THE MOST FREQUENTLY LITIGATED
SUBSTANTIVE PROVISIONS IN
FRANCHISE AND DEALERSHIP AGREEMENTS

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THE MOST FREQUENTLY LITIGATED SUBSTANTIVE PROVISIONS
IN FRANCHISE AND DEALERSHIP AGREEMENTS

I. INTRODUCTION

A. Overall Philosophy Of Courts As To How Franchise Agreements Are Written

Franchise agreements have been viewed by some courts as contracts of adhesion, presented to franchisees on a take-it-or-leave-it basis. From the franchisor's perspective, this take-it-or-leave-it-approach makes perfect sense: the franchisor has developed a program it is only willing to make available to the public if certain terms and conditions are met. If the franchisee does not want to agree to those conditions, he can choose to proceed with his second choice, on more favorable terms and conditions. Further, as several courts have noted, franchise agreements are less “necessitous” than other forms of adhesion contracts.

However, viewing the franchisee from the perspective suggested by Harold Brown—as a “functional illiterate”—the terms and conditions in the franchise agreement may first come to the franchisee’s attention only after a dispute has arisen—for example, when he first learns that he must travel to Alabama to arbitrate or that he has waived all consequential damages. The franchisee likens himself to someone agreeing to the fine-print conditions in a credit card agreement or an insurance policy, where he had the right to assume upon signing that there was nothing unduly prejudicial in an agreement he did not read or understand.

In considering provisions of franchise agreements that are most frequently litigated, this dichotomy in the positions of franchisor and franchisee becomes apparent in the very approach to the topic. The franchisor wants to know how bullet-proof he can make the agreement, foreclosing as much damage to the system as possible in advance of any litigation. The franchisee is looking for loopholes—onerous provisions that can be challenged on unconscionability grounds.

This positional conflict, which has now spanned generations, has taken its toll. Early franchise agreements from the 1950’s and 1960’s tended to be simple, but by the 1970’s, franchise agreements heavily favoring the franchisor’s rights, became the norm. Apparent inequities that had developed in the franchise relationship were the subject of a year-long investigation by the California State Finance and Banking Committee in 1969. These hearings

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led to passage of the first franchise regulation in the country, the California Franchise Investment Law, signed into law by then Governor Ronald Reagan on September 18, 1970.4

This legislation was soon followed by the adoption of the Wisconsin Franchise Investment Law and other state statutes, often closely following the provisions of the initial California law. However, these early regulations did little to limit the terms of franchise agreements. Notably, one of the few express statutory prohibitions on franchise contract terms was the initial prohibition in the California Franchise Investment Law against arbitration agreements in franchising. This was struck down by the United States Supreme Court in Southland Corp. v. Keating,5 as pre-empted by the Federal Arbitration Act.

The disclosure requirements of the California Franchise Investment Law were directed at clearing up problems in the franchise relationship, which were thought to be associated with misunderstandings between the contracting parties at the inception of the franchise relationship.6 The statute was passed so that a prospective franchisee would be provided with the information necessary to make an intelligent decision as to whether to become a franchisee.7 The statute appeared to assume that if there was full disclosure before the agreement was signed, franchisees would be protected from entering into agreements they did not understand.

Although legislators seemed content to allow the parties to franchise agreements to set their own contract terms, state and federal courts began to intercede, balking at the enforcement of contract terms that seemed to be unfair or over-reaching. Unconscionability has often been cited as a ground for declining to enforce franchise contract terms deemed to be onerous. Courts have thus taken it upon themselves to legislate against over-reaching contract provisions in franchise agreements and have increasingly declined to enforce terms they deem to be offensive.

In his dissent in Nagrampa v. Mailcoup, Inc.,8 Judge Kozinski notes that commercial “transactions today are typically governed by standardized contracts, the terms of which are non-negotiable.”9 He observes that the “era of the individually-negotiated contract—like that of the hand-crafted flivver—is fading from living memory.”10 Judge Kozinski notes “a disturbing trend of judicial hostility to form contracts.”11 Be that as it may, at present, an over-reaching adhesion contract invites the risk that a court will strike certain of its terms, so that the franchisor might have been better off with a more even-handed contract, with reasonable protections more likely to be enforced.

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8 469 F.3d 1257, Bus. Franchise Guide (CCH) ¶ 13,489 (9th Cir. Dec. 4, 2006) (en banc).
9 Id. at 1313.
10 Id.
11 Id.
As a result of increasing judicial hostility to form contracts, over-reaching procedural contract provisions have often become the focus of litigation, rather than the substantive terms of the contract. While some might argue that this is not necessarily a bad thing—a franchisor might see the increase in litigation costs relating to procedural issues as a way to exhaust a franchisee’s resources, while a franchisee might see the litigation over preliminaries as a vindication of important rights—it cannot be beneficial in the long run to leave franchise disputes substantively unresolved. Parties to litigation often mediate and settle their disputes, without the benefit of any substantive ruling on whether there was a breach of their agreement. Litigation that becomes bogged down in procedural issues similarly avoids any determination on the substantive merits of a claim.

Litigation over preliminary procedural issues has consumed franchise litigants in recent years. In one recent survey of the franchise cases reported in the year 2007, the authors concluded that “parties to franchise disputes are expending extraordinary amounts of their resources on the resolution of preliminary matters.”\(^\text{12}\) The most frequently litigated issues were personal jurisdiction and venue, with procedural arbitration issues not far behind.\(^\text{13}\) “The sheer volume of cases focusing on these pre-dispute concerns raises the question of whether the parties are being served where such a substantial portion of their resources are being expended on preliminary matters, rather than substantive issues.”\(^\text{14}\)

There are good reasons for the parties to franchise agreements to simplify contract terms and to avoid over-reaching provisions that will become the focus of any litigation between them, even to the point of overshadowing the substantive issues in dispute. More even-handed contractual provisions are more likely to be enforced and more likely to avoid unnecessary litigation expenses over procedural issues. As the courts have become increasingly less willing to enforce onerous contract terms and as the cost of litigating peripheral procedural issues has increased, the drafters of franchise agreements should consider drafting contracts that will avoid expensive and often unnecessary fights over non-substantive issues.

**II. SCOPE OF THE WRITTEN AGREEMENT**

The scope of the written agreement is an important factor in determining the potential for litigation. Writings and oral communications between the parties, both pre- and post-execution, may be the subject of litigation.

There are overarching themes that can be gleaned from careful study of case law on this topic. Below, these areas will be discussed in general with no particular jurisdiction in mind. However, the basic rules of contract formation are the same in the franchise arena as in other settings. These general requirements are offer, mutual assent, and consideration.

To these general requirements are added state and federal franchise statutes and regulations. For example, what constitutes an offer is often more broadly construed under a statute triggering duties to register or disclose. Consideration, however, is typically not an issue in the franchise setting because of the payment of fees by the franchisee and the grant of a


\(^{13}\) *Id.*

\(^{14}\) *Id.*
license by the franchisor. Consideration has even been found in situations such as a renewal when the statute provided for restricted termination rights and the grant of an exclusive territory when other non-franchisees where using the mark. There are, however, situations where consideration can be found lacking.

While the focus of this paper is on the written agreement, franchise contracts can arise in other situations. Oral agreements are expressly recognized as franchises by almost all state registration and disclosure statutes. Additionally, courts have enforced oral franchise agreements. Draft agreements and course of conduct can also be shown as proof of an oral franchise agreement.

Course of dealing and performance can create an enforceable implied franchise contract. Course of dealing is defined as “a sequence of previous conduct between parties to a particular transaction that is to be regarded as establishing a common basis of understanding for interpreting their expressions and their conduct.” Course of performance is “established through repeated occasions of performance by either party with knowledge of the nature of the performance and opportunity for objection to it by the other.” Continued course of dealing after the expiration of the agreement can show an implied contract. When this occurs, the implied contract incorporates the previous contract. Finally, an implied contract may be shown by course of dealing in compliance with unexecuted draft agreements. Where course of dealing

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18 The Indiana Franchise Act, Ind. Code § 23-2-2.5-1 et seq., does not expressly specify whether oral agreements fall under the statute’s definition of a franchise and the Virginia Retail Franchising Act, Va. Code § 13.1-557 et seq., only includes written agreements.


23 Id.


dealing and performance are viewed to determine whether an implied contract has been created. The court may look to draft agreements as evidence of contract terms.

Contract formation issues may seem basic, but a substantial number of cases turn on the existence of an enforceable franchise agreement. These concepts should be kept in mind while considering the more in-depth examination of specific provisions that follows.


1. Scope Of Provision

Courts have narrowly interpreted choice of law provisions to expand the potential remedies available to franchisees. In *Red Roof Inns, Inc. v. Murat Holdings, L.L.C.* the Texas Court of Appeals held that a choice of law provision that applied only to the interpretation and enforcement of the contract did not govern tort claims. The contract provided that it would be “interpreted, construed and enforced in accordance with the internal substantive laws of the State of Ohio, without regard to conflicts of laws principles.” Statutory and tort claims were not covered, so that the trial court had committed error when it granted summary judgment on a Louisiana Unfair Trade Practices Act claim, based on the choice of law provision.

The franchise agreement in *Heating & Air Specialists, Inc. v. Jones*, provided that the “laws of the State of Texas shall govern its interpretation.” The court held that the “plain meaning” of the provision was merely to provide that Texas rules of contract construction should apply, and that the parties had not intended to “effectively displace the entire body of Arkansas protective legislation.”

2. Choice Of Law And Public Policy issues

The parties in *Twin Cities Galleries, L.L.C. v. Media Arts Group, Inc.* had arbitrated a case in which the arbitrator had applied California law. In opposing confirmation of the arbitrator’s award, the franchisee claimed that the award should be vacated because the application of California law was contrary to a fundamental public policy of Minnesota. At issue was the definition of a franchise relationship. The franchisee claimed that the California statute excluded from a franchise fee the quantity of goods a reasonable franchisee would buy. Minnesota, however, did not exclude goods that the franchisee would not have purchased, himself, if the purchase had not been required. California was alleged to use an objective standard, while Minnesota used a subjective standard. The district court had vacated the arbitrator’s award based on this argument.

On appeal, the court found no real difference between the statutes of the two states on franchise fees and reinstated the arbitrator’s award, without necessarily reaching the issue of whether a violation of public policy would have supported vacation of an arbitrator’s award.

27 223 S.W.3d 676, 684 (Tex. App. 2007).

28 180 F.3d 923, Bus. Franchise Guide (CCH) ¶ 11,653 (8th Cir. June 7, 1999).

29 Id. at 930.

30 476 F.3d 598, Bus. Franchise Guide (CCH) ¶ 13,537 (8th Cir. Feb. 9, 2007).
In *Momentum Marketing Sales & Services, Inc. v. Curves, Int’l, Inc.*, a Texas district court adopted the recommendations of a magistrate judge that a Texas choice of law provision trumped the protective franchise legislation of several states where the plaintiffs, Curves franchisees, operated their businesses. The parties appeared to agree that Texas law applied to contract terms, but the franchisees claimed that the anti-waiver provisions in eleven states where they were located should have made the contractual choice of law provisions invalid. The court applied the “most significant relationship” test from the *Restatement (Second) of Conflicts of Law*, analyzing the factors to conclude that performance was to be rendered in McLennan County, Texas (as the agreement provided) and reliance had occurred in Texas, because the parties had entered into the contract in Texas. Texas also has an interest in regulating persons who operate businesses within the state. The court’s analysis was based on the *Restatement* factors, rather than on the choice of law provision in the franchise agreements.

The district court in *Momentum Marketing* concluded that “even if the eleven different anti-waiver clauses of the eleven different [franchise protective acts] operate to invalidate the choice of law provisions in the franchise agreements, the Restatement analysis remains the same, and . . . Texas law applies.” The court concluded that “the laws of the Plaintiffs’ home states are inapplicable,” including “tort laws, even those of the eleven different [franchise protective acts] with anti-waiver provisions.”

Although the same principles theoretically apply, the analysis often leads to radically different results when it takes place in the state where the protective franchise legislation is the governing law. In *Three M Enterprises, Inc. v. Texas D.A.R. Enterprises, Inc.*, a franchise agreement for an aftermarket automotive product franchise provided for a Texas choice of law. At issue was whether the franchise protective legislation of the state of Maryland would apply in the face of the contract choice of law provision, the same issue before the court in *Momentum Marketing*.

The Maryland court began its analysis by observing that parties to a contract may agree to have the law of another state govern their contract, unless the law of the chosen state would violate a fundamental policy of a state which has a materially greater interest than that of the chosen state, and whose law would have applied in the absence of the choice of law provision. The mere fact that the law of another state is dissimilar is not enough to set aside a choice of law provision—there must be a strong public policy against the application of the law of another state.

The *Three M* court determined that the Maryland Franchise Registration and Disclosure Law suggested a “strong public policy.” Because Texas law “does not provide for a comparable private right of action for failure to register a franchise, nor for failure to fully disclose material information relating to the franchise,” the application of Texas law would be a waiver of statutory protection that would be void against public policy. Addressing the issue of whether Maryland had a materially greater interest than Texas in the determination of franchise claims, the court concluded that “there is no question that it does.” The Texas choice of law provision was thus

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33 Id. at 458-459.
34 Id. at 459.
void. Thus, a Maryland court in *Three M* reached the opposite result of a Texas court in *Momentum Marketing* on the applicability of Texas law.

The result in *Cottman Transmission Systems, L.L.C. v. Kershner*,\(^{35}\) was similar. The court held that application of a Pennsylvania choice of law provision "would be contrary to the policies of California, Wisconsin, and New York, which have a materially greater interest than Pennsylvania in the determination of whether Cottman engaged in fraud and deception in franchise sales to residents of those states."\(^{36}\) A Pennsylvania federal district court found that the laws of each of those states had anti-waiver clauses as to franchise protective statutes and that those statutes, therefore, stated a strong public policy of each of those states.

The importance of the forum analyzing choice of law issues is highlighted in *Klosterman v. Choice Hotels, Int'l, Inc.*,\(^{37}\) where the applicability of a Maryland choice of law provision was determined by an Idaho district court. Idaho has a strong public policy against the enforcement of out-of-state choice of law provisions. Applying the "most significant relationship" test, the court determined that Idaho was the place of contracting, at least from the standpoint of the franchisee.\(^{38}\) Although the selection of Idaho law might encourage forum shopping, the court found that Idaho had a strong public policy in favor of having its own laws enforced; that Maryland public policy would favor the application of Idaho law; and that it is generally easier for a court to enforce the law of the forum state.

In *Sherman Street Assocs., L.L.C. v. JTH Tax, Inc.*,\(^{39}\) the Liberty Tax franchise agreements included a Virginia choice of law provision. In a dispute with a Connecticut-based franchisee, the issue was whether Virginia law would apply to claims under the Connecticut Unfair Trade Practices Act and the Connecticut Franchise Act. Because the Franchise Act contained an anti-waiver provision, it could not be negated by the choice of law provision. The Unfair Trade Practices Act, however, could be waived without violating a fundamental public policy. Connecticut law therefore applied to the Franchise Act claim, while Virginia law applied to the Unfair Trade Practices Act, barring that claim.

A similar result was reached in *New England Surfaces v. E.I. DuPont De Nemours and Co.*,\(^{40}\) where a dealership agreement included a choice of Delaware law as to the agreement "and any rights or remedies arising from the contract." This choice of law provision barred any claim under the Massachusetts Unfair Trade Practices Act.

Several Volvo dealers appealed an adverse North Carolina district court judgment, claiming a South Carolina choice of law provision contravened fundamental state policies of Arkansas and Louisiana.\(^{41}\) The Fourth Circuit determined that it would first have to resolve

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36 Id. at 469.
38 Id. at *4.
whether the Arkansas Act and Louisiana Act stated fundamental policies. Notably, it observed
that there “is no established rule for determining whether a state policy is fundamental.”

The court determined that where a statute does not contain an anti-waiver clause or a
legislative finding that it states a fundamental state policy, the statute cannot override a choice
of law provision. The Louisiana Act contained neither and, therefore, could not negate the
South Carolina choice of law. The Arkansas Act, however, did contain an anti-waiver provision.
Arkansas had a materially greater interest in determining whether a dealer agreement between
an Arkansas dealer and an out-of-state manufacturer could be terminated without cause. Under
the Fundamental Policy test, the dealer agreement was, therefore, governed by the Arkansas
Act.

The Beyond Juice franchise agreement before the California appellate court in Chong v.
Friedman43 provided that the agreement was subject to the laws of the State of Nevada and
called for arbitration in Nevada. The franchisee challenged a petition to compel arbitration by
claiming that an arbitration in Nevada would deny him the protection of the California Franchise
Investment Law. A California state trial court had ruled that the issue of whether the license
agreement was illegal was to be decided by the court.

The appellate court noted a strong California public policy in favor of enforcing
contractual choice of law provisions, as long as the chosen state has a substantial relationship
to the parties or the transaction, or there is a reasonable basis for the parties’ choice. Where a
fundamental public policy is violated, there is an exception. This may occur where application of
foreign law would “result in an evasion of . . . a statute of the forum protecting its citizens,”
such as the California Franchise Investment Law.44 Because there is no franchise law in
Nevada, “to enforce the choice of law provision in this case would defeat a fundamental policy
of California’s law.”45 The Nevada choice of law provision was, therefore, declared to be “invalid
as contrary to public policy.”46 The court found that the choice of law provision was severable
and therefore ordered arbitration, striking the Nevada choice of law provision.

In Bishop v. GNC Franchising, L.L.C.,47 a franchisee was unable to defeat a
Pennsylvania choice of law provision on the ground that it violated Indiana public policy,
because he had failed to assert any public policy arguments before the district court.

The franchise agreement in Pinnacle Pizza Co., Inc. v. Little Caesar Enterprises, Inc.,48
provided that the law as to franchise registration and certain other issues would be governed by
South Dakota law, but that contract issues would be determined under Michigan law. The
South Dakota franchise protection laws provided that “[a]ny provision in a franchise agreement

42 Id. at 608.


44 Id. at *3.

45 Id. at *4.

46 Id. at *4.


requiring the application of the laws of another state is void with respect to a claim otherwise enforceable under this chapter.” The court held that Michigan law would apply to contract claims, because the choice of law provision had skirted issues of “local concern.”

South Dakota law would apply to the plaintiff’s franchise claims.

In *Szymczyk v. Signs Now Corporation,* the franchisee challenged a Florida choice of law provision on the ground that its application would “be contrary to a fundamental policy” of North Carolina. The choice of forum provision was also challenged as violative of North Carolina policy. A North Carolina court determined that the contract had been entered into in Florida, when the franchisor had formed the contract by accepting it. Because Florida law viewed forum selection clauses with favor, the court upheld the provision on that ground, and reversed a trial court injunction against enforcement of the agreement in Florida. The appellate court was impressed by the fact that the franchisee had been admonished to seek legal counsel to facilitate understanding the contract and that the plaintiff had been given nearly a month to contemplate the terms of the contract before signing it.

3. Choice Of Law And The State-Required Addendum

In *Laxmi Invs., L.L.C. v. Golf USA,* a choice of forum provision in a franchise agreement was struck by the Ninth Circuit on the ground that there had been no meeting of the minds between the parties. The franchise disclosure document had included the required “California Addendum,” stating that the choice of forum provision “may not be enforceable under California law.” The court, rather improbably, concluded that this statement established, without further evidentiary support, that the parties had not agreed on the choice of forum. The decision may be seen as an over-reaction by the Ninth Circuit to an attempt to circumvent state protective legislation—in this case, the California prohibition on out-of-state required venues in franchise disputes.

In *Roberts v. Synergistic Int’l, L.L.C.,* the franchise agreement called for the application of Texas law. At the time the franchise agreement had been signed, the parties had also signed an “Addendum to Franchise Agreement For Residents of California,” stating that the governing law provision of the agreement was amended to add the statement: “This provision may not be enforceable under California law.” The plaintiff franchisee claimed that this provision invalidated the entire dispute resolution procedure set forth in the agreement.

The addendum provided that it would control if there was a conflict between the addendum and the franchise agreement, but that except as specifically modified by the addendum, the agreement remained fully effective. Nonetheless, the California district court concluded that there had been no “meeting of the minds” between the parties on the choice of
forum, choice of law and jurisdiction clauses in the franchise agreement, following Laxmi and Winter.\textsuperscript{55}

The California district court in Bridge Fund Capital Corp. v. Fastbucks Franchise Corp.,\textsuperscript{56} added an interesting proviso to the Laxmi line of cases. The franchise agreements provided for a Texas choice of law and forum. The court declined to enforce these provisions because the application of Texas law would mean that the California franchisees would lose the protection of California franchise laws. Notably, the court determined that Texas law would not recognize that the franchise laws could not be waived and, therefore, both the choice of law and choice of forum provisions would not be enforced. In Winter v. Window Fashions Professionals, Inc.,\textsuperscript{57} a California state court expanded the Laxmi meeting of the minds analysis to a choice of law provision as well—also based on the California Addendum.

There are policy reasons that may have justified the Laxmi meeting of the minds argument as to choice of law provisions. These policies do not justify expansion of Laxmi into the analysis of choice of law. California, and other states, have expressed strong public policies in favor of protecting the legal rights of franchisees. Several states have either statutes or policies against forcing franchisees to litigate in foreign venues.\textsuperscript{58} Many states with franchise statutes contain anti-waiver provisions. In recent years, there appears to be a trend of courts recognizing that these statutes cannot be waived.\textsuperscript{59}

However, beyond choice of forum and specific statutory franchise legislation meant to protect franchisees, there is no good reason to invalidate a choice of law provision. Franchise systems have very legitimate reasons for having legal issues resolved under the law of a single jurisdiction.\textsuperscript{60} California, for example, may negate choice of forum provisions in franchise contracts, but it does not invalidate choice of law provisions. Thus a Louisiana federal court ruled that the California Franchise Investment Law “does not specifically target choice of law provisions and, as such, the parties' choice of law provisions remain valid.”\textsuperscript{61}

The proper approach appears to have been taken in Lee v. GNC Franchising, Inc.,\textsuperscript{62} where the court ruled that a Pennsylvania choice of law provision would be fully enforceable, except “to the extent that the provision of Pennsylvania law conflicts with the [California

\textsuperscript{55} Id. at 938.


\textsuperscript{58} See, e.g., Cal. Bus. & Prof. Code § 20040.5.

\textsuperscript{59} See, e.g., Jones v. GNC Franchising, Inc., 211 F.3d 495 (9th Cir. 2000).

\textsuperscript{60} See Capital Natl. Bank of New York v. McDonald’s Corp., 625 F.Supp. 874, 880 Bus. Franchise Guide (CCH) ¶ 8502 (S.D.N.Y. Jan. 8. 1986) (“Because McDonald’s enters into a substantial number of franchise agreements in various states, it has an interest in having those agreements governed by one body of law.”).


Franchise Investment Law].” Lee followed Dollar Systems, Inc. v. Avcar, where the Ninth Circuit held that a foreign choice of law provision did not trump statutory franchise claims.

4. Choice Of Law Issues With Multiple Agreements

Multiple agreements can sometimes cause confusion. For example, in Belverd v. IHOP, a franchisee with sixteen separate franchise agreements convinced a court that provision in all of those agreements applying California law to the “legal relations” between the parties did not apply to an alleged oral agreement to grant additional franchises.

Belverd owned sixteen IHOP franchises in North Carolina. When IHOP franchised another operator near one of his stores, Belverd demanded that the Chairman of the Board fly to North Carolina to discuss the matter. Belverd later claimed that the parties had reached an oral agreement at that meeting that guaranteed him exclusive development rights for Kentucky and West Virginia, a right of first refusal on any new North Carolina location, a seat on the IHOP franchisee Procurement Committee and $250,000 in damages for encroachment. Belverd sued to enforce this alleged oral agreement in North Carolina, where there is no statute of frauds that would bar such an oral agreement.

IHOP argued that the sixteen Belverd franchise agreements all called for the application of California law to the “legal relations among the parties.” The court concluded that “legal relations” was an ambiguous phrase because it could mean either the existing franchise relationships or it could apply to any legal relationship between the parties. The court concluded that the meaning of the choice of law provision, in the context of a dispute that went beyond the existing franchise agreements, was a question for the jury.

In Brock v. Entre Computer Centers., Inc., a franchise agreement contained a Virginia choice of law provision. The parties subsequently signed a release as a part of a transfer of the franchise, but the release did not contain a choice of law provision. In a dispute about the release, the Fourth Circuit concluded that the contractual choice of law in the original agreement applied to the release as well. The release would not have existed if there had not been a franchise agreement, so that the contract provisions still applied.

When a franchise agreement is drafted, the parties may not be able to imagine all of the disputes that might develop over the course of the relationship. The scope of potential disputes is so extensive that the choice of law provision should be drawn broadly enough to encompass any possible dispute that might arise, whether or not it involves enforcement or interpretation of the franchise agreement. Choice of law issues are expensive legal disputes because the parties may have to brief the laws of two, and sometimes more, states on each issue where it is unclear which law will apply.

In Suburban Leisure Ctr., Inc. v. AMF Bowling Prods., Inc., AMF and Suburban had entered into an oral franchise agreement, granting Suburban the right to sell AMF pool tables.

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63 890 F.2d 165, Bus. Franchise Guide (CCH) ¶ 9498 (9th Cir. Nov. 13, 1989).
64 Bus. Franchise Guide (CCH) ¶ 12,026 (M.D.N.C. 2000).
66 468 F.3d 523, Bus. Franchise Guide (CCH) ¶ 13,475 (8th Cir. Nov. 17, 2006).
They subsequently entered into a separate, written agreement granting Suburban the right to install AMF products sold through its website; this agreement provided for arbitration.

AMF subsequently terminated Suburban’s right to distribute pool tables, in a notice that did not cite to the written agreement. Suburban then filed a suit for wrongful termination and AMF moved to compel arbitration. The district court denied the motion because Suburban’s claims did not arise under the written agreement, the only agreement that contained an arbitration clause.

The Eighth Circuit affirmed, because the parties had entered into two independent agreements. AMF argued that the integration clause in the written agreement did not bar evidence of a separate, non-contradictory agreement between the parties. The written agreement did not address Suburban’s right to sell AMF products and, therefore, did not affect the oral agreement because the agreements addressed separate subjects.

McDonald’s franchise agreements provide that Illinois law will govern any disputes regarding the agreements. In Motmanco, Inc. v. McDonald’s Corp.,⁶⁷ the dispute centered on an oral Re-Imaging Incentive Plan, rather than the franchise agreement. The court determined that the contractual choice of law provision was not broad enough to encompass this alleged ancillary agreement. The court did, however, view the choice of law provision to be a persuasive indication of the parties’ intentions, particularly because the parties had agreed on an Illinois choice of law in three franchise contracts. The parties had chosen Illinois law so that McDonald’s would not have to defend itself under different substantive laws. Because McDonald’s principal place of business was located in Illinois, where at least part of the alleged oral agreement would have to be performed, the court ultimately concluded that Illinois law would be applied to the oral contract claims.

B. Integration Clauses

Perhaps the most common complaint raised in franchisee law suits is that the franchisor made pre-contractual representations about financial performance, previously known as “earnings claims.” In fact, the first franchise law in the country was passed largely out of concern about such claims.⁶⁸

Parties signing a contract have legitimate reasons for ensuring that the terms of their agreements are set forth in full in the written instrument they are executing. Before the contract is signed, many issues may be discussed, but the final executed instrument is supposed to embody the entirety of the terms on which the parties have come to agreement. The whole purpose of an integration clause is to declare that the executed instrument contains all of the agreed upon terms and that any oral agreements not embodied in the final document are superseded. In theory, the inclusion of such a provision should serve as a signal to the parties to speak up if the document is not complete and to refrain from signing if the document is not a full statement of the terms of agreement.


But the matter is often not so simple, especially in the highly regulated arena of franchising, where both legislators and judges have often gone to great lengths to allow challenges to integration clauses.

In *Papa John’s International, Inc. v. Dynamic Pizza, Inc.*,69 the court applied Kentucky law to conclude that the presence of a merger and integration clause negated any claim of fraud in the inducement arising out of pre-contract misrepresentations. In *Marsala v. Mayo*,70 applying Georgia law, the court held that any claims of pre-contract fraud were not actionable “as a matter of Georgia law in light of the merger clause.”71

But other courts have reached the opposite conclusion—that a claim of fraud in the inducement defeats an integration and merger clause. They reason that proving that a contract was procured by fraud is not equivalent to varying the terms of the agreement.72

Given the frequency of such claims, franchisors have taken a variety of approaches to attempt to insulate themselves against such claims. Whether this is viewed as an attempt to escape accountability for wrongful conduct or a legitimate attempt on the part of the franchisor to understand the parameters of the relationship before signing an agreement and to avoid expanding obligations beyond those in the contract, the analysis comes out the same.

Beyond standard contractual disclaimers of any representations not included in the franchise agreement, franchisors have also taped or videotaped closings—where franchisees are asked to state all promises that have been made to them—or required franchisees to fill out various forms in which they deny that any extra-contractual promises have been made to them. In subsequent litigation, franchisees usually claim that they were told to say or write certain things and that they were merely following directions when saying that no promises had been made to them. Franchisees usually point to statutory anti-waiver provisions and argue that any attempt to disclaim the protection of franchise statutes is invalid.

Is there a way for a franchisor to protect itself from making warranties it was not willing to include in its franchise agreement? Courts have been divided in their views on this question. *Randall v. Lady of America Franchise Corp.*,73 a suit brought by franchisees of a ladies’ workout system, concluded that there was no way for a franchisor to protect itself. On summary judgment, the franchisor argued that the integration clause and various contractual disclaimers were sufficient to defeat claims under the Minnesota Franchise Act. The court disagreed, holding that section 80C.21 of the Act invalidated the contractual disclaimers. The court assumed for the purpose of argument that an unlawful earnings claim or a non-disclosure had, in fact, been made. The historical truth of this misconduct could not be negated without violating the anti-waiver provision.


71 *Id.* at *30. See also *Bakrac, Inc. v. Villager Franchise Systems, Inc.*, 164 Fed. Appx. 820, 824 (11th Cir. 2006) (because “neither loans, nor training, nor occupancy rates were promised in the Franchise Agreements,” alleged evidence on those issues could not be considered in an integrated agreement).


As the court analyzed the issue, “if the dishonest franchisor made misrepresentations, then he made misrepresentations, no matter what the franchise agreement says. Thus, the disclaimer can only be an attempt to change the legal effect of those misrepresentations. That is precisely what § 80C.21’s anti-waiver language forbids.”

The court went beyond this to find that even the following language did not hold up to the anti-waiver statute: “I did not make any representations about the revenues of existing franchises. If you disagree, you must list such representations below. If you don’t list a representation, you cannot later sue me for making that representation.” Such language “cannot change the historical facts of what representations were made.” The court was critical of this contractual language because no room had been left in the agreement for the franchisee to list any representations that had allegedly been made.

The court acknowledged that, with such a reading of the anti-waiver provision, “franchisors cannot use contractual provisions to protect themselves from being sued for misrepresentations under the Minnesota Franchise Act. Consequently, even scrupulously honest franchisors will have to defend against some misrepresentation claims . . . .” The court justified its conclusion on the ground that the Act had meant to place that burden on franchisors so that franchisees who had been lied to would have redress.

The franchisor took a very similar approach in Emfore Corp. v. Blimpie Associates, Ltd., and a New York state court reached a contrary conclusion as to the enforceability of the disclaimer. Blimpie franchisees had been asked to fill out a questionnaire that asked them whether any representations had been made to them before they had signed their franchise agreements.

The franchisees signed a letter identifying the persons with whom they had negotiated, all written materials they had received from those individuals and confirming that there had been no earnings claims, warranties or other representations made to them beyond those in the offering circular. The franchisees had also executed a questionnaire, asking them to circle “yes” or “no” as to the various representations, and had initialed each answer. One question asked whether any representations had been made to them about earnings. The franchisees executed the questionnaire without comment.

Like the franchisees in Randall, they claimed that representations on potential and actual earnings claims violated the disclosure and anti-fraud provisions of the Franchise Act. The contractual questionnaire was purportedly an “illegal” waiver and merger clause, barred by the Act. The court observed that while “the ‘clear and unambiguous’ language of the Franchise Act bars release and waiver clauses, there is no language barring the type of Questionnaire disclaimers herein. Nor is the broad statutory anti-fraud purpose furthered by construing the disclaimers in the Questionnaire/Rider as ‘illegal.’ Rather, it is consistent with the Franchise

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74 Id. at 1088-89.
75 Id. at 1089.
76 Id.
77 Id.
Act’s purpose enabling the prospective franchisee to assess the franchisor’s offer and to keep them fully informed as to its rights.\textsuperscript{79}

Unlike the Minnesota court in \textit{Randall}, however, the court in \textit{Emfore} found that “the instant Questionnaire/Rider is an interactive document that is a reflection of the ‘ongoing contractual relationship between franchisor and franchisee’ and solicits factual information and representations from a prospective franchisee.”\textsuperscript{80} The questionnaire was “a responsible attempt by Blimpie to confront prospective purchasers about any misrepresentations or misconceptions.”\textsuperscript{81} Because the franchisee had signed the questionnaire before executing the franchise agreement, “the [plaintiffs] could not justifiably rely on the alleged co-branding and earnings claims.”\textsuperscript{82}

The court noted that “[a] party is foreclosed from establishing justifiable reliance to support fraud where that party has, by its own specific disclaimer of reliance upon oral representations himself been guilty of deliberately misrepresenting his true intention.”\textsuperscript{83} The court granted summary judgment on the plaintiffs’ common law fraud claims because is was “clear that it is unreasonable for plaintiffs to rely upon the purported representations as a matter of law.”\textsuperscript{84} The court held that “it would be ‘difficult to envisage language which could more completely eliminate the claimed representations as an inducing factor.’”\textsuperscript{85}

The franchisee in \textit{Bakrac, Inc. v. Villager Franchise Systems, Inc.},\textsuperscript{86} claimed that he had been promised low interest loans, on-site training and a 70% occupancy rate. None of these promises was ever reduced to writing in the integrated franchise agreement, although the franchisee had negotiated an addendum, which reduced royalties and provided for no-penalty termination rights. In affirming summary judgment for the franchisor, applying New Jersey law, the Eleventh Circuit noted that the franchisee could not prevail on any of its claims because “neither loans, nor training, nor occupancy rates were promised in the Franchise Agreement.”\textsuperscript{87}

In \textit{Davis v. McDonald’s Corp.},\textsuperscript{88} a franchisee with encroachment claims sought to augment his contractual rights with a McDonald’s policy statement called the “Market Share/Impact Framework.” The franchisee pointed to sections of the agreement that incorporated various manuals, but the court held that the manuals referenced in the agreement

\begin{flushright}
\textsuperscript{79} Id.
\textsuperscript{80} Id.
\textsuperscript{81} Id. (Internal citations omitted).
\textsuperscript{82} Id.
\textsuperscript{83} Id.
\textsuperscript{84} Id.
\textsuperscript{85} Id.
\textsuperscript{87} Id. at 824.
\end{flushright}
were all operational manuals and that there was no intent to incorporate the impact framework into the franchise agreement. The impact framework, therefore, did not supplement the rights stated in the integrated franchise agreement.

*Domino’s Pizza L.L.C. v. Deak,* shows how difficult it is to analyze integration clauses. Deak was a Domino’s area developer who signed an initial ten year agreement that was extended for an additional five year period. The extension stated that it expired on July 31, 2005. Deak claimed, however, that he had been orally promised that the area developer agreement would be extended for as long as he operated Domino’s stores. Deak brought suit when Domino’s did not renew the contract when it expired pursuant to its terms in 2005.

The district court found that because the written contract stated clear time limits and was a fully integrated document, the issue of term fell within the scope of the parties’ agreement and could not be modified by parol evidence. Any discussions between Domino’s and Deak on renewability were inadmissible. Applying Pennsylvania law, the court refused to “throw out a viable and extensive contract” “because that contract was less accurate than [the plaintiff’s] off-the-record discussions with a Domino’s employee.”

The district court was “not disputing or even considering whether such discussions were made,” but found the factual question of what had been said to be “simply not relevant to the matter before this Court for adjudication.” The district court lacked “the omniscience that would enable complete understanding of all representations and all intentions upon the date of contract formation,” and so had to “rely upon what is available: the signed, executed, integrated contracts.”

Perhaps the best rationale for the court’s ruling was that if the parties had intended to provide renewal rights to Deak, then that term “should have been included in the written, signed, and executed Area Agreements.” This follows the logic of the court in *Ramada v. 6th & K.*

The district court ruling in *Deak* was overruled by the Third Circuit because a party has a right under Pennsylvania law to show by “clear, precise and convincing evidence” that the agreement as written did not express what the parties had intended and that an agreed-upon term had been omitted from the contract by mistake or accident. Although the burden was on the plaintiff to establish that the written document was incomplete, the matter should not have been resolved on a motion to dismiss.

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89 Id. at 1257-1258.


91 Id. at 345.

92 Id.

93 Id.

94 Id.

95 See infra note 101.

96 2010 WL 2222781 at *4.

97 Id.
The most litigated disclaimers involve disavowal of extra-contractual representations regarding earnings and performance claims. Express disclaimer language to the effect that no pre-contractual representations relating to revenues, profits, or the success of the franchise have been made is typically held to bar a common law fraud claim.98 A post-contractual disclaimer, acknowledged by the franchisee, has been held to foreclose the effect of pre-contractual representations.99 A detailed disclaimer is the most effective route to avoid liability.100 However, many jurisdictions will look past a disclaimer on fraudulent inducement claims.101

Carousel Creamery, LLC v. Marble Slab Creamery, Inc. illustrates a framework for determining whether a disclaimer will bar a fraud claim.102 The key factors are the existence of a dispute at the formation stage (typically not applicable in the franchise context), whether the parties negotiated at arms length, whether the parties were represented by counsel, and the level of sophistication of the parties.103 The court found the negotiation was not at arms’ length and the franchisees were neither represented by counsel nor sophisticated, leading to denial of summary judgment.104

As with other provisions discussed above, the effectiveness of a disclaimer provision is dependent on its language. The most effective disavowals will be detailed, non-formulaic, and executed by the franchisee.

1. Consideration Of Parol Evidence Where Contract Ambiguous

Parol evidence may be considered where the terms of the agreement are ambiguous. The notion of limiting the parties to the express terms of their agreement does not work very well when it is not clear to the court what the parties meant to agree upon in their integrated agreement. For example, in Ingraham v. Planet Beach Franchising Corp.,105 the court found the agreement to be ambiguous as to the issue of exclusive territory. The agreement did not allow the placement of another franchisee within an exclusive territory. The franchise agreement,


103 Id. at 393-94.

104 Id. at 394.

however, did not mention “the possibility of overlapping territories of franchisees.” The court found that statements about the right to extra-territorial marketing, with the franchisor’s consent, raised an ambiguity about whether overlapping marketing areas were allowed under the agreement. Unable to determine the issue as a matter of law, the court denied summary judgment because it would consider parol evidence on the issue.

In 6th & K Ltd. v. Ramada Franchise Systems, Inc., the franchisee claimed that it had received a letter from the President of Ramada promising it a certain level of reservations from the reservations system. The parties had signed an integrated agreement. The franchisee later sued claiming it had been induced to sign the contract by fraudulent representations. The agreement stated only that the franchisee would receive a “computerized reservation system.”

The court noted that “the contract does not mention a minimum or guaranteed number of reservations to plaintiff.” The court also noted that the parties had negotiated several terms in the agreement, but even though the franchisee claimed it had relied on promises of specific reservation system contributions, the matter had not been mentioned in the final agreement. The court declined to rewrite the franchise agreement, especially where the parties had the experience and access to legal expertise to establish any necessary terms in the agreement.

The court then analyzed whether extrinsic evidence could be introduced to explain the meaning of the contract provision on reservations. The court held that in the context of a twenty-year contract term, “expected minimum performance levels in this context would naturally have been a part of the written agreement.” Expanding the contract requirement to provide a reservations system into a requirement that the system would generate a particular level of reservations would have expanded and enlarged Ramada’s obligations under the agreement. The court granted summary judgment to Ramada because the franchise agreement was not reasonably susceptible to the interpretation offered by the plaintiff without significantly adding to or varying the terms of the agreement.


Where there is an integrated franchise agreement, can its terms be expanded by the terms of the franchise offering circular? In Martrano v. Quizno’s Franchise Co., L.L.C., the integration clause stated that the franchisee would not rely on statements not contained in the franchise agreement or the franchise offering circular. The franchisor moved to dismiss breach of contract claims asserting that the franchisor had failed to negotiate supplier agreements for the franchisees’ benefit in accordance with the UFOC. Viewing the evidence in the light most favorable to the plaintiff, the court found that the statements in the UFOC could be read to mean

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106 Id. at *4.
108 Id.
109 Id.
110 Id.
that the parties “had a binding expectation—that is, an agreement—that those representations would be fulfilled, and that Quiznos would negotiate supplier arrangements on the franchisees' behalf.”

C. Provisions As To The Legal Status Of The Relationship

Parties often neglect to state the legal relationship they are intending to establish by agreement. For example, where guarantors and principals also sign an agreement, the document should clarify which entity is the “franchisee.” Where the parties do not intend to create a franchise relationship, that should be stated, even though the parties cannot avoid the creation of a franchise merely by disavowing it.

The absence of the word “franchise” in an agreement, however, can be a relevant factor in determining that no franchise has been created. Moreover, some courts have held that contract language as to the express intentions of the parties may, in fact, have a bearing on whether or not a relationship is viewed as a franchise.

D. Modifications

Purported contractual modifications can give rise to litigation. Most franchise agreements have a clause banning non-written contract modifications with language to the effect that the agreement “may only be modified by a writing signed by both parties.” However, non-written modifications can occur through a waiver of the no oral-modification-provision that is either oral or through passive or active conduct.

Southern States Cooperative Inc. v. Global Ag Assoc. demonstrates how an agreement with a no-oral-modification clause can be modified through conduct. The retailer was sued for non-payment of debt and credit terms were at issue. The retailer submitted evidence of on-

112 Id. at *17.

113 See, e.g., Jerome-Duncan, Inc. v. Auto-By-Tel, L.L.C., 989 F. Supp. 838, 842 (E.D. Mich.1997) (“First, the word ‘franchise’ does not appear anywhere in the parties’ agreement. While not dispositive, it is clearly probative of what type of agreement was reached.”).

114 See also Adcom Express, Inc. v. EPK, Inc., Bus. Franchise Guide (CCH) ¶ 10,685 (Minn. Dist. Apr. 12, 1995) (interpreting California law) (where the agreement said the parties did not intend to create a franchise: “Given the express language of the Agreement, EPK waived any right to assert franchise rights.”); Kempner Mobile Elecs., Inc. v. Sw. Bell Mobile Sys., L.L.C., No. 02 C 5403, 2003 WL 22595263, Bus. Franchise Guide (CCH) ¶ 12,699 (N.D. Ill. Nov. 7, 2003) (“Kempner’s claim that it was a franchise flies in the face of the provision in the 1999 Agreement expressly stating that the relationship between the parties was not a franchise.”).

115 Bobrow Palumbo Sales, Inc. v. Broan-Nutone, LLC, 549 F. Supp. 2d 249 (E.D.N.Y. 2008) (applying Wisconsin law and finding that an oral modification can occur notwithstanding a no oral modification clause if parties agreed to waive clause and reached an agreement to modify); Bishop v. Gasiger, Inc., 692 F. Supp. 2d 762 (E.D. Mich. 2010) (generally accepted that no oral modification clause can be waived orally or through passive acceptance of benefits of oral modification); Blaske v. Burger King Corp., Bus. Franchise Guide (CCH) ¶ 10,490 (D. Minn. June 27, 1994) (written contract modified by course of dealing to include franchisee’s right to open new stores); Dunafon, Bus. Franchise Guide (CCH) ¶ 10,919 (an oral agreement to allow a franchisee to expand may have been formed by the course of dealing despite the absence of such agreement in the written agreement, which contained an integration clause).

116 Civ. Action No. 06-1494, 2008 WL 834389 (E.D. Pa.).

117 Id. at *2.
going negotiation of the payment terms, with those terms being frequently altered throughout the course of the relationship. 118 The court held that even though clear and unmistakable proof of mutual assent to the modification was required, there were genuine issues of material fact and summary judgment on the issue was denied. 119

Accordingly, contract clauses that only allow for modification in a writing signed by both parties do provide protection. However, care must also be taken throughout the relationship in order to avoid waiver of the provision, either orally or through conduct.

E. Consideration

Franchise agreements are usually filled with the franchisees’ obligations, but rarely go into much detail in setting forth the obligations of franchisors. Some franchisees have challenged their agreements on the ground that they are illusory because they impose no real obligations on the franchisor. The traditional legal maxim has been that recitation of any form of consideration—whether the proverbial peppercorn, or more commonly, $1, or “for valuable consideration, receipt of which is hereby acknowledged”—is all that is necessary to establish consideration.

The issue is not quite that simple. In an Eighth Circuit case, 120 an auto dealer executed a release in exchange for “the sum of One Dollar ($1.00), in hand,” along with “other good and valuable consideration.” By affidavit, the dealer told the court that this “peppercorn” consideration was never, in fact, exchanged. The court allowed the challenge to consideration to proceed because Missouri law allowed parol evidence to explain a “mere recital” of consideration. 121 Where the consideration is a part of the contract itself, such as an ongoing promise of payment, the rule did not apply. But where the parties had made no effort to “identify the true nature of the value exchanged or forbearance exercised,” parol evidence was admissible to challenge the actual receipt of consideration. 122

In Moses v. Business Card Express, Inc., 123 the franchisee claimed a lack of consideration because there was a dispute as to whether another party had the right to operate in Alabama. The court held that even if the franchisee had not obtained “clear title” to the right to operate the franchise, he still received the right to operate a franchise and had been able to open a business, so that he received a benefit sufficient to constitute consideration.

In De Walshe v. Togo’s Eateries, Inc., 124 a franchisor conditioned a transfer on the new franchisee passing an English Language Proficiency Assessment. The franchisee agreed to

118 id.
119 id. at *2-3
121 id. at 461.
122 id. at 462.
this condition in a rider to the franchise agreement. The franchisee later challenged the rider on the ground that it lacked consideration. The court rejected the argument because the Rider called for additional consideration in the form of representations and disclosures between the parties to the transfer.

In *Minuteman Press Int’l, Inc. v. Mathews*, a franchisee claimed that its franchise agreement was supported by inadequate consideration. A federal district court in New York found that the franchisee had received a bargained for consideration in the form of support services. Because there was a minimal standard for determining the existence of consideration, the franchisee’s claim failed.

III. PERFORMANCE REQUIREMENTS

A. System Standards And Changes In System Through Operations Manual

Franchises are usually long-term relationships. Over time, franchise systems must change to meet the times to remain competitive. A real estate franchise in 1962 would not have required franchisees to purchase specific computer equipment, but fifty years later, no real estate company could hope to remain competitive without retaining the ability to make system-wide changes. In franchise systems, these changes are usually implemented through a contract provision that requires compliance with an operations manual that will change from time to time. The question often becomes the extent to which changes can be required without forcing the franchisee into a relationship he never would have agreed upon.

Generally, courts have supported franchisors in their efforts to change system standards, as long as the requested changes appear to be commercially reasonable. As one court put it, changes in a system were objectionable only “where used by the franchisor to extort additional profits for the franchisor at the franchisees’ expense.”

For example, in *Custom House v. Doubletree*, a panel of three arbitrators ruled that Hilton had the right to impose its frequent guest reward program on Doubletree franchisees after Hilton purchased Doubletree.

In a bankruptcy dispute in Rhode Island, a franchisee failed to implement systemic changes required by Baskin-Robbins. The court concluded that “[the franchisee’s] failure to shape up and live up to the conditions in the new franchise agreement gave Baskin-Robbins reasonable cause to refuse her the new product line.” “In addition, Baskin-Robbins has introduced credible testimony indicating numerous . . . violations of the franchise agreement.”

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125 Bus. Franchise Guide (CCH) ¶ 12,466 (E.D.N.Y. Nov. 13, 2002).
129 *Id.* at 598.
130 *Id.*
In an early case, 131 Burger King changed its system standards by increasing the amount of meat used in its hamburgers and requiring the provision of specified condiments for customers. The new standards substantially increased operating costs for franchisees. One franchisee refused to comply with the new standards and challenged the modification. The court concluded that Burger King had a right to “make reasonable changes in such standards and specifications from time to time as circumstances may dictate” and to terminate any non-complying franchisee. 132 The Florida court found that it was “clear from the language of the instrument that one of the objects is to provide uniformity among all franchised “Burger King” restaurants. Review of the clauses of the agreement . . . reveals that this uniformity is accomplished by providing that the defendant [franchisor] set and maintain standards and specifications which the plaintiff must follow or suffer termination of the agreement.”

In In re: Sizzler Restaurants, Int'l, Inc., 133 two franchisees challenged Sizzler’s right to change its marketing strategy. The court held that the change in the Sizzler system would be justified if it had been supported by a “legitimate business reason.” If such justification existed, other motives for the behavior became irrelevant. Courts will not second-guess the business decisions of franchisors as long as they fall within accepted commercial practices. Noting that system changes were supported by sales figures and that the trustees of the National Sizzler Franchisee Association had endorsed them, the court held that the contract had not been breached.

After reviewing cases from across the country, the court determined that Sizzler had a discretionary right to change the franchise system, unless it “acted dishonestly or outside of accepted commercial practices, or with an improper motive or in an unreasonable manner that was arbitrary, capricious, or inconsistent with the reasonable expectations of the parties.”134 Sizzler showed that it was trying to respond to problems associated with the buffet court concept, including lower average checks and a diminished customer perception of the quality of the chain.135 The court held that as long as Sizzler’s decision-making process had been honest or “within accepted commercial practices,” it would not second guess its business decisions.136

132 Id. at 57.
134 Id. at 474.
135 Id. at 471.
B. System Sales Quotas And Market Share

Contractual performance standards for dealers, as modified by applicable state statutes, must generally be: (1) well-defined; (2) communicated (i.e., to the dealer); and (3) reasonable. Performance standards generally seen in the form of sales quotas or market share requirements—that are poorly defined are often challenged by franchisees and dealers on “lack of notice” grounds. Performance standards that are unreasonable will typically be challenged as unenforceable.

To avoid franchisee or dealer “pushback” or litigation related to these issues, franchisors and manufacturers must not only have well defined performance standards, but those performance standards must be reasonably attainable. Further, franchisors and manufacturers should be prepared for arguments that there are in fact no quotas or market share requirements if they are not contained in the parties’ written agreement.

The following cases illustrate the importance of drafting performance standard that is well defined and reasonable.

In a 1997 dealer case, a Minnesota federal court ruled that a construction equipment dealer’s consistent failure to meet a manufacturer’s market penetration requirement for three straight years constituted good cause for non-renewal because the dealer had received adequate notice and the manufacturer’s requirements were reasonable. The manufacturer also alleged that contractual requirements for stocking of inventory and service parts were had not been met by the dealer.

In another case out of Minnesota, a laundry equipment distributor’s failure to meet sales requirements constituted good cause for termination of the distributorship because the contractual requirements, including a “best efforts” requirement, were deemed reasonable and essential. Under the statute, dealerships may be terminated for failure to achieve reasonable sales goals and the distributor’s performance “was poor by any standard.”

Similarly, the Seventh Circuit held that a motorcycle dealer’s refusal to order or sell a manufacturer’s products during the pendency of a termination hearing before a state administrative agency constituted a substantial and material breach of the dealership agreement that justified termination of the dealer. The contractual provision requiring the dealer to use its best efforts to sell the manufacturer’s products case was found to be reasonable.

Poor sales performance, a differing market philosophy, and reorganization of a distributor’s sales force contrary to representations can constitute good cause for termination of a liquor distributor.

A manufacturer’s representative’s failure to meet sales penetration goals that were reasonable and non-discriminatory constituted good cause for termination.

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139 American Suzuki Motor Corp. v. Kummer, Inc., 65 F.3d 1381 (7th Cir. 1995).

Other courts have found that good cause for termination did not exist in cases alleging failure to meet sales quotas or market share requirements.

For example, the Minnesota Court of Appeals held that John Deere violated an equipment dealer’s rights when it terminated the dealer for its failure to meet the required market penetration.\(^\text{142}\) The court determined that, although a manufacturer can have “good cause” to terminate based on a failure to meet reasonable requirements for market penetration, the termination was unlawful for three reasons: (1) the market share requirement had not been communicated to the dealer before the year it was to begin, and it was not realistic that the requirement could be met in the limited time available; (2) termination was only permissible when the dealer “consistently fails” to meet market penetration requirements and because the market share data was compiled annually, the manufacturer would have to show that the dealer has failed to comply for at least two years; and (3) termination had been based on the sales in 1989, but, because the notice had not been sent until 1990, the dealer had been given no meaningful way to address or “cure” the asserted performance deficiency.\(^\text{143}\)

Another case involving John Deere demonstrated that a farm equipment dealer’s less-than-average market penetration might not constitute cause for termination under the Missouri farm implement dealer law. The manufacturer’s failure to assess the dealer’s performance in relation to the performance of dealers in comparable marketing areas raised the possibility that the dealer had achieved satisfactory market penetration over prior years.\(^\text{144}\)

The Connecticut Supreme Court held that the dealer had performed on its contractual obligation to aggressively market the manufacturer’s products, despite generating no net sales growth from 1990 to 1995, given the economic hardship faced by the dealer.\(^\text{145}\)

Similarly, a 1994 First Circuit case confirmed that a distributor’s failure to meet sales objectives assigned by a supplier did not constitute just cause for termination under Puerto Rico’s dealer law, because the supplier had failed to show that the distributor’s actions adversely affected the supplier’s interests.\(^\text{146}\) Evidence in the case indicated that the distributor’s decline in sales had been caused, at least in part, by the supplier’s direct sales to a retail store at the same price offered to the distributor.\(^\text{147}\)

A Pennsylvania court affirmed the ruling of the Pennsylvania Board of Vehicle Manufacturers, Dealers, and Salespersons, finding that a vehicle manufacturer had set an unreasonable sales quota.\(^\text{148}\)


\(^{143}\) *Id*.


\(^{146}\) *Newell Puerto Rico, Ltd. v. Rubbermaid Inc.*, 20 F.3d 15 (1st Cir. 1994).

\(^{147}\) *Id*.
As illustrated above, the drafting of well defined, reasonable market share goals or sales quotas is vital.

IV. SCOPE OF GEOGRAPHIC TERRITORY

A. Territorial Exclusivity

Most franchise and distribution agreements have a provision regarding territory. Some grant an exclusive territory, while others deny a grant of exclusive territory. The critical factors are specificity and the use of express terms.

The best method of avoiding litigation in this area is for the franchisor to expressly reserve the right to grant new franchises in a specific area. When the franchisor has expressly reserved the right to grant new franchises, the courts have upheld these provisions. An express, unambiguous provision in conjunction with an integration clause provides the most protection for the franchisor. Further, courts have held that express provisions exclude claims under the implied covenant of good faith and fair dealing.

In *In re Vylene Enterprises, Inc.*, although there was no protected territory in the franchise agreement the court found that building a restaurant within a mile and a half of the franchisee’s location was a breach of the covenant of good faith and fair dealing. The bad

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148 *Subaru of Am., Inc. v. Bd. Of Vehicle Mfrs., Dealers & Salespersons*, 842 A.2d 1003 (Pa. Commw. Ct. 2004). In this case, the manufacturer had set a quota of 506 vehicles but only supplied 366 vehicles to the dealer for sale. *Id.* at 1014-15. The manufacturer argued to no avail that the dealer had not requested more vehicles. *Id.* at 1015. However, the court stated that the manufacturer’s system of vehicle allotment was flawed in both numbers and style resulting in not allowing the dealer to acquire enough vehicles to meet its quota. *Id.*

149 *KFC Corp v. Vangeloff*, Bus. Franchise Guide (CCH) ¶ 9160 (W.D. Ky. June 29, 1988) (no breach of market protection clause when new franchise established outside 1.5 mile and 20,000 population area contemplated); *Romacorp, Inc. v. TR Acquisition Corp.*, Bus. Franchise Guide (CCH) ¶ 10,360 (S.D.N.Y. Dec. 1, 1993) (establishment of new restaurant within five miles did not breach agreement when plaintiff franchisee negotiated for and accepted a covenant with a one mile territorial limitation).

150 *K. Cook Enters v. Little Caesar Enters.*, 210 F.3d 653, Bus. Franchise Guide (CCH) ¶ 11,842 (6th Cir. Apr. 24, 2000) (franchisor did not breach agreement by placing new franchises outside one mile area expressly stated in agreement and alleged representation by franchisor’s representatives of a larger area was barred by integration clause and the parol evidence rule); *Vulcan Tools of Puerto Rico v. Makita USA, Inc.*, 23 F.3d 564, Bus. Franchise Guide (CCH) ¶ 10,433 (1st Cir. May 4, 1994) (evidence of oral promise that manufacturer would limit number of distributors in Puerto Rico was barred by parol evidence rule because it contradicted a clear and unambiguous provision in the contract); *Payne v. McDonald’s Corp.*, 957 F. Supp. 749, Bus. Franchise Guide (CCH) ¶ 11,140 (D. Md. Feb. 13, 1997) (franchisor did not breach contract when agreement expressly stated that franchisee was not given exclusive territory, disavowed inference of exclusive territory in agreement, and integration clause barred incorporation of franchisor’s internal policies and practices); *Vicorp v. Village Inn Pancake House of Albuquerque, Inc.*, Bus. Franchise Guide (CCH) ¶ 10,994 (D.N.Mex. Aug. 16, 1996) (applying Colorado law) (franchisor had right to place units anywhere outside of protected territory).

151 *See Orlando Plaza Suite Hotel, Ltd-A v. Embassy Suites, Inc.*, Bus. Franchise Guide (CCH) ¶ 10,457 (M.D. Fla. Mar. 1, 1993) (hotel franchisor did not breach implied covenant of good faith and fair dealing by establishing additional franchise within one mile of existing franchise when franchisor had expressly retained the right to establish additional franchises at any other location); *Sparks Tune-Up Centers, Inc. v. White*, Bus. Franchise Guide (CCH) ¶ 9411 (E.D. Pa. May 1, 1989) (establishment of two franchises within five miles of franchisee did not breach implied covenant of good faith and fair dealing when the franchisor was expressly authorized to open new franchises).

152 90 F.3d 1472, Bus Franchise Guide (CCH) ¶ 10,050 (9th Cir. July 29, 1996).

153 *Id.* at 1477.
faith character of the placement of the restaurant was “clear when one considers that building the competing restaurant had the potential to not only hurt Vylene but also to reduce Naugles’ royalties from Vylene’s operations.” 154 There were extenuating circumstances in Vylene involving the personal relationship between franchisor and franchisee that contributed to the finding of bad faith.

In a dispute involving a McDonald’s franchisee in Florida, Davis v. McDonald’s, 155 the franchise agreement provided that the franchisee had no exclusive, protected or other territorial rights. The UFOC was consistent with the agreement, in stating that there was no “exclusive grant, exclusive area, exclusive territorial rights, protected territory, nor any right to exclude, control or impose conditions on the location or development of future McDonald’s restaurants at any time.” 156 The franchisee claimed, however, that a document called “The Market Share/Impact Framework” was incorporated into the terms of the contract. The Impact Framework established a procedure whereby franchisees impacted by the development of new restaurants could seek economic assistance from McDonald’s.

Notably, the court observed the lack of any evidence on the record establishing the frequency of application of the Impact Framework to the plaintiff or to other franchisees. Thus, the franchisee failed to invoke the document as evidence of a course of dealing, trade usage or course of performance under the UCC. 157

The court noted that it could “imagine a situation where a franchisor’s development of a restaurant next door to an existing franchise might so completely frustrate the purpose of the franchise agreement and deprive the existing franchisee of the fruits of the agreement that an action for breach of contract would exist.” 158 As a practical matter, the court had difficulty foreseeing such a situation because a franchisor “has every interest in maintaining sufficient distance between stores so as to sustain a healthy level of profits at all locations and thereby render the locations suitable for the franchisor’s own operation or capable of attracting franchisees.” 159 Because there was no express contractual right to an exclusive territory, the court granted summary judgment on the contract claims, applying Illinois law.

Applying Florida law to the tort claims, the court in Davis found triable issues of fact on the fraud claim because even if the franchisee had “no right to any protection from encroachment, he may nonetheless have reasonably relied on misrepresentations about future impact when deciding to continue investing in his own restaurants and/or to refrain from pursuing other business opportunities.” 160 If the franchisee were to prevail, it would not mean

154 Id.
156 Id. at 1258-1259.
157 Id. at 1258.
158 Id. at 1259.
159 Id. at fn. 9.
160 Id. at 1261.
that he had a protected market area, but would "merely provide a remedy for McDonald’s allegedly tortious conduct."\textsuperscript{161}

A Lamborghini dealer convinced district court Judge Shira Scheindlin that he had "a reasonable understanding that Lamborghini would not ‘cannibalize’ its dealer by introducing additional competitors into the same territory."\textsuperscript{162} Although the agreement had no exclusivity rights, the dealer been the only Lamborghini dealer in New York.

The dealer was allowed to proceed on an implied covenant theory, based upon the unique nature of the Lamborghini market and the "understanding that the manufacturer will not ‘park a competitor in [an] approved dealer’s backyard, such that the exclusivity term could fairly be implied into the contract."\textsuperscript{163} Lamborghinis are very expensive and the standards required for showrooms are so high that the addition of other dealers could deny the existing dealer the "fruits of its contract."\textsuperscript{164} A loss of market share to a new dealer would cut into the allocation of cars to the plaintiff and would also increase the risk of termination, due to sales quotas. Even though there was no contractual right to proceed, the dealer was allowed to proceed on an implied covenant theory.

In \textit{Cook v. Little Caesar Enterprises, Inc.},\textsuperscript{165} the court held that the contract language limited to a one mile exclusive territory barred any breach of contract claim that a larger exclusive territory had been promised to him. The court also affirmed the dismissal of fraud claims because statements made in "negotiations leading up to a franchise agreement" were future promises that “are contractual and do not constitute fraud.”\textsuperscript{166}

When the agreement is not explicit as to the rights and reservations of the franchisor, the courts are more split in their interpretation. The court in \textit{Boyle v. Douglas Dynamics, LLC}\textsuperscript{167} held that appointment of a new distributor did not breach the dealership agreement when there was no written agreement prohibiting appointment of new dealers in a given area and the oral statements relied on by the distributor were generalized reassurances that the manufacturer hoped for a good relationship. However, courts have found a breach of contract\textsuperscript{168} and breach of the implied covenant of good faith and fair dealing\textsuperscript{169} when the agreement only expressly

\textsuperscript{161} Id. at 1261.


\textsuperscript{163} Id.

\textsuperscript{164} Id. at 214.

\textsuperscript{165} 210 F.3d 653, Bus Franchise Guide (CCH) ¶ 11,842 (6th Cir. 2000).

\textsuperscript{166} Id. at 658.


\textsuperscript{168} May v. Roundy’s Inc., 524 N.W.2d 647, Bus. Franchise Guide (CCH) ¶ 10,550 (Wis. Ct. App. Sept. 13, 1994) (franchisor may have breached license agreement by placing a new store within 3 miles when, although the agreement was non-exclusive, it guaranteed the licensee “all the rights and privileges” under the franchisor’s system and a three mile protection might be considered a right or privilege).

\textsuperscript{169} See Scheck v. Burger King Corp., 798 F. Supp. 692, Bus. Franchise Guide (CCH) ¶ 10,049 (S.D. Fla. July 6, 1992) (denial of territorial rights did not imply franchisor could open franchises at will and agreement did not mention
denies the grant of an exclusive area. Further, a listing of accounts reserved by the franchisor can lead to the inference of an exclusive territory for the franchisee.\footnote{DuPage Fork Lift Servs. v. Machinery Distribution, Inc., Bus. Franchise Guide (CCH) ¶ 10,635 (N.D. Ill. March 15, 1995) (denying dismissal on breach of contract claim based on alleged exclusive rights when the agreement’s explicit reservation of accounts could reasonably be interpreted to prohibit franchisor sales to unlisted entities).} Finally, the specific language used in the agreement must be carefully drafted.\footnote{Camp Creek Hospitality Inns, Inc. v. Sheraton Franchise Corp., 130 F.3d 1009, Bus. Franchise Guide (CCH) ¶ 11,306 (11th Cir. Dec. 11, 1997) (franchisor may have breach implied covenant of good faith and fair dealing by establishing a company hotel in same area as franchisee when agreement granted a “site only” territory but did not reserve the right for the franchisor itself to open a new hotel in the vicinity).}

Accordingly, the avoidance of litigation on territorial exclusivity is best accomplished by an explicit, unambiguous contract provision that addresses exclusivity, the subject territory, and the reservation of the right of the franchisor to appoint new franchises.

**B. Alternate Channels Of Distribution**

An agreement should clearly state the rights of the franchisor to compete through alternate channels of distribution. While franchise agreements traditionally addressed protected geographical territories, contract provisions on alternate channels of distribution, such as the Internet, catalog sales or supermarket sales, were often unclear in their scope. In same-brand competition, the express language of the contract is extremely important. The most common area where franchisors face litigation relating to same brand competition is when the franchisor attempts to directly sell to the customer.\footnote{See Stelwagon Mfg. Co. v. Tarmac Roofing Systems, Inc., 802 F. Supp. 1361, Bus. Franchise Guide (CCH) ¶ 10,549 (E.D. Pa. Sept. 12, 1994) (direct sale by manufacturer within its distributor’s exclusive territory could be breach of implied covenant of good faith and fair dealing); Capital Equipment, Inc. v. CNH America, LLC, Bus. Franchise Guide (CCH) ¶ 13,350 (E.D. Ark. Apr. 28, 2006) (manufacturer may have breached agreement by selling equipment through an auction house when some ambiguity over whether parties agreement which permitted, “direct sales to end users,” contemplated such sale by manufacturer); BJM & Assoc. v. Norrell Servs., Inc., 855 F. Supp. 1481, Bus. Franchise Guide (CCH) ¶ 10,485 (E.D. Ky. May 3, 1994) (franchisor’s solicitation of customers for management services program in franchisee’s exclusive area constituted breach of agreement even though franchisor had informed franchisees that management services were no longer in franchisees’ spectrum of services and the franchisor’s actions “smacked of impermissible opportunism”).} While some cases had little problem in supporting the franchisor’s rights in such alternate channels, others decided differently. Compare, for example, *Carlock v. Pillsbury Co.*,\footnote{719 F. Supp. 791, Bus. Franchise Guide (CCH) ¶ 9465 (D. Minn. Aug. 8, 1989).} and *Rosenberg v. Pillsbury Co.*\footnote{718 F. Supp. 1146, Bus. Franchise Guide (CCH) ¶ 9445 (S.D.N.Y. Jul. 28, 1989).} (supermarket ice cream sales did not violate the franchise agreement) with *Carvel v. Baker*\footnote{F. Supp. 2d 53, Bus. Franchise Guide (CCH) ¶11,208 (D. Conn. Jul. 22, 1997).} (supermarket ice cream sales may have violated the franchise agreement).

In *Carlock*, the contract gave the franchisor the right to distribute Haägen-Daz products through any distribution method which may from time to time be established. When franchisees
sued because Haägen-Daz sold its ice cream to supermarkets, the case was dismissed because the franchisor was exercising an expressly reserved contract right.

In *Emporium Drug Mart, Inc. v. Drug Emporium Inc.* In *Emporium Drug*, the franchisor had established an e-commerce subsidiary and begun direct sales. A group of franchisees brought a complaint in arbitration seeking a preliminary injunction. The arbitration panel held the franchisees were likely to succeed on claims that the Internet sales violated the exclusivity provisions of their franchise agreements and diluted the trademark license they had been granted. The panel reasoned that franchisees had an expectation under their agreements that they would not be forced to compete with direct sales by the franchisor or its subsidiary. The resulting injunction prohibited Internet sales in the franchisees’ territories and required the franchisor to put a notice on the website and direct customers to the nearest franchised outlet.

However, other courts have not been as willing to find Internet sales to be an intrusion into exclusive territories.

As previously mentioned, the first reported franchise Internet sales dispute was resolved in favor of the franchisee in an arbitration proceeding. *Emporium Drug Mart, Inc. v. Drug Emporium, Inc.* In *Lee v. General Nutrition Cos., Inc.*, GNC franchisees sued, challenging GNC’s establishment of an Internet-based store, www.drugstore.com, where customers could buy GNC products at prices significantly below what franchisees could charge. They also challenged GNC’s program of placing a store-within-a-store for GNC products in Rite Aid stores located near their franchised locations. The Rite Aid stores allegedly also sold GNC products at prices franchisees were unable to match.

GNC argued that the contract granted its franchisees a limited protected territory, but retained all rights outside the protected territory to the franchisor. The franchisees countered that the way in which GNC established these competitive outlets violated the implied covenant of good faith and fair dealing. The California district court ruled, on a motion to dismiss, that the defendants had established “that the conduct alleged is authorized by the agreements between the parties.” The *Lee* dispute continued on for several years, focused on other issues. The district court eventually granted summary judgment for GNC on all counts, a decision that was


177 *id.*

178 *id.*

179 *id.*

180 *id.*


later affirmed by the Ninth Circuit. The franchisees failed to raise the encroachment issue on appeal and the issue was not addressed by the Ninth Circuit.

Similarly, in *In the Matter of Hale v. Conroy’s*, where the franchise agreement specifically reserved the “right to develop, advance, and use other systems of technology,” an arbitrator found that Internet sales by a franchisor did not encroach on the territory of a bricks and mortar florist.

An example of the importance of clear drafting arose in *Carvel Corp. v. Baker*. In *Carvel*, a group of ice cream shop franchisees, operating under two different franchise agreements, alleged breach of contract and breach of implied covenant of good faith and fair dealing when the franchisor began distributing branded products to supermarkets and convenience stores.

The older form of the franchise agreements stated that there was a “unique system for the production, distribution and merchandising of Carvel products,” provided territorial protection limited to ¼ mile on the same street, and reserved all other rights in the name and trademark to the franchisor. The newer form of franchise agreement retained the “unique system” language, but added an express reservation for the franchisor to sell or license to sell products through the same or different delivery systems, channels, or concepts. Further, the UFOC, provided in conjunction with the new agreement, listed supermarkets as one of the channels that the franchisor reserved.

The court held that under the old agreement, summary judgment on the contract claim was inappropriate because there was an inherent conflict between the “unique system” language and the limited reservation of “all other rights” in the names and trademarks. However, under the new franchise agreement, the franchisor had expressly and unambiguously reserved the right to distribute in other channels and the listing of supermarkets in the UFOC cleared any ambiguity that could arguably be present. Accordingly, summary judgment was proper under the new franchise agreement on the contract claim.

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184 *Bus. Franchise Guide (CCH)* ¶ 12,177 (JAMS arbitration June 14, 2001).
186 *Id.*
187 *Id.*
188 *Id.*
189 *Id.*
190 *Id.*
191 *Id.*
192 *Id.*
The court next addressed the implied covenant of good faith and fair dealing claims. Under the older franchise agreement, the court held summary judgment to be improper because it was reasonable to presume the parties intended that the “unique system” would preclude the franchisor’s distribution at the wholesale level to other retail outlets. Further, there was evidence that supermarkets and other ice cream stores were considered direct competitors by the parties. The court concluded that the supermarket program would deprive the franchisees of the benefits of the agreement under this construction of the older agreement. The court also held that the newer agreement not amenable to summary judgment on the implied covenant of good faith and fair dealing claim. The court reasoned that while the franchisor had the right to institute an alternative distribution program, the franchisees could reasonably expect that such a program would not be in direct competition with them.

Overall, the ability of the franchisor to sell directly to customers in the exclusive territory of the franchisee is dependent on the language of the agreement. The more explicit and unambiguous the provisions, when reserving the right for the franchisor to sell directly or utilize alternate distribution channels, the less likely that litigation will occur.

C. Covenant Of Good Faith And Fair Dealing

The implied covenant of good faith and fair dealing is an overarching concept that colors the interpretation of many substantive contract provisions. The best way to avoid litigation on the subject is for the franchise agreement to expressly define and/or limit the parties’ rights and responsibilities. The covenant itself is rooted in the common law and the Uniform Commercial Code, where applicable, and has been imposed by some relationship statutes.

The covenant prohibits a party from acting in a manner that will result in injury to the right of the other party to receive the benefits of the bargain. Most states apply the covenant of good faith and fair dealing in all contracts, although the covenant cannot override an express contractual term.

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193 Id.
194 Id.
195 Id.
196 Id.
197 Id.
198 Id.
199 Interim Health Care of Northern Illinois, Inc. v Interim Health Care, Inc., 225 F.3d 876, Bus. Franchise Guide (CCH) ¶ 11,930 (7th Cir. Aug. 25, 2000) (franchisor did not breach agreement by soliciting and servicing customers in franchisee’s designated territory when agreement did not explicitly bar such action by franchisor or other franchisees and only prohibited the establishment of an office in the designated territory); Totally Everything, Inc. v. ATX Research, Inc., Bus. Franchise Guide (CCH) ¶ 11,293 (E.D. Pa. Dec. 3, 1997) (distributor did not show reasonable chance of success for preliminary injunction because it was unclear whether manufacturer’s reservation of right to sell to national accounts applied only to end users).
The covenant of good faith and fair dealing arises in franchising as to provisions relating to territory, termination, and renewal. The most common territorial issue is encroachment. Encroachment involves the placement or attempted placement by the franchisor of a new franchise or company-owned unit in close proximity to an existing franchisee. Litigation on encroachment typically occurs when the injured franchisee is not provided with an exclusive market or territorial rights.

When the franchise agreement expressly reserves the right of the franchisor to establish additional franchises at any location, breach of the covenant of good faith and fair dealing is rarely found. A good example is *Rado-Mat Holdings, U.S., Inc. v. Holiday Inns Franchising, Inc.*, where a hotel franchisor established a new hotel within two blocks of an existing franchise.\(^{201}\) The court held the franchisor did not breach the covenant of good faith and fair dealing because the franchise agreement expressly disclaimed any grant of an exclusive territory and the implied covenant could not contradict or alter an explicit term.\(^{202}\)

However, a disclaimer of territorial rights not does always give the franchisor a free hand in franchise placement. In *Scheck v. Burger King Corp.*, the franchise agreement expressly disclaimed a grant of any area, market, or territorial right.\(^{203}\) The court, however, held that a denial of territorial rights does not mean that the franchisor can open new franchises without regard to their effect on current franchisees.\(^{204}\) The court reasoned that because the agreement did not mention the franchisor's rights in placing new franchises, no explicit contract term was being overridden.\(^{205}\)

A breach of the covenant of good faith and fair dealing may be found when a manufacturer sells directly in the distributor's exclusive territory.\(^{206}\) Such was the case in *Stelwagon Mfg. Co. v. Tarmac Roofing Systems, Inc.*, where the court held that an express term of the agreement did not have to be implicated for a breach of the covenant of good faith and fair dealing because the UCC expressly imposed the covenant on every contract for a sale of

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\(^{202}\) *Id.*


\(^{204}\) *Id.*

\(^{205}\) *Id.; See also Blaske v. Burger King Corp.*, *Bus. Franchise Guide (CCH)* ¶ 10,490 (D. Minn. June 27, 1994) (oral modification and covenant of good faith and fair dealing result in breach of contract when franchisor denied franchisee right to open new store). *But see Burger King Corp. v. Weaver*, 169 F.3d 1310 (11th Cir. 1999).

\(^{206}\) *See Rose Equipment, Inc. v. Freightliner Corp.*, Business Franchise Guide (CCH) Letter 240, Issue 243 (Oct. 29, 1999) (arbitrator determined manufacturer actions of refusing to give dealer two new product lines, reducing dealer’s assigned area of responsibility, allowing competitor to establish service facility in former dealers area, and engaging in direct sales with dealer’s largest customer amounted to constructive termination and breach of covenant of good faith and fair dealing).
The court concluded that the outcome depended on the reasonable expectations of the parties.

D. Good Faith As To Discretionary Acts

Of course, most written contracts do not cover all possible contingencies and circumstances, and franchise agreements frequently vest one party with discretion to make future decisions, including decisions relating to pricing, site selection, transfer of ownership by the franchisee, early termination of an at-will agreement, and training and assistance to be provided by the franchisor. The covenant of good faith and fair dealing is also applied to situations outside of any express contract provisions such as sale of the system, operating procedures, and supply restrictions. In these situations, the franchisor can avoid litigation by acting reasonably and exercising discretion in good faith and with due regard for the franchisee (often defined as honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade).

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208 Id.
209 See In re De Rosa, 98 B.R. 644, Bus. Franchise Guide (CCH) ¶ 9383 (Bankr. R.I. Mar. 29, 1989) (breached by charging top prices for inferior products, late deliveries, and not providing entire line of products).
210 TCBY Systems, Bus. Franchise Guide (CCH) ¶ 10,518 (breached when manager with no previous experience did not follow franchisor’s internal guidelines).
212 See Sklar v. Rowe Furniture Corp., Bus. Franchise Guide (CCH) ¶ 10,188 (D. Minn. Mar. 19, 1993) (recoupment implies reasonable contract duration to provide dealer time to recoup expenditures and is available on termination without cause when dealer has substantial unrecovered expenditures).
216 See Crossroads Feed & Hardware, Inc. v. Ralston Purina Co., 857 F.2d 1468, Bus. Franchise Guide (CCH) ¶ 9201 (4th Cir. Aug. 1, 1988) (breach by franchisor when refusal to fill dealer’s order and attempt to limit dealer’s line of supplies after agreeing to provide full line).
The other areas in which the covenant of good faith and fair dealing is heavily litigated are terminations and non-renewals. As with territorial disputes, a well drafted, explicit provision is essential to avoid litigation on termination or non-renewal. Courts have defined the standard as an obligation to act in good faith that is not arbitrary in order to protect reasonable expectancy with regard to discretionary items.\textsuperscript{218} Bad faith may be found where there is evidence of an improper or retaliatory motive.\textsuperscript{219} However, one court has held that termination is permissible if good cause exists regardless of motive.\textsuperscript{220} More typically, courts find no breach when the termination or nonrenewal was not arbitrary, followed an explicit provision, and was not in bad faith.\textsuperscript{221}

In sum, there are several key strategies that can be used to avoid litigation on the covenant of good faith and fair dealing. Those strategies are (1) draft contract provisions that expressly define and limit the parties’ rights and responsibilities; (2) avoid placing discretion in one party’s hands, if practical; and (3) where discretion in a contract provision is necessary, ensure that the franchisor exercises that discretion in a reasonable, good faith manner.

V. TERMINATION FOR CAUSE

A. Litigation Regarding The Termination Of Franchise and Dealership Agreements

Franchise and dealer agreements typically contain two different clauses covering termination for cause. One clause typically outlines various reasons for termination after the dealer or franchisee has been given a period to “cure” the defect, while the other lists breaches that will result in immediate termination, without an opportunity to cure.

Common breaches resulting in termination without a right to cure the violation within a set period of time include: failing to maintain the contractual levels of sale of inventory,\textsuperscript{222} failing


\textsuperscript{222} See Frieburg Farm Equipment, Inc. v. Van Dale, Inc., 978 F.2d 395, Bus. Franchise Guide (CCH) ¶ 10,109 (7th Cir. 1992) (holding that there was not good cause to terminate the dealer based on its low sales because the dealer’s failure to meet the required goals was due, in part, to the manufacturers appointment of three additional dealers in surrounding counties).
to pay rent or royalties, threats to the public health or safety, operational or contractual defaults which may adversely affect the business of the dealer or company.

Reasons warranting immediate termination of the agreement typically include the following: insolvency, bankruptcy, or transfer or assignment without prior approval, materially false or misleading representations made by the dealer or franchisee, abandonment of the franchised business, loss of possessory rights to the premises, misrepresenting revenue, repeated breaches, unsafe operation, failure to pay taxes, unauthorized use of the license or trademarks, or the franchisor's withdrawal from the market. These actions typically warrant immediate termination because the breach either cannot be remedied, or it strikes at the heart of the agreement.

Not surprisingly, the termination or attempted termination of dealers and franchisees is often litigated. When a dispute of this sort arises, as with most franchise issues, the first place to look for guidance is the language of the agreement itself. Typically, litigation growing out of termination involves a claim that either (1) the distributor or franchisor failed to comply with the proper notice or opportunity to cure requirements, or (2) the distributor or franchisor did not have the requisite “good cause” to terminate the dealer or franchisee.

Although the following analysis focuses specifically on the language of the contract in relation to termination, it is equally important to be aware of any applicable state dealer or franchise statutes. These statutes often protect dealers and franchisees to a greater extent than the parties’ written agreement, and quite frequently mandate notice, cure, and good-cause termination requirements which will override less protective contractual provisions.

The following discussion explores some of the more frequently litigated issues surrounding termination disputes and highlights a few points to keep in mind when drafting agreements so that unnecessary litigation can be avoided if the relationship comes to an end.

### B. Determining Whether The Agreement Is Only Terminable For Cause

In some cases, courts must determine whether an agreement is terminable at will or can only be terminated by cause. Many courts hold that contracts of indefinite duration are

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223 See *Open Pantry Food Marts of Wis. Inc. v. Heathercone, Inc.*, Bus. Franchise Guide (CCH) ¶ 8072 (Cir. Ct. Wis. Oct. 31, 1983) (holding that a contractual requirement that franchisees have at least $3,000 in net worth in the business, incorporates the concept of insolvency and constitutes independent grounds for termination).

224 See *AGI Realty Serv. Group, Inc. v. Red Robin Intl., Inc.*, Bus. Franchise Guide (CCH) ¶ 10,904 (6th Cir. Mar. 28, 1996) (the failure to disclose a prior felony constitutes a material misrepresentation, warranting immediate termination, but a past felony conviction alone cannot serve as an independent basis for termination under the agreement).


terminable at will by either party.\textsuperscript{228} However, usually when an agreement allows termination only for cause, without specifying a fixed duration, the agreement can only be terminated for cause, and not at will.\textsuperscript{229} These rules have led to some interesting litigation in the franchise context when the agreement is for an indefinite term but also provides for termination for specific breaches.

For example, in \textit{Lichnovsky v. Ziebart Int'l Corp.}, the Supreme Court of Michigan held that a franchise agreement could only be terminated for cause, even though the agreement stated that it would last indefinitely, because the agreement also provided for termination upon breach.\textsuperscript{230} The agreement declared that it would continue in “full force and effect indefinitely, unless terminated at an earlier date” “[s]hould licensee fail to perform any of the terms, conditions or provisions” of the agreement and “remain in default for a period of 30 days after the receipt of a notice.”\textsuperscript{231} The court concluded that an agreement will only be terminable at will when the parties have not agreed upon a term or the manner of its termination.\textsuperscript{232} Thus, the court agreed with the franchisee that the agreement could only be terminated for cause.\textsuperscript{233}

However, even though courts generally disfavor enforcement of indefinite agreements, at will, courts will not always read in a for-cause termination provision when the language is ambiguous. In \textit{Jepersen v. Minnesota Mining & Manufacturing Co.},\textsuperscript{234} a distributor agreement provided that it would continue in force indefinitely,” but that the manufacturer “may” terminate the agreement for any of the following reasons for cause. When the agreement was terminated as a result of a merger, the distributor brought suit claiming that the agreement’s inclusion of specific events triggering termination meant that the agreement was not indefinite, but rather could only be terminated for cause.\textsuperscript{235} The court held, however, that “where the parties have drafted a contract that is otherwise indefinite in duration and terminable at will, the delineation of instances of material breach in the context of a permissive and nonexclusive termination provision will not alone create a contract terminable for cause.”\textsuperscript{236}

\textsuperscript{227} See \textit{Shaull Equip. & Supply Co. v. Rand}, Bus. Franchise Guide (CCH) ¶ 12,939 (M.D. Pa. Nov. 4, 2004) (holding that the manufacturer’s repeated statement to the dealer that “if its market share stayed above the national average, the dealer had nothing to worry about,” was sufficient to conclude that the terminable at-will agreement had been orally modified to permit termination only for cause).


\textsuperscript{229} \textit{R.J.N. Corp. v. Connelly Food Products, Inc.}, 529 N.E.2d 1184, 1187 (N.D. Ill. 1988).

\textsuperscript{230} 324 N.W.2d 732, 741 (Mich. 1982).

\textsuperscript{231} \textit{id.} at 736.

\textsuperscript{232} \textit{id.} at 739-740.

\textsuperscript{233} \textit{id.} at 741.

\textsuperscript{234} 700 N.E.2d 1014, 1016 (Ill. 1998).

\textsuperscript{235} \textit{id.}

\textsuperscript{236} \textit{id.} at 1017.
C. Notice And Opportunity To Cure Issues

Courts will usually strictly construe notice and opportunity to cure provisions because of the significant impact that terminations have on dealers and franchisees.237

In a win for the franchisees, the court in Bray v. QFA Royalties LLC granted the franchisees a preliminary injunction because they were likely to succeed on the merits of their claim that they had been wrongfully terminated by Quiznos. The terminated franchisees were all officers or members of the Toasted Subs Franchisee Association, Inc., and had been sent notices of termination immediately after they had posted a letter from a deceased franchisee owner on the association’s website which discussed his litigation battle with Quiznos.239 The termination letters, however, had failed to mention the specific misconduct or violation that had occurred and did not mention how any violation could be cured.240 The franchise agreement allowed for termination without the right to cure if the franchisee “engages in conduct that, in the sole judgment of Franchisor, materially impairs the good-will associated with the Marks . . .”241 The court focused on the term “sole judgment” and stated that the word judgment describes the process of deliberate fact gathering and the exercise or reason.242 Thus, Quiznos’ rash and unsupported act of immediate termination without specifying the manner in which the franchisee could cure and without having made any investigation into the matter probably fell outside of its authority to terminate immediately in its “sole judgment.”243

Even if an agreement (or statute) provides a required notice period and a manufacturer complies with the notice period, the termination may still be unlawful. For example, in Al Bishop Agency v. Lithonia-Division of Nat’l Serv. Indus., Ltd.,244 the court determined that the defendant had good cause to terminate the plaintiff and the cure period of 60 days notice was “sufficient in a technical sense,” but it was “wholly inadequate in a practical sense,” because curing the default within that time frame had been impossible.245 To cure the default, the defendant had requiring the plaintiff to bring his whole year’s sales up to company average in only 60 days. In reviewing this cure requirement, the court stated “it becomes apparent that the steps that a grantor requires in order to rectify a deficiency must be reasonable.”246 Given the nature of the

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237 See Manpower Inc. v. Mason, 377 F. Supp. 2d 672 (E.D. Wis. 2005) (granting franchisees preliminary injunction when franchisor sought to terminate the agreement without giving an opportunity to cure and the franchise agreement required a ninety day prior written notice to terminate and the allowance of sixty days to cure).

238 486 F. Supp. 2d 1237, 1254 (D. Colo., 2007).

239 Id. at 1239.

240 Id. at 1240.

241 Id. at 1252.

242 Id. at 1253.

243 Id. at 1253-54.

244 474 F. Supp. 828 (E.D. Wis. 1979)

245 Id. at 843.

246 Id. at 835.
business and the fact that it takes six weeks after an order was placed for a dealer to even get credit for the order, the cure requirements were inherently unreasonable.247

Similarly, in Wadena Implement Co. v. Deere & Co., the court held that a dealership had been wrongfully terminated for allegedly failing to meet the manufacturer’s market share requirements.248 When the manufacturer had begun to impose a market share obligation years into the parties’ relationship, the court concluded that “[i]f a specific market share is to be required for a particular year, elementary notions of fairness would dictate that the dealer unambiguously be informed of the requirement before the year begins.”249 Further, the requirement should have been reasonable so that it could have been met in the time required.250 The court then held that not only had the requirement been unreasonable (it required the dealer to increase market share by 500 percent in one year), but the notice and opportunity to cure had been deficient because it would have been impossible to achieve in the time allotted.251

The opposite, however, can sometimes be true as well, and franchisees should be aware that certain violations may warrant immediate termination, notwithstanding express contractual language granting a franchisee time to cure. This can occur when it is not possible to cure the deficiency.252

Recently, the Supreme Court of Pennsylvania addressed this question of “whether a breaching party’s conduct may justify the immediate termination of a contract even where the contract includes an express provision granting the breaching party a period to cure its breach before the contract is terminated.”253 The franchisee of an air-freight forwarding business breached the agreement by diverting shipments away from the franchisor and to a direct competitor of the franchisor.254 Upon learning of this conduct, the franchisor sent a letter to the franchisee stating that it was terminated immediately.255 The franchisee filed suit, asserting breach of contract by wrongful termination because the franchisee had not been given a chance to cure.256 The franchisee claimed that the agreement provided the opportunity to cure all defaults within ninety days of receipt of written notice. Further, the alleged breach had been

247 Id.


249 Id.

250 Id. at 388.

251 Id. at 389.

252 See Gueyffier v. Ann Summers, Ltd., Bus. Franchise Guide (CCH) ¶ 13,912 (Cal. Sup. Ct. June 9, 2008) (holding that failure to provide notice of termination, as required by the parties’ agreement, was excusable because the breaches were no longer curable).


254 Id. at 642.

255 Id. at 643.

256 Id.
included in the agreement under specific grounds for termination. Nevertheless, the court looked to precedent in other jurisdictions and held that a non-breaching party may terminate the contract without notice and time to cure when the breach goes to the essence of the contract.

Similarly, in *Baskin-Robbins Franchising v. Mihranian*, the franchisee was immediately terminated pursuant to the agreement’s no-cure provision when Baskin-Robins learned that it was selling unauthorized yogurt products. The franchise agreement prohibited (1) selling products not authorized in writing by Baskin-Robbins, and (2) using the franchised premises “for any illegal or unauthorized purpose, including, without limitation, palming off or substitution of products under the Proprietary Marks or other marks of Baskin-Robins.” Baskin-Robins survived the motion to dismiss with the court holding that this breach “reflects materially and unfavorably upon the operation and reputation of the franchise business” and thus falls into an exception under the California Franchise Relations Act, which usually invalidates no-cure provisions.

**D. Proffered Reasons For Termination**

The franchisor or manufacturer’s reasons for termination should be closely scrutinized, because sometimes the reason for termination either does not rise to the level of cause required, or the reason was simply a pretext to terminate the franchisee or dealer for an unjustifiable reason. Further, even when a distributor has breached the distribution agreement more than once, such breaches may not always rise to the level of a “chronic failure of performance,” entitling the supplier to terminate the distributor for cause.

In *Northwest Bakery Distributors, Inc. v. George Weston Bakeries Distribution, Inc.*, a distributor was successful in obtaining a preliminary injunction preventing George Weston Bakeries from terminating its distribution agreement for cause. George Weston Bakeries asserted that it had two reasons to terminate the plaintiff for cause under the distribution agreement: (1) the commission of an act of dishonesty that could affect the plaintiff’s ability to

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257 *Id.* at 646.

258 *Id.* at 652. See also *Olin v. Central Indus. Inc.*, 576 F.2d 642 (5th Cir. 1978) (the termination provision in the agreement which required notice and time to cure for any default of the covenants did not bar the manufacturer from unilaterally terminating the contract with no time to cure when distributor engaged in fraudulent conduct); *Larken v. Larken Iowa City Ltd. Partnership*, 589 N.W.2d 700 (Iowa 1998) (holding that immediate termination was not prohibited by the agreement when the breach was material and struck the heart of the agreement).


260 See *Shell Oil Co. v. K.E.M. Service, Inc.*, *Bus. Franchise Guide (CCH) ¶ 10,796 (1st Cir. Oct. 26, 1995)* (granting franchisee’s preliminary injunction when it was terminated for mere technical violations of the franchisee’s reporting requirements).

261 See *Pepperidge Farm, Inc. v. Mack*, *Bus. Franchise Guide (CCH) ¶ 9530 (S.D. Cal. Nov. 29, 1989)* (when franchisee’s food product route was terminated for failure to maintain adequate supplies or to realize full sales potential, a jury concluded that those reasons were simply pretext for termination because of the franchisee’s leadership role in the Pepperidge Owners Association, and therefore, the termination was wholly without cause); *Van Zeeland Implement Co. v. J.I. Case Co.*, *Bus. Franchise Guide (CCH) ¶ 8567 (Cir. Ct. Wts. Apr. 22, 1986)* (holding that the manufacturer’s termination of the dealer for failing to meet the market strength requirement did not constitute good cause because the termination was really a business decision based on the manufacturer’s belief that the territory was not strong enough to support two dealers).

262 No. 045 C 8233, 2005 WL 66044 (N.D. Ill Jan. 11, 2005).
perform under the distribution agreement due to an incident of theft by the plaintiff’s independent contractor at a store that the plaintiff was responsible for delivering to; and (2) the issuance of two breach letters related to stores running out of products.

In granting a preliminary injunction, the court held that the plaintiff was likely to succeed on the merits of the case. The court determined that an incident of theft by the distributor’s independent contractor, whom the plaintiff had fired immediately upon learning of the incident, was not likely an act of dishonesty that affected the plaintiff’s ability to perform within the meaning of the distribution agreement. The court also determined that the plaintiff was likely to prevail on the out-of-stock violations because it submitted evidence that running out-of-stock was common in the bakery industry and sometimes out of the control of the distributor.

When termination provisions are drafted broadly, giving one party a great deal of leeway in deciding what conduct constitutes a breach warranting termination, courts will sometimes mandate that the termination still must be objectively reasonable. In another Quiznos case, the court held that the franchisee did not breach the franchise agreement, and that Quiznos had breached the agreement by its wrongful termination.\textsuperscript{263} The franchisee had been terminated when it allegedly failed Quiznos “mystery shopper’s” test, which had been based on weighing the meat from a single sandwich on one particular day. Quiznos again relied on the provision in the agreement which stated that termination is permitted if the franchisee engages “in conduct that, in the sole judgment of [Quiznos], materially impairs the goodwill associated with [Quiznos’ trademarks and service marks].” The court stated that because the language of the agreement gives the franchisor limitless discretion in a termination decision, there must be an implied requirement of reasonableness. Therefore, because the mystery shoppers test was “laughably unreliable,” Quiznos wholly failed to demonstrate how the franchisee had impaired its goodwill.

\section*{E. Planning Ahead: Methods Of Avoiding Litigation Regarding Contractual Termination Provisions}

Although there is an abundance of litigation regarding for-cause termination, it is not difficult to see how much of this litigation could be avoided through better drafting practices. First, a franchise or dealer agreement must be drafted in light of any state statute that may govern the parties’ relationship. Most statutes require “good cause” for termination and specify the minimum procedural requirements for notice and opportunity to cure.\textsuperscript{264} Although an agreement can surely provide more protection for the dealer or franchisee, it must at the least comply with the minimum required by law.

Regardless of any applicable statutes, the parties’ agreement should provide the dealer or franchisee with reasonable notice of a potential termination and an adequate opportunity to cure. Uncertainty will be minimized if these procedures are clearly addressed in the agreement. And as much as possible, the agreement should also specifically state what events or requirements will constitute cure within the given time period.


\textsuperscript{264} For example, the Arkansas Franchise Practices Act, Ark. Code Ann. § 4-72-204 requires good cause for termination, 90 days notice in advance of termination, and must provide the franchisee at least 30 days to cure any claimed deficiency.
Lastly, it is best to define carefully the events that will constitute cause for termination. In doing so, the dealer or franchisee should be provided with a concise and specific list. This will give all parties involved a much clearer expectation of what is required to remain in good standing with a franchisor or distributor. Regardless of what the agreement provides for, courts will sometimes impose an additional requirement of reasonableness, which is especially true when the agreement is drafted broadly and gives wide latitude to one party.

VI. RENEWAL

When the franchisee’s twenty-year term expired in *Payne v. McDonald’s Corp.*, McDonald’s conditioned renewal on modernization of the premises. The agreement did not require a renewal term at all, but the franchisee claimed that imposing renovation obligations as a condition for renewal violated the covenant of good faith and fair dealing. Because McDonald’s was under no obligation to renew at all, the court held that it was “at liberty to impose conditions for renewal deemed appropriate by it for the furtherance of its business interests.” There was no duress because the franchisee “faced merely that economic pressure regularly encountered by a businessman when confronted with stringent demands during negotiations for renewal of a lease or other agreement.”

A. Good Faith As To Renewal

What happens where a contract provides for renewal on such terms as may be agreed upon by the parties? May a franchisor simply claim that there is no enforceable duty to negotiate terms and refuse to renew? The Ninth Circuit declined to endorse such a claim in *In re Vylene Enterprises, Inc., Debtor, Vylene Enterprises v. Naugles, Inc.* Vylene had been granted an initial ten-year contract term, with an eight-year renewal term “on terms and conditions to be negotiated.” At the end of the initial franchise term, Vylene gave notice of its intent to renew.

Naugles responded by presenting a proposed new contract. The proposed new contract was rejected by Vylene’s attorney who stated that it was “so obviously onerous that no one could operate the business except at a loss.” The court held that even though the required terms of renewal were vague, the renewal provision “obligated Naugles to negotiate in good faith concerning the terms and conditions on a renewal.” The bankruptcy court had already held a hearing and determined that Naugles had not negotiated in good faith on renewal terms. The court found that the proffered renewal agreement was commercially unreasonable and that the franchisor had known or should have known that the franchisee would reject it. The franchisor had thus breached its contract by failing to negotiate in good faith.

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266 *Id.* at 758.

267 *Id.* at 759.

268 90 F.3d 1472, Bus. Franchise Guide (CCH) ¶ 10,981 (9th Cir. Jul. 29, 1996).

269 *Id.* at 1473-74.

270 *Id.* at 1476.
In Watkins & Son Pet Supplies v. The Iams Co.,\(^{271}\) a pet food distributorship agreement provided that the agreement would automatically expire on a named date, providing that it could be renewed “thereafter on terms mutually agreeable to the parties only in a writing signed by the parties. . . . “ As in Vylene, the issue was whether the agreement implied a duty to negotiate renewal terms in good faith.

The trial court ruled, and the Circuit Court affirmed, that the agreement differed from the one in Vylene, where the franchisee had an explicit right to renew. The Iams contract did not evidence any intent to reach a future agreement, merely providing that future renewal could be granted on “mutually agreeable” terms. None of the terms of a proposed renewal were provided in the contract and there was no obligation to even discuss an extension. The mere possibility of an extension did not impose any duty of good faith negotiation.

As with territorial disputes, a well drafted, explicit provision is essential to avoid litigation on termination or non-renewal. Courts have defined the standard as an obligation to act in good faith that is not arbitrary in order to protect reasonable expectancy with regard to discretionary items.\(^{272}\) Bad faith may be found where there is evidence of an improper or retaliatory motive.\(^{273}\) However, one court has held that termination is permissible if good cause exists regardless of motive.\(^{274}\) More typically, courts find no breach when the termination or nonrenewal was not arbitrary, followed an explicit provision, and was not in bad faith.\(^{275}\)

B. Renewal On What Terms?

The agreement in Test Services, Inc. v. The Princeton Review, Inc.\(^ {276}\) provided that the franchisee had the right to renew for successive ten year terms if certain conditions were met. Among those conditions was the execution of an agreement “on the terms and conditions then being offered to new franchisees,” except that royalties could not be increased.\(^ {277}\) When the term expired, the franchisee gave notice that it wished to renew on the original terms of the

\(^{271}\) 254 F.3d 607, 610 (6th Cir. 2001).


\(^{277}\) Id. at *3.
expiring agreement. A Colorado federal district court held that the renewal provision did not require continuation of the contractual relationship on the same terms, with the exception of the royalty rate.\footnote{Id. at *7-8.}

Renewal terms are often a source of conflict between the franchisee, who is comfortable with the existing contract relationship, and the franchisor, who is looking to upgrade what may be perceived as an outdated facility. In \textit{McLaughlin v. The Krystal Co.},\footnote{No. 08-0611-CG-C, 2009 WL 2514210 at *1, Bus. Franchise Guide (CCH) ¶ 14,207 (S.D. Ala. Aug. 14, 2009).} an Alabama franchisee had the contractual right to renew his franchise, if he executed the franchisor’s “then-current form of Agreement” which “may differ from the terms of this Agreement, including without limitations, a different percentage Royalty and Service Fee and advertising fee.”

As often happens in conjunction with a renewal, the parties in \textit{McLaughlin} engaged in some rather ambiguous correspondence on renewal. Issues arose as to whether the existing location could be properly refurbished. The franchisee complained that the franchisor had pressed him to either remodel the existing location or to build a new free-standing location. The franchisor had also insisted that if the existing location was renewed, the dining area would have to be enclosed. Two years of wrangling produced neither a remodeled location nor a new free-standing location. The court ruled that the franchisor had already granted several extensions and was not obligated to grant more. Because neither the remodel nor the building of a new location had occurred, the franchisor was granted summary judgment on its right to terminate the franchise without renewal.

In \textit{Casual Dining Development, Inc. v. QFA Royalties, L.L.C.},\footnote{No. 09-cv-01301-REB-MJW, 2009 WL 2869335, Bus. Franchise Guide (CCH) ¶ 14,217 (D. Colo. Sept. 3, 2009).} a Wisconsin franchisee entered into an area development agreement with Quizno’s for a ten-year term, with a renewal right for an additional ten-year period. The plaintiff claimed that it had complied with all contractual conditions on renewal, but that Quizno’s had refused to renew because of disagreements over the proposed schedule of sales and opening goals. Neither party had placed the agreement before the court.

The plaintiff sued under the Wisconsin Fair Dealership Law, alleging that Quizno’s newly-imposed conditions for renewal worked a substantial change in the competitive circumstances of the dealership. The defendant pointed out that proof of this claim required a showing that there had been actual changes to the original agreement, not merely a continuation of existing contract terms. Because the contract was not before it, the court refused to dismiss because it could not tell whether the plaintiff could establish a statutory claim.

The franchisee in \textit{Jet, Inc. v. Shell Oil Co.},\footnote{381 F.3d 627, Bus. Franchise Guide (CCH) ¶ 12,891 (7th Cir. Aug. 24, 2004).} brought suit under the Petroleum Marketing Practices Act (“PMPA”), claiming that a take-it-or-leave-it set of revisions on renewal amounted to a constructive non-renewal. The franchisee asserted that the new agreements that had to be signed on renewal included “illegal and unconscionable provisions, including ‘unlawful waivers, forfeitures, penalties, limitations of liability, reductions of the applicable statute of limitations . . . unconscionable penalties in the form of liquidated damages, commercially unreasonable and
excessive transfer fees and unreasonable restraints on alienation of the franchisee’s interest in the franchise . . . .”

The franchisor advised the franchisee that the franchisor’s proffered terms were non-negotiable and that if they were not accepted, a non-rescindable notice of non-renewal would be issued. The franchisee signed the agreement under protest, then brought suit for constructive termination. The court held that the franchisee could not sign under protest and file suit under the PMPA. When the franchisee was presented with the take-it-or-leave-it renewal terms, it had a choice of either accepting those terms or moving for an injunction under the PMPA to prevent non-renewal. Because the franchisee had signed the renewal agreement, it had no claim for wrongful non-renewal.

C. Release As A Condition Of Renewal

A common condition for the renewal of a franchise relationship is that the franchisee execute a full release. The best justification for this requirement is that a franchisor should not be obligated to renew its relationship with a franchisee who is unhappy with the system.

In Lee v. General Nutrition Companies, Inc., renewal was conditioned on the execution of a release in a form satisfactory to the franchisor. During the pendency of a RICO claim, the franchisee was required to either sign a release, as a condition of a 20-year franchise renewal, or risk losing its two franchised locations. The franchisee signed the releases, under alleged economic duress.

After signing a release so that they could transfer their franchises, the plaintiffs brought suit, claiming that their need to transfer left them with no choice but to execute the release. The court rejected claims of duress because the franchisee had agreed to the release as a condition of renewal when it signed its initial franchise agreement, at a time when it was under no business duress and could choose from different franchise systems.

A similar result occurred in Blockbuster, Inc. v. C-Span Entertainment, Inc., where a franchisee had previously signed a release as a condition of a transfer of his franchises to a corporate entity. The franchisee had then obtained a multi-million dollar damages award against Blockbuster. On appeal, the court enforced the release over the franchisee’s argument of failure of consideration and overturned the damages award.

282 Id. at 628.


284 Id.


VII. TRANSFER AND SALE ISSUES

A. Transfer By Franchisor

Most commercial contracts are freely assignable. Franchisors justify the retention of the right to approve franchisee transfers because the contracts are deemed personal as to the franchisee—a substitute assignee cannot be forced on the franchisor unless the conditions for transfer have been met. Do franchisees have similar rights to challenge transfers by franchisors? Generally, the answer has been no, although the issue has only been raised in a few cases. In Marc’s Big Boy Corp. v. Marriott Corp., a Wisconsin district court considered whether a franchisor could transfer a franchise system without the consent of its franchisees. In 1968, Marriott had acquired the rights and duties of Big Boy Franchises, Inc. with regard to its franchisees. Twenty years later, Marriott assigned its rights as franchisor to its largest franchisee, Elias Brothers.

The plaintiff sued to enjoin “Marriott from abandoning its obligations to [the plaintiff] under the franchise agreements.” The court initially observed that the duties of a corporation are generally delegable. The issue was whether performance by the assignee would vary materially from performance by the assignor.

The franchisee was concerned that Elias might not be as good a franchisor as Marriott. There was no evidence on the record, however, that Elias would provide inferior services to its franchisees. The court noted that Elias was itself a franchisee of the system, and, thus, familiar with the duties of franchise administration. The court also noted that every other franchisee but the plaintiff had consented to the assignment and released Marriott from its obligations. The court, therefore, declined to issue an injunction.

In a dispute over the sale of the Burger Chef system, the court observed:

... nothing in any of the franchise agreements signed by plaintiff related to the ownership of the Burger Chef company. There were no provisions, express or implied, suggesting that corporate ownership of the Burger Chef Systems would remain static. Thus, the identity of the corporate parent of Burger Chef was not part of the subject matter of the contract.

(3d Cir. Mar. 26, 1997) (upholding release as a condition of transfer); Franchise Management Unlimited, Inc. v. America’s Favorite Chicken, 561 N.W.2d 123, Bus. Franchise Guide (CCH) ¶ 11,101 (Mich. Ct. App. Jan. 24, 1997) (failure to sign a release as a condition of transfer was a default; until the release had been signed, the court could not compel a franchisor to approve a requested transfer); McDonald’s Corp. v. Magruder, Bus. Franchise Guide (CCH) ¶ 10,774 (D. Ariz. Sept. 28, 1995) (approving right to condition relocation on having the “slate wiped clean” by release); Giampapa v. Carvel Corp., Bus. Franchise Guide (CCH) ¶ 11,442 (D.N.J. June 18, 1998) (upholding right to condition expansion on release).

288 Id.
290 Id. at 1352.
There was, therefore, no reason why ownership of the Burger Chef franchise system could not be sold.

In *Clark v. BP Oil, Co.*, the court also found no contractual justification for blocking the sale of a franchise system:

While it is safe to assume that BP is a corporation of considerably more wealth than Downey, there is no evidence to show that any financial difference between the refiner and the distributor in itself affects the performance of the franchisor’s obligations under the dealer lease and supply agreement.

In another case, Red Lion franchisees sued Hilton in New York District Court after it sold the Red Lion brand to a smaller hotel company that became the new franchisor. The plaintiffs alleged that they were given oral assurances that Hilton would never sell the Red Lion brand. One of the franchisee-plaintiffs negotiated an exit clause that allowed it to leave the system after three years if Hilton sold the brand.

The court determined that one of the plaintiffs was a sophisticated party, represented by counsel, who should have understood the risk of a Red Lion sale and attempted to negotiate certain rights if such a sale occurred. Although the other plaintiff was not a sophisticated party, the court found that it could not have reasonably relied on statements that Hilton was going to grow and promote the Red Lion brand.

The court found an absence of scienter and lack of reasonable reliance and dismissed the case on summary judgment, a ruling affirmed by the Second Circuit. The court also dismissed the plaintiff’s claims that they had not received the same quality of reservations system and marketing after the sale of the system. The plaintiffs had bargained for the Red Lion reservations and marketing systems and had received those, even if the ownership of the franchisor had changed. The court found that the agreements did not specify the extent and type of marketing or detail the reservations system that would be provided.

The agreements provided that if the Red Lion brand were to be sold that Hilton’s reservations system would no longer be available to franchisees. The plaintiffs asked the court to “look to the understanding and expectations of the parties in order to determine the terms of the marketing and reservation portions of the Franchise Agreements.” The court found that these provisions were not ambiguous. The plaintiffs had not negotiated for the “world class” reservation and marketing services that they claim they had been promised. The agreement promised them the Red Lion marketing and reservations systems and they received those systems, even if the ownership of Red Lion changed.

**B. Transfer Issues—The Prospective Franchisee**

Once the franchisee has made the decision to exit the franchised system by way of a transfer or sale to a third party, the franchisee’s objectives are generally to cut all ties with the franchisor as quickly as possible and receive as high a price for the franchised unit as

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possible. Unlike the franchisee, the franchisor is likely more concerned with the prospective transferee’s qualifications and the franchisor’s ability to continue receiving an income stream. Given these divergent objectives, it is not surprising that the transfer of a franchise creates a fair potential for litigation.

The easiest and best way to avoid litigation in connection with the potential transfer or sale of a franchise is to ensure that the franchise agreement contains a well crafted and fair transfer provision. Such a provision should set forth specific qualifications that any proposed transferee would be required to meet, and so long as the proposed transferee meets those qualifications, the franchisor should agree to approve the transfer.

Some qualifications often found in transfer provisions require the prospective transferee to demonstrate a good moral character, financial well-being, and experience operating the type of business in question. If, however, the proposed transferee is already in the franchised system, demonstrating that the proposed transferee meets these qualifications is much easier. Even if certain express qualifications are set forth in the transfer provision, some courts might determine that the franchisor may not refuse to approve a proposed transfer on that basis if those qualifications had not been required of prior prospective franchisees. For example, in *BASCO, Inc. v. Buth-Na Bodhaibge*, the Eighth Circuit held that a franchisor may have breached the franchise agreement by refusing to approve a transfer where the evidence showed that the proposed transferee had greater financial ability than the majority of franchise applicants in the system, and the franchisor had failed to require other proposed franchisees to devote one hundred percent of their time to operating the franchise.

Perhaps the most litigated provision relating to the transfer of a franchise is a requirement that the franchisor is under an obligation to act reasonably in evaluating proposed transferees. While many franchisee counsel believe that the franchise agreements should include an express provision requiring the franchisor to act reasonably (and if one is not included, the franchisee should negotiate for one prior to signing), courts will on certain occasions utilize the implied covenant of good faith and fair dealing to require the franchisor to

\[293\] One provision that disturbs franchisee lawyers is a provision that requires the franchisee to personally guarantee the proposed transferee’s performance for a number of years after the sale has been consummated. When a franchisee elects to exit the system, the last thing that a franchisee wants to do is have a continuing relationship with the purchaser and the franchisor. Franchisee counsel often attempt to have these provisions removed before the franchisee signs the agreement.

\[294\] See, e.g., *Holt Motors, Inc. v. General Motors Corp.*, 860 F.2d 1079 (table) (6th Cir. 1988) (stating that withholding approval of a transfer was reasonable where the proposed transferee failed to provide about its major investors).

\[295\] See, e.g., *Portaluppi v. Shell Oil Co.*, 869 F.2d 245 (4th Cir. 1989) (stating that it was not unreasonable to deny transfer to an individual, where that individual “had no previous experience” operating a service station); see also *Sun Refining and Marketing Co. v. Brooks-Maupin Car Centers, Inc.*, Bus. Franchise Guide (CCH) ¶ 9325 (E.D. Mich. 1998).

\[296\] For example, in *Bayview Buick-GMC Truck, Inc. v. General Motors Corp.*, 597 So.2d 887 (Fla. App. 1992), the court held that the proposed transferee’s qualifications were “presumptively acceptable,” given that the proposed transferee was “already a dealer of GM motor vehicles”; see also *Richter v. Dairy Queen of Southern Arizona, Inc.*, 643 P.2d 508 (Ariz. Ct. App. 1982).

\[297\] 198 F.3d 1053, Bus. Franchise Guide (CCH) ¶ 11,756 (8th Cir. 1999).

\[298\] Id. at 1058.
act reasonably when evaluating the proposed transfer, even if the language in the contract does not require it.

For example, in *Larese v. Creamland Dairies, Inc.*, the Tenth Circuit was presented with the question of "whether a franchisor has a duty to act reasonably in deciding whether to consent to a proposed transfer." While a franchisor’s obligations related to approving a proposed transfer are often set forth in the text of the agreement, the franchise agreement at issue was silent as to whether the franchisor had an absolute right to withhold consent or, instead, had to act reasonably in deciding whether to consent to a proposed transfer. The court began by noting “that the franchisor-franchisee relationship is one which requires the parties to deal with one another in good faith and in a commercially reasonable manner.” Given this implied obligation of good faith, the court stated that an absolute right to withhold consent could not be found in a transfer provision "which provides simply that the franchisee must obtain franchisor consent prior to transfer." Instead, the court held that the transfer provision required the franchisor to act reasonably in determining whether to grant its consent to the proposed transfer.

**VIII. NON-COMPETITION PROVISIONS**

**A. Post-Term Covenants Not To Compete In Franchise Agreements**

Franchise agreements almost always include both post-term and in-term covenants not to compete, and enforcement of these covenants comprises an increasing amount of litigation between franchisors and their current or former franchisees.

Non-compete covenants in franchise agreements are largely viewed as a hybrid of employment and sale of business contracts that aim to protect the goodwill associated with a franchisor’s marks and system. In general, states are divided as to whether non-competes in franchise agreements should be treated in the same manner as non-competes in employment agreements or those in sale of business contracts.

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299 767 F.2d 716 (10th Cir. 1985).

300 Id. at 717.

301 The franchise agreement stated that the franchisee “shall not assign, transfer or sublet [the] franchise, or any of [the] rights under [the] agreement, without the prior written consent of [the franchisor].” Id. at 716-17.

302 Id. at 717.

303 Id. at 718. Even if the transfer provision itself does not obligate the franchisor to act reasonably, at least one court has looked at other areas of the franchise agreement to require a franchisor to act reasonably when evaluating a proposed transfer. *See Woody v. General Motors Corp.*, 9 F.3d 1107, Bus. Franchise Guide (CCH) ¶ 10,336 (4th Cir. 1993) (looking not only at the transfer provision, but also the relocation provision and the disposition of assets provision of a franchise agreement in determining that the franchisor had a duty to act reasonably in evaluating a proposed transfer).

304 Id. (noting that if the franchisor “must bargain for a provision expressly granting the right to withhold consent unreasonably”); *see also Prestin v. Mobil Oil Corp.*, 741 F.2d 268 (9th Cir. 1984).

1. **Scope Of Post-Term Non-Competition Clauses**

A post-term restrictive covenant in a franchise agreement generally defines a time period following termination or expiration of the franchise agreement during which the restriction is effective, along with the specified geographic area in which the restriction applies and a description of the scope of the activity restricted. The scope of each of these provisions must be reasonable for a court to find that a non-compete is enforceable.\(^{306}\)

In *Pirtek USA, LLC v. Layer*, the court held that a franchisor’s covenant not to compete was reasonable as to time, distance and line of business when it restricted the former franchisee’s activities for two years after termination of the franchise agreement, within fifteen miles of Pirtek franchise territory or promotional zone, and as to the sale of products and services similar to the products and services sold by a Pirtek business.\(^{307}\)

Many courts hold that geographic limitations “must be tailored so that the scope of the agreement is no greater than reasonably necessary to protect” a legitimate business interest.\(^{308}\) While non-competes prohibiting competition within a former franchisee’s territory, and even for some radius outside of that territory, may be reasonable, prohibiting a former franchisee from competing within other franchisee’s territories may be unreasonable.\(^{309}\)

Covenants not to compete must also be reasonable in regard to the scope of activity restricted. In *Bennigan’s Franchising Co. v. Swigonski*, the court held that the franchisor was unlikely to succeed on the merits of its claim to enforce a post-term non-compete because the covenant contained an overbroad restriction upon the operation of “any casual dining or other restaurant business.”\(^{310}\) The fact that the franchise agreement included a list of what it deemed to be “casual dining” businesses did not sufficiently limit the overbroad nature of the restriction because there was no “common thread” among the restaurants listed.\(^{311}\)

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307 *Bus. Franchise Guide (CCH)* ¶ 13,527 (M.D. Fla. Sept. 23, 2005). See also *Victory Lane Quick Oil Change, Inc. v. Hoss*, No. 07-14463, 2009 WL 5943234, at *6 (E.D. Mich. Nov. 13, 2009) (three year, 10 mile limitation was reasonable); *Naturalawn of Am., Inc. v. W. Group, LLC*, 484 F. Supp. 2d 392, 400 (D. Md. 2007) (holding that a covenant not to compete was clearly reasonable under Maryland law because it extended only to the former franchisee’s territory for a two-year period after termination of the franchise agreement); *ServiceMaster Residential/Commercial Servs. L.P. v. Westchester Cleaning Servs., Inc.* No. 01 Civ. 2229, 2001 WL 396520 (S.D.N.Y. April 19, 2001) (one-year, single-county restriction was valid); *Quizno’s Corp. v. Kampendahl*, No. 01 C 6433, 2002 WL 1012997 (N.D. Ill. May 20, 2002) (two-year, five-mile radius from original location restriction was valid).

308 See, e.g., *Victory Lane* at *6.


311 *Id.* at *3.
Similarly, in *Novus Franchising v. Oksendahl*, the court held that the franchisor had failed to show a likelihood of success on the merits of its claim that the former franchisee was breaching the post-term non-compete because the covenant was not reasonable. The covenant, which prohibited competition with the franchisor’s “Business System,” broadly restricted activities beyond the former franchisee’s continued use of the franchisor’s marks and products, and, therefore, was overbroad.

Additionally, litigators should note that some states have statutes governing the enforceability of restrictive covenants. These statutes may be very useful for former franchisees defending against motions brought by a franchisor to enforce a restrictive covenant and arguing that the scope of the non-compete is unreasonable.

**B. In-Term Covenants**

Franchises often involve trade secrets. Franchisors are often reluctant to allow their franchisees to operate businesses that compete with the franchised business because a franchisee could take advantage of trade secret information—whether on sources, pricing, market research, competition or know how—to operate a non-franchised business which does not pay royalties to the franchisor but still takes advantage of the franchisor’s trade secrets. Franchisees often complain that these purported concerns of franchisors are no more than anti-competitive restrictions that should not be enforced for public policy reasons.

In *Atlanta Bread Co. Int'l v. Lupton-Smith*, the franchise agreement provided that neither the franchisee nor any principal shareholder could “directly or indirectly engage in, or acquire any financial or beneficial interest in (including any interest in corporations, partnerships, trust, unincorporated associations or joint ventures), advise, help, guarantee loans or make loans to, any bakery/deli business whose method of operation is similar to that employed by store units within the System.”

Under Georgia law, contracts that restrain trade are void against public policy. Atlanta Bread contended that the cited provision was merely a “loyalty provision” rather than a restrictive covenant, and should not be scrutinized for reasonableness as to time, territory and scope. The Georgia Supreme Court disagreed, holding that the provision prohibited the franchisee from engaging in certain types of businesses during the term of the agreement, making it a partial restraint of trade. When such provisions “are found in franchise or distributorship agreements, [Georgia] jurisprudence has held time and again that these restraints are subject to strict scrutiny, receiving the same treatment as non-competition covenants found in employment contracts.”

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313 *Id.*
314 See, e.g., *CAL. BUS. & PROF. CODE § 16600; COLO. REV. STAT. § 8-2-113(2).*
316 *Id.* at 588.
317 *Id.*, 258 Ga. at 589.
Comedy Club, Inc. v. Improv West Assocs.\textsuperscript{318} was a franchise dispute between two comedy clubs. An arbitrator had ruled that the licensor could enforce a nationwide in-term covenant not to compete against a licensee. The Ninth Circuit came to consider the arbitrator’s award after the Supreme Court’s decision in Hall Street Assocs. LLC v. Mattel, Inc.\textsuperscript{319} By all rights, the court’s review of the arbitrator’s award should have been circumspect in light of that decision. The court, however, applied the manifest disregard of the law standard, stating that it still remained the standard for overturning an arbitration award in the Ninth Circuit.

The Ninth Circuit found that the arbitrator’s award was, in fact, in manifest disregard of California law, because an in-term covenant in a franchise agreement is void if it forecloses competition in a substantial share of a business, trade or market. Against this standard, the court found that a covenant not to compete in the entire United States until 2019 was so broad that it foreclosed competition in a dramatic geographic and temporal scope. The Ninth Circuit ruled that the arbitrator’s award should be vacated as to any county where the licensor did not currently operate a comedy club.

Given its arbitration context, Comedy Club is a questionable decision. It appears to be another instance where the Ninth Circuit had just had enough of what it perceived to be an overly restrictive form franchise agreement. The court was particularly incensed that the in-term covenant extended to cousins of former spouses and that the arbitrator’s injunction was directed at such persons. Despite its acknowledgement that it was working under a highly deferential standard as to the arbitrator’s award, the court was disturbed by a bar against competition in forty-eight states that lasted until 2019.

Comedy Club may demonstrate that those who over-reach in their contract provisions are likely to face an unwilling court in the Ninth Circuit when they move to enforce those terms. Those drafters of contracts who look to squeeze their counterparts to the last drop might think twice about adopting such an approach, especially in the Ninth Circuit. Judge Kozinski’s comments in the Nagrampa case, cited above in the introduction section, show the perception of the Chief Judge of the Ninth Circuit that judges are hostile to over-reaching form-contracts. These concerns should be considered when franchise agreements are drafted.

The Comedy Club decision is extraordinary in finding not only that in-term covenants are invalid under California law, but that an arbitrator’s enforcement of an in-term covenant was so contrary to the law that it warranted vacating the arbitrator’s award. This point is underscored by the opinion in Keating v. Baskin-Robbins USA, Co.,\textsuperscript{320} where a North Carolina district court held, under California law, that it was “beyond cavil that an ice cream franchise may reasonably require a franchisee not to operate a competing ice cream store during the term of its franchise agreement.” The court further observed that “the Ninth Circuit has held that ‘California cases clearly establish that contractual prohibitions against current employees’ competing with their employers do not violate [California statute].’” In other words, just a few years before the Comedy Store decision, a federal district court viewed California law as the arbitrator did. The effect of Comedy Store on California law will have to be observed in the next few years.

\begin{itemize}
\item \textsuperscript{318} 553 F.3d 1277, Bus. Franchise Guide (CCH) ¶ 14,055 (9th Cir. Jan. 29, 2009).
\item \textsuperscript{319} 128 S.Ct. 1396 (2008).
\item \textsuperscript{320} Bus Franchise Guide (CCH) ¶ 12,102 (E.D.N.C. Mar. 27, 2001).
\end{itemize}
C. Public Policy Concerns

In the past, courts have held that non-compete covenants in franchise agreements were illegal restraints of trade and void as contrary to public policy. However, some courts now routinely enforce non-compete covenants that are within a lawful contract, reasonable, and not contrary to the public interest, where there is no statutory prohibition.

Courts have noted a public interest in preventing customer confusion and in enforcement of assumed contractual obligations, including covenants not to compete. For example, in Furniture Media, L.P. v. Jantzen, the court held that the public interest would not be harmed by the enforcement of a post-term covenant not to compete in a franchise agreement because there was no evidence that customers would not be served, and the public had an interest in preventing those who purchased franchises from appropriating the franchisor's knowledge and information. Franchisors may have a good argument that enforcement of a post-term covenant not to compete will serve the public interest.

On the other hand, franchisees seeking to avoid enforcement of an unreasonable non-compete should point out that the public has a significant interest in ensuring that only reasonable non-compete covenants are enforced. Covenants that operate only to put the former franchisee out of business and fail to remedy any potential wrong to the franchisor are contrary to the public interest.

D. Legitimacy Of The Asserted Franchisor Interest

1. Goodwill

The argument most commonly asserted by franchisors seeking to enforce post-term noncompetes is that the franchisee’s breach would result in customer confusion, leading to injury to the franchisor's brand, trademark and goodwill.

In Atlanta Bread Co. International, Inc. v. Nine Star Enterprises, Inc., the franchisor sought a preliminary injunction enforcing a non-compete because the former franchisee was operating a deli in the building where he had operated the franchise, and continued to sell the franchisor's products. In granting the franchisor's motion for injunctive relief to enforce the non-

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322 Id.


324 Certified Restoration Dry Cleaning Network, LLC v. Tenke Corp., 511 F.3d 535, 551, Bus. Franchise Guide (CCH) ¶ 13,748 (6th Cir. 2007); see also NaturalLawn of Am., Inc. v. W. Group, LLC, 484 F. Supp. 2d 392, 401-402 (D. Md. 2007) (noting that the public interest would be served by the issuance of injunctive relief to enforce a covenant not to compete because there is a public interest in repudiating activities such as the former franchisee's blatant breach of the non-compete).


327 Bus. Franchise Guide (CCH) ¶ 12,521.
compete, the court noted that, until the former franchisee ceased operation, the franchisor had lost control of its trademark and reputation. Thus, courts will likely be willing to enforce a covenant not to compete in order to protect a franchisor’s trademark and the associated goodwill when a former franchisee operates a business that is competitive with the franchised business out of the same location where he operated the franchised business, and while continuing to sell the franchisor’s product.

Likewise, in Lockhart v. Home-Grown Industries of Georgia, Inc., the court granted a preliminary injunction enforcing a non-competition provision when the franchisor presented evidence that the former franchisee was reaping the goodwill established by the franchisor. The fact that the former franchisees continued to operate restaurants in the same location as their franchises, and offered almost exactly the same products, thereby attracting the same customers, supported a finding of irreparable harm to the franchisor’s goodwill.

On the other hand, courts are less likely to find protection of the franchisor’s goodwill and avoidance of customer confusion to be legitimate interests warranting protection through enforcement of a non-compete when the franchisor’s trademarks are not threatened. In Bennigan’s, the court held that the franchisor failed to make the showing of irreparable harm to the Bennigan’s marks necessary to support the issuance of injunctive relief. The former franchisee, while continuing to operate a casual dining restaurant in the location where he had operated the franchised restaurant, removed all of the franchisor’s marks and substantially deidentified the restaurant. The Bennigan’s court also emphasized the fact that the former franchisee’s restaurant was 210 miles from the closest franchised restaurant, making it unlikely that customers would be confused.

The Bennigan’s opinion reinforces the theory that franchisees may have a strong argument against enforcement of a non-competition provision if they can demonstrate a lack of potential customer confusion resulting from the alleged breach.

328 Id.
329 Id.
332 Id.
333 Id.
334 See also Curves International, Inc. v. Mosbarger, 525 F. Supp. 2d 1310, 1315 (M.D. Ala. 2007) (holding that the risk of customer confusion was negligible when the former franchisee’s new gym used different equipment and operated at a new location and under a different name as the franchised gym); Noodles Dev. L.P. v. Ninth St. Partners, LLP, 507 F. Supp. 2d 1030 (E.D. Mo. 2007) (holding that a restaurant franchisor was unable to establish irreparable harm to its goodwill or customer confusion when the former franchisee operated a new restaurant at the same location after removing all items related to the franchise and changing the menu, name, and general look of the restaurant); Second Cup Ltd. v. Niranjan, Bus. Franchise Guide (CCH) ¶ 7,397 (Ont. Aug. 17, 2007) (holding that the difference between organic and nonorganic coffee was enough to distinguish a former franchisee’s coffee shop from the franchised shop).
2. Efforts To Refranchise And The Phantom Franchise Purchaser

A franchisor that can demonstrate that it has been unable to establish new franchises in the former franchisee’s territory due to a breach of a covenant not to compete will likely be able to enforce that non-compete in court. The same can be said when a franchisor can show that a former franchisee’s breach of a restrictive covenant has harmed the franchisor’s relationships with other franchisees, and its ability to enforce existing franchise agreements.

Yet, the failure of a franchisor’s efforts to refranchise in the former franchisee’s territory is not always sufficient evidence of the irreparable harm that a franchisor must establish in order to obtain equitable relief enforcing a covenant not to compete. For example, in Novus Franchising, Inc. v. Oksendahl, the court held that the franchisor’s claimed inability to refranchise the former franchisee’s Area of Primary Responsibility did not constitute irreparable harm when the former franchisees were providing competing services, but not in connection with the Novus name. The court stated that “Novus’s alleged difficulties in re-franchising the area would have no apparent connection to the goodwill associated with Novus products and services.” Thus, franchisors must be able to establish a causal relationship between a former franchisee’s breach of a non-compete and the franchisor’s inability to refranchise the territory.

Then again, in some states, franchisors will have to try to refranchise—and fail—in order to get relief enforcing a restrictive covenant. In Pirtek USA, LLC v. Whitehead, the court held that the franchisor seeking a preliminary injunction to enforce a non-competition provision had failed to establish a likelihood of success on the merits of its claim that the former franchisee had breached the restrictive covenant because the franchisor was not operating or attempting to operate a franchise in the area covered by the restrictive covenant. Under a Florida statute governing restrictive covenants, the franchisor’s lack of efforts to franchise the covered territory could deem the covenant unenforceable.

IX. CONCLUSION

In recent years, some courts have shown what has been referred to as a hostility towards form contracts and an unwillingness to enforce terms in franchise agreements that appear to be over-reaching. Contract forms that were drafted at a time when courts could be expected to enforce nearly any terms agreed upon by the parties in an agreement should be re-drafted to take into account a developing judicial sensibility that has a different perspective.

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335 See, e.g., Lockhart v. Home-Grown Indus. of Ga., Inc., No. 3:07-CV-297, 2007 WL 2688551, Bus. Franchise Guide (CCH) ¶ 13,709; NaturaLawn of Am., Inc. v. W. Group, LLC, 484 F. Supp. 2d 392 (D. Md. 2007) (holding that the franchisor was irreparably harmed because it was unable to refranchise the former franchisee’s territory as a result of the breach).

336 Id.


338 Id. at *5.


341 Id. (referencing FLA. STAT. ANN. § 542.335(b)).
Courts are far more likely to enforce contracts that include mutuality of rights and limitations that appear to be somewhat reasonable. The Ninth Circuit’s decision in the Comedy Club case is a good case in point. There, the court went out of its way to set aside an arbitrator’s award because the court believed that the contract, as written, was over-reaching and unfair.

As the law of franchising develops, there are subtle changes that ought to be made, both as to the tone and terms, of franchise agreements, to ensure that the intentions of the parties are fully enforced. Issues like distribution through as yet undiscovered channels of distribution must be taken into account, along with developments in the substantive law. Ideally, better-drafted franchise agreements would provide clarity as to many of the procedural issues which often become the focus of litigation, so that the parties can devote their resources to litigating and resolving the substantive issues in dispute.
Jonathan Solish or his firm were counsel on:

*Custom House v. Doubletree*

*Lee v. GNC Franchising*

*In re Hale v. Conroy’s*
Bus. Franchise Guide (CCH) ¶ 12,177 (JAMS arbitration June 14, 2001)


*Red Roofs Inns, Inc. v. Murat Holdings, LLC*
223 S.W.3d 676, 684 (Tex. App. 2007)

*Belverd v. IHOP*
Bus. Franchise Guide (CCH) ¶ 12,026 (M.D.N.C. 2000)

Bus. Franchise Guide (CCH) ¶ 10,721 (S.D.Cal. 1995)

*Nagrampa v. MailCoups, Inc.*
469 F.3d 1257, Bus. Franchise Guide (CCH) ¶ 13,489 (9th Cir. Dec. 4, 2006) (en banc)

354 Fed. Appx. 496 (2d Cir. Nov. 25, 2009), Bus. Franchise Guide (CCH) ¶ 13,745

*Ramada Franchise Systems, Inc. v. Kouza,*


John Holland or his firm were counsel on:

*Novus Franchising, Inc. v. Oksendahl*

*TCBY Systems, Inc. v. RSP Co.*

*Blaske v Burger King Corp.*

*Dunafon v. Taco Bell Corp.*

*Emporium Drug Mart, Inc. v. Drug Emporium Inc.*
Heck Implement, Inc. v. Deere & Co.

Paul E. Carlson, Inc. v. Trak International
Bus. Franchise Guide (CCH) ¶ 11,190 (D. Minn. 1997)

Shaull Equipment & Supply v. Rand

Wadena Implement Co. v. Deere & Co.
480 N.W.2d 383, 387 (Minn. Ct. App. 1992)
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