system's ability to veto prospective franchise locations and suggest advertising did not demonstrate "continuing control" over operations. Further, "[t]he right to require that all products be purchased from the franchisor . . . in itself does not indicate that a right of control over the franchisee vested in the franchisor."\textsuperscript{189}

However, a franchisor puts itself at risk when it exercises control over those aspects of the system that influence goodwill and are part of the instrumentality that causes harm. In \textit{People v. JTH Tax, Inc.}, the Attorney General of California sued Liberty Tax Services for false advertisements run by Liberty and its franchisees.\textsuperscript{190} Liberty argued it was not vicariously liable because "it acted only to protect its trademark and goodwill, and it should be excepted from liability in any event because it was ignorant of the illegal advertising, did everything it could to stop it, and refused to accept its benefit."\textsuperscript{191} The court was not convinced. The court found that Liberty retained control in excess of that necessary to protect its trademark and goodwill. Of potentially major significance, the appellate court reasoned that "Liberty retained an open-ended right to modify the operations manual without consent of the franchisees. This right of essentially complete control over franchisee operations, and specifically advertising operations, exceeded what Liberty reasonably needed to protect its trademark and goodwill.\textsuperscript{192}

\textsuperscript{185} \textit{id.} at 740–41.
\textsuperscript{186} \textit{id.} at 741.
\textsuperscript{187} 654 F. Supp. 7 (S.D. Ohio 1986).
\textsuperscript{188} \textit{id.} at 8.
\textsuperscript{189} \textit{id.} at 9–10.
\textsuperscript{191} \textit{id.} at 1238.
\textsuperscript{192} \textit{id.} at 1243–44.
VI. DRAFTING THE AGREEMENTS – IS THERE ROOM FOR “BOTH SIDES” TO OWN SOME GOODWILL?

The end of a franchisor-franchisee relationship is often like a divorce, with the parties engaged in a heated battle over the ownership of the franchise goodwill. In this debate, the same franchisors or franchisees often change their positions on goodwill ownership depending on current needs.173

Franchisors traditionally insist that all of the goodwill associated with the marks, the system, and the individual franchised units and franchisees belong exclusively to the franchisor. Yet, when franchisors review franchisee requests to transfer, rarely, if ever, do they take issue with the purchase price allocated to goodwill. Purchase and Sale Agreements involving franchised businesses routinely include language setting forth that the buyer is purchasing from the seller “all of the intangible rights and properties of the Seller relating to the Business, including all Intellectual Property Assets, going concern value, past and present goodwill and other intangible assets associated with the Business.” Granted, franchisors are not parties to the Purchase and Sale Agreement and are generally loathe to dictate the terms of a franchisee’s sale, other than a requirement that they comply with the transfer provisions of the franchise agreement. However, by approving the sale and transfer with knowledge of the allocation of part of the purchase price to “goodwill”, does the franchisor create the impression that the “new” franchisee, the Buyer, owns the goodwill associated with that location? If the franchise agreement is later terminated, or the franchisor seeks to buy-back the franchise, can the franchisee argue that it should be compensated for the value of its goodwill in the business? These are questions that have not been addressed by the courts to the authors’ knowledge. They do, however, highlight the widely disparate treatment given to the broad issue of “goodwill ownership” in the franchise relationship depending on the factual and procedural circumstances.

But not all is lost for franchisees. Some franchise agreements do provide the franchisor with the option to purchase all of the franchisee’s assets, including local or personal goodwill if the franchise agreement expires, or if the franchisor exercises a right of first refusal upon proposed transfer of the franchise. For example, some franchise agreements provide that the franchisor has “the right to repurchase the Franchised Business within thirty (30) days of termination or expiration of this Agreement at fair market value minus any money you owe Franchisor, its affiliates or the landlord.” Undoubtedly though, this form of agreement is in the minority. The overwhelming majority of franchise agreements expressly provide that the franchisor has no obligation to pay the franchisee for licenses, permits, customer information, or goodwill, under any circumstances.

Ultimately, whether a franchisee has any ownership rights in the goodwill associated with its business depends on the language in the franchise agreement drafted by the franchisor and historically franchisors have been very stingy in this regard.

VII. CONCLUSION

Perhaps it makes sense for both franchisors and franchisees to examine the notion of goodwill at the outset of the relationship, and for each to acknowledge the intangibles contributed by the other. The franchisee might agree that the goodwill associated with the

173 Emerson, supra note 95, at 349.
franchisor's marks belongs to the franchisor. The franchisor might acknowledge that the 
franchisee is encouraged to develop local and personal goodwill at the location in which the 
franchisee operates and, should the relationship end, the franchisee is entitled to compensation 
for that personal or local goodwill. No doubt members of the franchise bar are more than 
capable of crafting language that can protect the franchisor's goodwill attributable to the system 
and marks, while also recognizing the importance of the franchisee's development of local and 
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