Differential Treatment of Franchisees in Tough Economic Times

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I. Introduction

Differential Treatment of Franchisees in Tough Economic Times is quite a mouthful for franchisor and franchisee alike. But good, bad or indifferent, it is an unfortunate reality in today’s tumultuous economy. Franchisors are facing some of the most difficult times in their respective systems due to little or no available credit, less consumer spending, varying demands from franchisees, difficult state and federal legal hurdles, and very little extra capital both domestically and worldwide.

Differential treatment of franchisees is a frequent franchisee claim and is more often than not styled as some type of discrimination claim arising from support issues, terminations, royalty concessions, waivers and deferments, encroachments, product distribution issues, debt rearrangement, and so on. The complaining franchisee usually relies on legal theories arising from common law doctrines and specific state anti-discrimination and relationship statutes. Most states do not specifically regulate disparate treatment of franchisees. As discussed below, there are a number of states that do attempt to broadly regulate discrimination by franchisors, and the statutes of these states place the burden of proving unlawful discrimination squarely on the franchisee.

The numerous discrimination claims franchisors have faced throughout the years have caused most franchise systems to take a rather hard line approach, if not a policy implementation, of treating all system franchisees identically regardless of circumstances. Most franchise systems have adopted such an approach to avoid discrimination claims by franchisees even though such a hard line attitude may have adverse consequences to the affected franchisees, and even to the franchisor and the system.

While lawyers disagree on even the definition of the word “discrimination,” most would agree that not all discrimination is or should be unlawful. Even franchisor and franchisee counsel would probably agree that markets are different due to a number of geographical and socio-economic variables and that franchisee circumstances may differ dramatically due to those variables and other influences that franchisees simply do not share in the system from market to market or territory to territory. Often such circumstances require franchisees to operate differently and often on the edge of compliance with system standards.

At the time this paper is being written, both the world economy and that of the United States are mired in what the most learned economists are viewing as the deepest recession since the FDIC crash of the mid-1980s, with many comparing it to the Great Depression of the 1930s. The United States is 14+ trillion dollars in debt with no relief in sight, and unemployment is climbing weekly. Banks and other lenders have not only rolled up the red carpet for new loan applicants, they have almost removed it completely. While franchisors and franchisees plod through this economic recession, many interesting and new challenges will emerge on both spectrums. Such economic times will require, if not force, both franchisors and franchisees to engage in cooperation, collaboration, innovation and sharing on a level probably never before seen in the franchise community; and, that is just to weather the economic storm.

In such an environment, the question becomes: with a wide and diverse variety of economic influences and circumstances affecting franchisees, can or should a franchisor treat all franchisees the same even though strong economic and business reasons urge the franchisor to treat franchisees differently? This short dissertation will examine disparate treatment of franchisees from various standpoints, taking into account these trying economic times. These standpoints will range from franchisor enforcement decisions to franchisee claims
II. Franchise System Issues Arising More Often In Tough Economic Times

A. The General State of Financing

Whether you are a franchisor, franchisee or potential franchisee, to further your business you need money. It doesn’t matter what you need money for, whether to remodel an existing unit, continue your development, expand your system, buy a franchise, or simply get some cash flow dollars, your business simply cannot go forward without it. Franchise system issues arising more often in tough economic times are universally centered around money. Access to credit, factoring, and merchant cash advances are a necessity to not only expand business, but to survive.

In early July 2011, the Wall Street Journal flashed statements like “Smaller Businesses Seeking Loans Still Come Up Empty” and “businesses expected 2011 to be the moment a years-long credit freeze would finally begin to thaw. But borrowing has only gotten worse.” Not encouraging signs for those seeking credit. The dozens of articles published in the past few months in numerous publications addressing the small business and franchise credit crunch all have the same theme, “Credit Access Is The Number One Issue Affecting Business/Franchise Growth.”

The U.S. Chamber of Commerce Small Business Outlook Survey, April 2011, posted some interesting survey results from the small business sector. Small business owners almost universally agree - by a 73% to 17% margin - that the lending climate of the last two years has hindered their growth.1 Small business owners are worried about current regulations but are even more concerned about what Washington will do next. 80% said America’s debt and deficit have a negative impact on their business and 72% said the health care law has made hiring and conducting business more difficult.2

Regardless of the cause of the current economic crises it is clear that the current lending attitude and perspective on small business credit, which is the life blood of many franchise systems, is dim and that money is tough to find. All aspects of franchise lending are tight in these uncertain economic times even though the franchise industry continues to grow. Regardless of general franchise industry growth, most banks will not give a franchise loan any more preference than any other business loan, especially to a new customer. Whether franchisor or franchisee, if a party does not have the necessary free and clear assets to put up as collateral coupled with the demonstrable means to timely repay the loan, it will probably not get a traditional loan, from anyone. With the existing credit crunch in the franchise world, an additional burden is imposed on the franchisors as, when there is no credit available by third party means, the franchisees will look to the franchisor for help. As examined below, such help may come in various forms such as franchisor financing, franchisor assisted financing, royalty deferral, and other similar programs.

1. Financing Programs Provided By Franchisor or its Affiliate

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2 Id.
Because of today’s void in traditional and/or third-party lending, the question “does the franchisor get into the lending business” begs to be asked. Such a question is probably worthy of dissertation of its own, but today it is a decision many franchisors are facing. Banks and other lending institutions determine who is worth loaning money to by simply keeping track who pays them back and who doesn’t. A franchise system obviously has no data like this on a loan to a new franchisee so that loan is basically a roll of the dice, although it is also a confirmation of belief in the success of the brand by the franchisor. But in today’s economy, the franchisor may find itself loaning money to an otherwise uncreditworthy individual or company in order to expand or maintain their system. For franchisors who loan money to their franchisees, there are clear downsides. They include but are not limited to - (i) tying up capital (which may have better system uses including growth); (ii) booking the contingent liabilities which drag down the balance sheet; (iii) carrying the sole risk of collection or loss in the event of default; (iv) incurring the cost and hassle of servicing the loans; (v) being perceived as the heavy handed loan collector; (vi) losing opportunities to fund key projects, etc. because of capital shortfall; (vii) incurring a lot of frustration in having to wait years for monthly note payments to dribble in; (viii) fearing not only financial loss from the loans if their franchisees default but also having to close a franchise; and, the worst yet, (ix) fear of somehow being drawn under federal or state regulators for some unknown lending violation. Now ask again, is a franchisor who loans money to its franchisees smart or just reacting to today’s credit crunch?

If a brand is on the down side of the SBA 585 list, no lender may be willing to extend any credit to franchisees thus leaving the franchisor being the only lender standing. Then the big question may become, expand and finance - or - don’t finance and don’t expand? Even a franchisor who decides to lend will face a multitude of lending regulations and hurdles that require compliance in each state and federally in order for a franchisor to become a legal lender. A decision merits examining all applicable lending laws in the jurisdictions in which a franchisor intends to engage in lending business.

2. Financing Provided Through A Third Party and The Franchisor’s Role

As discussed above, lending to franchisees has changed dramatically in the past two years alone. Prior to 2008, lenders would just underwrite the franchisee, but today the lender will scrutinize the franchisor and find it necessary to approve the franchise system even before discussing a loan with the franchisee. Today the lender carefully examines the franchisor, the system and the brand and must be comfortable with the franchisor or a lender won’t even bother entering into discussions with a potential franchisee borrower. If the franchise system has recent “lending issues”, that franchisor may have to explain why their franchisees had a large failure rate with the SBA or other lenders. Without a very plausible failure rate explanation it is doubtful that a lender would even consider lending to such a franchise system. Today, lenders and other financial institutions want all the franchisor’s disclosures, including the audited financial statements, closure history, etc. and it is incumbent upon the franchisor to provide the lender with the “right stuff” in order to help the franchisee obtain financing. Often the lender will ask the franchisor to step up and co-sign a franchisee’s loan which can be a very dangerous practice for many reasons. Guaranteeing franchisee loans is a risky business practice for any franchisor as it goes on the FDD, it may lead to discrimination claims from other franchisees, it ties up valuable assets on the balance sheet, it exposes the franchisor to liability not totally under its control and the list goes on. Unless the co-signing franchisor is golden, the loan may still be denied as the franchisee applicant will still need cash, credit and collateral or the result may be the same, no loan.
B. Development Quotas

When the franchisor and the master/developer/franchisee enter into an agreement with a specific development quota, the quota is usually the result of well thought out planning and open negotiations on the part of both sides. Development quota usually means the minimum number of stores a franchisee agrees to have open and in operation at the end of each development period. A development quota with respect to each development period is usually set out in the master franchise agreement, development agreement or whatever other form agreement is used to make the deal. Tied with the development quota is usually a requirement that the franchisee is and remains in good standing, timely meeting the expansion criteria and paying the required franchisee fees and other payments due under the agreement. Franchisors normally prefer to hold true to the development schedules as such is usually a part of a well-timed and planned system expansion. However, today is probably a different scenario because of the lending problems, available space, labor and a variety of other commercial forces and circumstances that act on an expanding franchise system.

The primary concern for a franchisor in terminating a development agreement is that the master franchisee, area director or area developer may have been told at some time, through words or course of dealing, that strict conformance with the development schedule was not required. Even in the face of a contractual anti-waiver clause, courts will often find a waiver through conduct or course of dealing. The fact that other area developers are also deficient in their performance but have not been terminated is a fact consistent with the developer’s claim that strict performance has been waived by the franchisor. An “anti-waiver clause” in a development agreement may be insufficient to help the franchisor if a waiver has occurred.3

The failure to terminate any other development agreements for non-performance, combined with representations to the area developer that strict performance would not be required may give rise to a substantial extension of the agreement at issue.

Generally, the franchisor and the franchisee have entered into an agreement with very specific and well thought out development quotas tied to specific development periods. Both parties leave the table confident performance is not an issue as to the development schedule/quota. Well, unfortunately, circumstances changed in ways, most franchisors, franchisees and business folks never anticipated. Such a large change in economic circumstances certainly impacts all aspects of business, including franchise development. In spite of the best efforts of both the franchisor and franchisee in negotiating and setting reasonable deadlines for expansion, conversion and/or construction, an unforeseen change in economic circumstances after the deal was made can make it difficult, if not impossible, for the franchisee to comply with the quota deadlines provided for in the development/franchise agreement. The difficulty often arises from those same old business issues consisting of unavailability of financing, no extra cash flow for development, lack of space or locations, etc. Such circumstances may render those development quotas and deadlines unattainable due to franchise system performance or the general state of the economy. Space and good locations are sometimes very difficult to find and will delay openings even in the best economic times. Franchisors must consider carefully whether it is appropriate under the circumstances to extend quotas and deadlines that are embodied in a development/franchise agreement.

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When the developing franchisee runs into a brick wall due to adverse economic changes, there are a myriad of things a franchisor can do to help the franchisee and still progress with expansion. Even in normal times, expansion has required “flexibility” by the franchisor and waiver and/or modification of development quotas is often the norm, not the exception.

When the developing franchisee calls and states, “I cannot open another franchise this year much less the three called for in my development agreement”, what does the franchisor do? A savvy franchisor may sit down and discuss the quota situation with the franchisee before it deteriorates to termination. Generally, if the failure to meet quotas and deadlines is due to circumstances over which the franchisee has little or no control, the franchisor should be willing to make adjustments to quotas and deadlines. This is especially true in situations where there is poor system performance, lack of available credit, etc. and involves a well-qualified franchisee that is using its best efforts to meet the quotas. If the franchisor wants the franchisee to remain in the system and wants to salvage the relationship, then waiver, modification and/or even a delay in the development should be considered and reconfigured into a schedule/quota that both franchisor and franchisee can live with.

However, if a franchisee is capable of meeting deadlines in all respects and simply elects not to do so, then the franchisor should take necessary and appropriate action under the circumstances. Usually a franchisee not meeting its development quota and deadlines may have some adverse impact on the brand and if the failure to meet quotas is intentional or negligent, the franchisor may have no alternative but to act definitively. Also, from a practical standpoint the franchisor must determine whether or not the franchisee (whether a master, sub, area developer, etc.) is someone it wants in its system. If not, the franchisor may wait for the default and terminate.

C. Upgrades, Including Remodeling, Renovation, Re-Imaging, New Computer Systems, POS and/or Equipment – “Stop, Wait A Minute!” “I Can't Afford It!” – “Not Now!”

When instituting any type of system-wide upgrade program, the franchisor has usually carefully, thoughtfully and systematically walked through the same prior to any implementation. Many times the walk through will include discussions with franchisees and franchisee associations and coops. Along with system upgrades, remodeling, renovation and re-imaging, many franchisors believe the introduction of new computers, point of sale systems and other new equipment may be necessary to maintain a competitive advantage and economically operate the franchise business. This is also true with remodeling, renovation and re-imaging in highly competitive franchise businesses such as fast food and hotels, where franchisors feel the need to continue to enhance their brand standards to maintain that competitive edge. But, in these tough economic times, is today the right time to upgrade? Although differentiation can be made between system-wide upgrades as opposed to selective unit remodel, renovation, re-image or some new equipment, all require the expenditure of money on the part of the franchisee. For the remainder of this discussion, “upgrades” will include upgrades, remodeling, renovations, re-imaging, new computers, point of sale systems and other new equipment.

Often upgrades are already in cycle as part of a continuing system-wide directive or even pursuant to a schedule set forth in the franchise agreement. New equipment is often replaced on a “time in service” measurement or because it becomes obsolete. As with most major franchisee expenditures, a possible economic recession is seldom in the discussion when a franchisor structures upgrade implementation time tables or the life span of a piece of
machinery. Economic woes may occur some 5-10 years after the franchise agreement was signed and the upgrade plans set in stone. More often than not, when franchisors mandate upgrades it is usually to further productivity, gain a competitive advantage and/or improve operations, rather than just for the system’s good looks. Also most upgrades, especially remodeling/re-imaging, usually come with a significant upfront price tag that requires franchisees to reach deeply in their pockets.

Despite the best efforts of a franchisor to set reasonable schedules, deadlines and requirements for upgrades, even in today’s economic environment, franchisees may have difficulty meeting upgrade schedules and deadlines provided for in the franchise agreement or mandated by the franchisor. Today there are a multitude of good reasons why franchisees cannot go forward with upgrades, including the inability of the franchisee to obtain financing, changes in the franchisee’s economic circumstances, cash flow barely breaking even, poor system performance and/or just the general state of the economy.

When a good franchisee sends the message, “Just can’t do it. Don’t have the money,” how does a franchisor respond? Even if a well-qualified franchisee is using its best efforts to comply, but simply lacks sufficient cash and cannot obtain credit or a loan, should the franchisor be willing to make adjustments rather than follow stringent SOP which often leads to termination? What does a franchisor do when 20% or 30% of the system says the same thing? Scrap the upgrade? Enforce? Or, treat the franchisees differently?

What does a franchisor do when a franchisee says, “No, I’m not going to do it”, even though the franchisee is capable of completing upgrades on a timely basis but simply refuses to do so? In such a case the franchisor may have to enforce the upgrade mandate as to not could have a significant adverse impact on the brand as well as other franchisees.

If the upgrade is not a system-wide necessity and can be done on a franchise by franchise basis in an ample time frame, it may behoove the franchisor to view the franchisees’ abilities to implement the upgrade mandate one by one. As time consuming and arduous as it may be, it may be in the system’s best interest to examine each franchisee’s situation carefully, as to whether or not it would be appropriate under that particular franchisee’s circumstances, to extend upgrade requirements and deadlines or defer such. Can the franchisor treat each franchisee differently under these circumstances? After a good discussion with counsel, taking into consideration the state or jurisdiction where the franchisee is located, the discrimination and relationship laws, the answer is probably, if the franchisor so chooses. In reality, a franchisor is probably going to treat a franchisee that is well-qualified, a good operator, a team player, etc. much differently than a franchisee that is not. However, the franchisor needs to make sure any differential treatment of franchisees is based upon sound business principles and does not stray into the realm of being “arbitrary or capricious”. So long as there is a valid business reason, the franchisor, even in the states with specific discrimination and relationship statutes, can rely on the courts to allow differential treatment of similarly situated franchisees when it comes to enforcing upgrades.

D. Franchisee Sales And Transfers

When times are good and franchisees are making money, the thought of selling is seldom on the front burner. In the difficult economic times of today, many brands are suffering poor unit performance, there is an acute lack of available capital, expenses are increasing, income has declined, and many other difficulties abound that lead to the franchisee frustration, burn out and eventually a decision to exit their system. Often running a single franchise unit
can be extremely repetitive and frustrating, not to mention many times the franchisee’s family fortune is wrapped up in one basket. It is no secret that when economic times are tough it leads to an increase in transfers, sales and assignments in franchise systems as franchisees look to exit the system rather than face continued frustration, stress, losses and mounting liability.

A well drafted franchise agreement will clearly define a transfer, which is when a franchisee elects to sell or assign any portion of the franchise agreement, ownership interests in the franchise entity and/or assets of the business before the term of the franchise agreement expires. If a system is facing an increase in transfers, it may in fact be a product of today’s economy and presents franchise systems some interesting challenges, especially if the franchise agreement provides for a right of first refusal to repurchase the franchise. Another transfer hurdle facing franchisors is the fact many of the buyers/transferees the franchisees desire to transfer to do not meet the franchisor’s normal qualifications for new franchisees, not to mention the buyers that want to reflag the business and operate under a different business concept. Of course under any of these circumstances, the franchisor should have a valid objection to the transfer but that may be dependent upon the jurisdiction. A well written franchise agreement will require the franchisor's written consent to any transfer or sale, however, the franchise agreement usually contains a protection for the franchisee which provides that such consent not be “unreasonably withheld”. Denials and the issues surrounding the same are discussed below.

1. Assessing Prospective Transferee Franchisees – Bending The Rules?

It is no secret that in the majority of U.S. franchise systems, sales have slowed and for all too many, systems sales have either dwindled to a trickle or stopped altogether. Does the franchisor lower its financial standards for new franchisees in order to facilitate more transfers to avoid closures? Does the franchisor “bend the rules”? If so, just what are the dangers to the franchisor, the transferee and the system? After all, many franchisors would agree that a marginal new franchisee is better than a closure. If the standards are lowered for new franchisees does this open the franchisor to a discrimination claim for disparate treatment or is this just a good sound business decision? What about the prospective franchisee who was denied a year ago who now would be acceptable under current “changed” criteria? Well, again it depends on the jurisdiction and the basis upon what criteria the decision was made. Many of the prospective franchisees in lower investment systems are now being looked at with less scrutiny than an applicant would have been in good economic times. If you have a franchisee who wants out, it is probably going to achieve that one way or another; so as a franchisor, do you close one eye taking the position it is better to take a lesser prospect than close a store? Do you bend the rules?

Sometimes a franchisor doesn’t even get an opportunity to bend the rules as in today’s recession bankruptcy filings are high and the bankruptcy rules are not often friendly to a franchisor/creditor. Bankruptcy, of course, changes the playing field as the franchisees seek protection with the courts in an effort to interfere with the franchisor’s right to deny their transfer. Franchisees have quickly learned that bankruptcy courts have the power to allow rehabilitation of the franchisee/debtor and permit the sale of franchise at the highest price possible for the benefit of the creditors. Of course the bankruptcy laws basically suspend the normal rules governing transfers so long as the franchisor cannot show it has not been or will be materially damaged, which is a very tough burden of proof. Franchise agreement clauses sometimes referred to as “ipso facto” clauses, which permit the franchisor to terminate when the franchisee becomes insolvent or files bankruptcy, are generally unenforceable under federal bankruptcy
law.\textsuperscript{4} \textit{Ipso facto} clauses, which terminate a franchise agreement based upon the bankruptcy or insolvency of a franchisee, generally are unenforceable against a franchisee/debtor in bankruptcy under Code Section 365(b). If a franchisee files for bankruptcy and wants to assign to a third party it is imperative the franchisor be aware of Section 365 and its applicability to the assignment and transfer of franchise agreements.

2. Denial Of Consent To Transfer And Reasonableness Of Standards

Franchise agreements typically contain provisions that restrict a franchisee’s ability to transfer the franchise or any part of the ownership without the express written consent of the franchisor. Transfer in a franchise system is more complex than a sale of a single business because of the nature of the assets involved, the proprietary business methods, the trade secrets, the trademarks/trade dress and the fact that those assets are held or governed in a complicated franchise agreement where the franchisee may own the real and personal property, but the franchisor owns the rest, including the trademarks, proprietary systems and intellectual property. Franchisors and franchisees are inextricably bound to each other in a hybrid ownership of the franchise and have a certain mutual dependence on each other for survival and success of the brand. Denial of transfer and reasonableness of the standards applied by the franchisor to approve or deny a transfer raise a variety of complex issues and have been the subject of much litigation throughout franchise history. Franchise agreements can include a variety of conditions that address a franchisor’s obligation to approve or deny a transfer. The contractual provisions in the franchise agreement will usually be upheld when such provisions are reasonably applied. In \textit{Perez v. McDonald’s Corporation},\textsuperscript{5} the terms of the franchise agreement said McDonald’s could not arbitrarily withhold consent to franchisee selling the franchise. But the franchise agreement did give McDonald’s the right to require prospective transferees meet the same criteria as McDonald’s would apply to a new franchisee, including completion of the preliminary applicant training program which McDonald’s offered at its sole discretion. In this case, McDonald’s denied the transfer because the proposed transferee had not completed McDonald’s training program which was a condition precedent to being a franchisee. The court found for McDonald’s and upheld its denial.

With today’s economic crunch, more franchisees desire to exit systems by selling out, usually in an effort to cut their losses. Granted, many franchisees have not taken care of their franchise business(es) but a franchisee will not factor that into the equation, rather it will want to quit and exit the system. When a franchisee finds a potential buyer, it wants the franchisor to immediately approve the buyer regardless of the franchisor’s criteria for qualifying a potential new franchisee. The franchisor is then faced with lowering its standards or being sued for denying the transfer. In today’s economy, franchisees are very quick to play the “litigation” card as well as the “bankruptcy” card when they want out of the system. This places the franchisor in a difficult situation.

While the franchisor looks at some of the legal issues of a proposed transfer, i.e., will the transfer cure all financial defaults; will the transfer cure all other defaults; will the exiting franchisee sign a release; will the new franchisee sign a release; should the first right of refusal be exercised; and, so on, the franchisee narrowly looks at its remedies if the franchisor denies the sale, i.e., bankruptcy and/or litigation? If the transfer is approved the franchisor must

\textsuperscript{4} 11 U.S.C. 365(b)(2). \textit{See also In re Tornado Pizza, LLC}, 431 B.R. 503, 510 (Bankr. D. Kan. 2010) (franchise agreements “usually found to be executory contracts [and] generally may be assumed or rejected by the debtor,” although pre-petition terminations can be found valid).

\textsuperscript{5} Gerardo Perez and LuAnn Perez v. McDonald’s Corporation, 60 F. Supp.2d 1030 (E.D. Cal. 1998).
minimize its legal exposure in processing the transfer within its current policies, procedures and documentation; not only from the exiting franchisee, but also from the new franchisee. Releases from all involved should be sought.

3. Financial Qualifications of Transferee As Compared To New And/or Existing Franchisees

Normally a franchisor will apply the same scrutiny to and require a prospective third-party transferee to meet the same business and financial qualification criteria as it does a new franchisee. In good or normal economic conditions, franchisors review and consider several guiding key factors in evaluating a prospective franchisee and/or transferee. Most factors involve finances such as the prospect’s overall financial strength, net worth of each guarantor, general liquidity and adequate capitalization for the franchise operations. In today’s economic climate there is a very good chance the transferee will not meet the normal financial qualifications required of a new franchisee. Does the franchisor then bend the rules and lower the bar? Another factor to take in consideration is that the selling/transferring franchisee may be in arrears as to some obligation. A franchisor must determine whether or not all arrearages need to be cured as a condition of franchisor’s consent to a transfer. If a third-party proposed transferee does not meet the normal financial qualifications of a new franchisee, the franchisor may well be within its rights to deny a transfer. Today’s economy dictates that today’s applicants probably will not be as financially qualified as those in good economic times. It is therefore up to the franchisor to embark on a course of action to take lesser qualified candidates than it is under a legal or contractual obligation to do so.

III. Franchisee Defaults Arising More Often In Tough Economic Times – How Do You Deal With Them?

In good economic times with prospective franchisees waiting in line to purchase franchises and few financial issues or defaults in the system, the attitude of a franchisor may be to treat all franchisees strictly in accordance with the terms of the franchise agreement, without engaging in any flexibility to address problems or arrive at sensible business solutions. The current economic crisis has left many franchisees financially upside down and has put a serious dent in the royalty income of franchisors. Many franchisees have simply not taken care of franchise locations, suffer from low morale, have no ready cash or savings and are having trouble paying bills each month. For these struggling franchisees, their problems, whether business or personal, will distract them from focusing on their franchise business, improving customer service, improving products and growing their revenue, all of which add up to a failing business and eventual default. In these cases, should a franchisor “step up and prop up”?

In tough economic times, the standard operating procedures of yesterday may not be appropriate. Franchisors may instead be required to invest money back into the franchise systems and the franchisees, in order to curb defaults and closures. Listening to franchisees regarding their economic situations, their franchise operations and system defaults is a good place to start. For franchisors, the trick is to address system defaults by successfully helping franchisees cure defaults and/or turn around distressed units—all while sustaining franchised operations and not getting into financial or legal trouble themselves. To assist struggling/defaulting franchisees, the franchisor must devise practical solutions to financial problems, such as reducing or deferring royalties, reducing or deferring other financial obligations, offering financing, buying out or converting franchised units to company operated stores, relocating franchised units, providing suggestions relating to management of franchised units and postponing upgrades or re-imaging requirements. Franchisors must carefully pick the
franchisees capable of being saved and then not be afraid to treat franchisees differently. Not all struggling franchisees can be saved. Established solvent franchisors not have large financial resources while smaller franchise systems may lack not only financial resources but also management expertise and the ability to intervene, diagnose the problem(s) and render aide.

A. Royalty/Advertising Fees - Franchisee Non-Payment

The most obvious sign that a franchisee may be in financial difficulty is its failure to pay royalties, advertising fees and other amounts due under the franchise agreement. A critical first step in addressing payment defaults under a franchise agreement is to analyze what the franchisor’s rights and remedies are under the franchise agreement and applicable law. Most franchisors monitor (or should) franchisee payments and payment patterns closely and usually deal with delinquencies quickly. Additionally, franchisors should enforce the financial reporting requirements and audit opportunities set forth in the franchise agreement as well as analyzing the information and trends in those reports/audits in an effort to identify potential problems before they get out of hand. Since advertising fees are a pass through for the benefit of the franchise system, the franchisor's hands are tied in respect to ad fees and the franchisor is often unable to offer deferrals or reductions of advertising or marketing fees.

When payment defaults arise, the franchisor usually has two issues to consider: one is how to handle past due amounts and the other is how to ensure payments going forward.

1. Past Due Amounts

A franchisor's best approach to handling past due amounts with a particular franchisee will probably hinge on whether the franchisee is unable to pay because of circumstances or has simply chosen not to pay. If a franchisee has historically had a good operating and payment history and the payment defaults being a recent occurrence, the franchisor might explore whether there are specific issues affecting the franchisee’s ability to pay. As set forth above, there may be personal or business reasons for non-payment, such as health problems, changes in franchise personnel, operational issues, lavish living expenses, revocation of credit lines, or any number of other causes for the franchisee’s delinquency in monetary payments. If the reason for non-payment can be corrected within a reasonable period of time, the franchisor may work with the franchisee by providing assistance in the form of additional deferral of the past due amounts or even extending credit to the franchisee in the form of a promissory note. Either cures the default and allows the franchisee to proceed forward with a clean slate. If the past due amounts cannot be cured by the franchisee and the franchisor is unwilling to defer them or extend credit, then termination or a sale to a third-party may be the only alternative. A franchisor should consider that deferred fees may never be collected. However, if the franchisee may be salvaged by ensuring that fees will be paid going forward, it may be worth the write-off to do so.

2. Payments Going Forward

If the franchisee cannot cure past due amounts, whether royalties or other financial obligations due under the franchise agreement, then the chances are probably slim that the franchisee can maintain the viability of its franchise going forward, much less pay royalties, advertising fees and other financial obligations. One method of ensuring that the franchisee makes going forward is for a franchisor to ask for a credit card to insure the minimum monthly payment will be captured if the franchisee does not send it by regular means. The franchisor should be aware that this process will take time and effort to track, and is probably not a viable
alternative outside of the smallest franchised ventures. If the franchisor has already made financial concessions to a franchisee in the form of royalty deferrals, etc., then the franchisor should set up a monitoring system to make certain their payments going forward will be timely met. System trends have shown that once a franchisee is in default, there is a reasonably good chance that the franchisee will default again. If this happens, the franchisor will have to once again assess the franchisee’s viability for survival and determine a course of action.

**B. Responses and Solutions To Non-Payment**

1. **Collection Activity**

   When franchisees engage on a pattern of non-payment, the franchisor will usually rely on contractual protections in the franchise agreement for its remedies to address the default. In addition to having strong language in the franchise agreement, the franchisor should have in place and be able to implement collection practices designed to identify and respond to non-payment and collection problems at the earliest stages.

   Most royalties and other amounts are paid monthly. Monthly should be the least frequent interval that a franchisor requires payments from a franchisee, as the more frequent the payment schedule, the less likely a large delinquency/receivable will accrue. The sooner the franchisor recognizes a payment problem, the quicker the franchisor can respond and implement corrective or collection efforts. The franchise agreement should clearly require the franchisee to submit periodic financial statements and allow the franchisor to do audits as necessary. Review of the statements and audits as received should give an indication of a franchisee’s financial status and problems. Mystery shoppers, field staff representatives, suppliers, etc. may also be used to monitor the franchisee’s financial health, particularly where failure to follow system standards may be contributing to a loss of customers and revenue.

   Periodic and random audits can help identify problems like drop in income, unreported or underreported royalties and expenditures. If a problem is easily recognized, like a bounced royalty payment, the franchisor should immediately contact the franchisee and discuss the franchisee’s financial situation. A phone call is a good start, but if the franchisee refuses to discuss anything that is an indication the franchisor may need to implement collection procedures.

   With the tough economy today, the franchisor should take the necessary time to review the situation and carefully evaluate the best approach to take in dealing with the franchisee, unless the franchisee has indicated it will not pay, perhaps in response to some other dispute with the franchisor.

   Maintaining a central data bank of correspondence, notes from all conversations and communications with the franchisee coupled with open communication between legal, operations and accounting (actually all departments) is critical for a coordinated approach to franchise system collections. Each franchise system should have an early warning system; an operational review; a financial review; a method/team to work with a franchisee that is delinquent; open communication between legal, operations and accounting; and, of course solutions. Regardless of the ultimate outcome, the franchisor must be prepared to take all necessary steps to protect and preserve its legal right to collect the full amount owed under the franchise agreement or by applicable law.

2. **Franchise Termination**

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Termination is always the option of last resort. Even in the best of circumstances, termination is not something franchisors relish, given that no franchisor is in the business of closing locations. In today’s economy, termination has increased in most systems even though franchisors are typically trying to work with franchisees. When termination is implemented, it is not uncommon for franchisees facing termination to claim they have been singled out and make allegations that other franchisees are more indebted to the franchisor; other franchisees have committed more serious breaches of the franchise agreement; other franchisees have breached system standards in more grievous ways; and, other common law claims manifesting such allegations in the form of lawsuit threats or counterclaims. A savvy franchisee knows that such counterclaims and lawsuits have to be defended. If such allegations and claims were widely accepted, the franchisor may never achieve termination or enforcement actions against a franchisee. Accordingly, franchisors may decide that their interests are best served by always treating all franchisees alike regardless of the circumstances.

In situations where termination arises from non-payment, franchisees who believe they are being “picked on” will have little chance raising defenses of discrimination as almost all jurisdictions hold termination for non-payment to be a good cause for termination. In Baskin-Robbins Usa, Co. v. Mac II Enterprises Inc., Baskin moved for judgment that the franchisee was terminated for non-payment of almost a year’s worth of advertising and royalty fees; and to recover other monies due under the franchise agreement and personal guarantees. The defendants raised a number of common law defenses contesting the termination and filed counterclaims seeking compensatory and punitive damages arising from the claimed wrongful termination of the franchise agreement. The court held the termination was valid and dismissed the defendants’ causes of action. In Quinn v. Doctor’s Assoc. Inc. the court found that franchisor’s motivation for termination is irrelevant in the face of a legal right to do so.

Even if the franchisor bends over backwards working with a franchisee through royalty deferrals, waiving or deferring upgrades, reducing other fees where possible and/or other work out procedures, sometimes termination is necessary to protect the system and brand. Termination also provides closure eliminating future franchisor expenditures of money and personnel time spent managing the situation.

3. Payment Deferral Programs

Many systems are now receiving more requests for financial help in the form of financial deferrals, including royalties and other financial obligations. Obviously a decision by a franchisor to defer required royalties and other financial obligations must be done prudently since deferrals will have an adverse impact on the franchisor’s revenues, even if only for a limited period of time. Royalty deferral may be appropriate in certain instances for a limited time, but the franchisor must take the time to examine each situation carefully.

At some point, the franchisor must assess whether royalty deferral will improve the likelihood of success and survival for a particular franchisee. If a franchisor implements a “one fits all” deferral program (which is somewhat dangerous) such as offering all franchisees a 3 month, 6 month or longer deferral program, such a program may end up being merely a Band-

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6 Baskin-Robbins USA, Co. v. MAC II Enterprises, Inc., 279 A.D.2d 947, 720 N.Y.S.2d 75 (Table), 2001 WL 167637 (N.Y.A.D. 1 Dept.).
Aid and not a solution, even creating worse financial problems. The franchisor must set some prudent parameters for deferrals including a formal deferral plan to ensure paramount system success, remembering one shoe does not fit all franchisees. Franchisees that might need limited financial relief in order to make it through temporary economic difficulties and who have a proven track record as capable operators may be good candidates for a royalty deferral so long as they are in compliance with the other obligations of their franchise agreement. Deferrals will probably result in disparate treatment of franchisees, so it is important the franchisor base deferral decisions on good sound business reasoning and judgment.

If a franchisor does defer royalties or other payments, it should require the execution of a franchise agreement addendum stating that any contract concession shall not constitute a waiver, course of dealing, implied modification or estoppels of any other terms of the franchise agreement. The addendum may also secure the debt through a promissory note. In addition, since the franchisor is giving measurable consideration to the franchisee in the form of some type of financial relief from an obligation, it is an opportunity for the franchisor to obtain a release of all claims from the franchisee up to and through the date of the addendum. This may be considered a win-win since the franchisee is able to continue to operate and the franchisor keeps a franchised unit open while getting an enforceable release up to and through the date of the financial relief granted in the addendum.

4. Waiver, Abatement, Reduction

Abatement, reduction and/or waivers by a franchisor of royalties or any other obligations due under the franchise agreement is treading on dangerous ground. Once waived or reduced, such income will never be recoverable and may encourage other franchisees to request the same treatment, regardless of their economic situation. One big question is, if a franchisor waives, abates or reduces any royalties or other fees due under the franchise agreement, how does the franchisor protect itself from a franchisee(s) later pursuing discrimination claims where the franchisee(s) will allege the franchisor has waived the enforcement of certain claims by failing to exercise its full rights under the franchise agreement, i.e., after waiving, abating or reducing any royalties or other fees due under the franchise agreement? The franchisor does not want its good intentions and actions ending up in a loss of its ability to enforce the terms of the franchise agreement.

Of course, waiver is much easier to accomplish with a startup than an existing franchise system, as evidenced by the programs Taco John’s, Papa John’s, Pizza Inn and other restaurants implemented in late 2010 in an attempt to build up its franchise system through development incentives. These incentives include waiving royalties and waiving initial franchise fees, but of course carried with them restrictions and time constraints. One could ask the question, were these true “incentives” or a necessity to forward brand development in this economic recession? Such an incentive strategy employed by these large franchise brands would probably not even have been considered in good economic times.

C. Closure Of (Or Failure To Open) Franchised Business

1. Failure To Timely Open For Business Or Complete A Conversion

Another topic that tends to arise more often in difficult economic times is the failure of franchisees to complete construction and open their franchised business or failure to renovate a converted business and re-open under the franchised brand’s flag in the time required under the franchise agreement. Most seasoned franchisor companies have had ample experience
with franchisees that seem highly motivated at the time they secure a franchise, but later fail to get the franchised business off the ground. As a result, well-crafted franchise agreements make the failure to open the franchised business within a certain time period (either an absolute date or a range following expiration of the site selection process) an explicit and terminable breach. As with most types of franchise agreement defaults, decisions on whether and when to “pull the trigger” and terminate a particular franchise agreement for failure to open is left in the franchisor’s discretion.

The franchisor’s decision-making process becomes the subject of a claim of differential treatment - why was one franchise agreement terminated for failure and not another? The franchisor’s actions become even more ripe for scrutiny when the termination of the franchise agreement associated with an unopened unit results in the franchisee’s forfeiture of a non-refundable initial franchise fee, application fee, or both, or serves as the basis for a franchisor’s liquidated damages of lost future royalties claim.

As with any optional and potentially unpopular action taken in connection with a franchisee, franchisors are well-advised to think through and document on the front-end the legitimate business reasons (such as restraining the franchisor from opening a unit in the market) for the decision to default or terminate, as well as the factors that make the franchisor’s decision “fair” or “unfair” in light of actions taken or not taken with respect to other similarly situated franchisees.

a. Deadline Extensions

A decision to extend the franchisee’s deadline for opening (rather than terminating) is inherently less risky and more defensible as reasonable as it pertains to the franchisee whose franchise agreement is at stake. This continues to be true (again, with respect to that franchisee) even if the franchisee’s deadlines have already been extended one or more times in the past. However, deadline extensions may create more risk if they will later serve as the basis for a terminated franchisee to claim that other, similarly situated franchisees were treated more leniently. The prudent franchisor will fully consider what the policies, criteria, and reasonable justifications and excuses will be throughout the system for deadline extensions, rather than simply reacting the first time an extension is requested and unintentionally setting a precedent that the franchisor will later regret. If you find yourself saying, “I know that Franchisee X will be a good operator someday, and so I will extend his/her deadline,” consider whether you may later find yourself saying, “I wish I had developed and applied a more concrete set of standards when I extended Franchisee X, because now my termination of Franchisee Y looks unfair!” Or, if you find yourself saying, “I wish I had never signed up Franchisee X, because he or she is now proving to be flakey, this is a good opportunity to get rid of them,” then consider whether you may later find yourself saying, “I wish I had not taken such a hard line with Franchisee X, now I feel like my hands are tied with Franchisee Y.”

Of course, documentation of the extension is also a key component of extending deadlines and should be handled with thoughtfulness and care. It does a franchisor little good to develop and apply uniform standards for termination versus extension, if it cannot later show in court that these standards were documented, used and communicated to franchisees. At a minimum, documentation will include setting forth the terms of any deadline extension in a letter or agreement, and detail the franchisor’s rights and options in the event of failure to meet an extended deadline. A franchisor and its attorney should also consider whether documentation should include development of a written, standard policy for deadline extensions. Development
of such a policy, however, should be approached with caution inasmuch as failure to later follow the policy may create a soft target in litigation.

b. Evaluating the Franchisee: Genuine Economic Obstacles Or Mere Delay?

When a franchisee fails to open (or convert) his/her franchised business, all “economic” reasons cited for the failure to open may not be created equal. Some franchisees will fail to open a franchised unit because of genuine economic obstacles, such as a sudden and unexpected lack of available financing or a radical change in the circumstances affecting unit economics (e.g. cancellation of strip center development). Unless these circumstances are specifically provided for in the franchise agreement (which is uncommon), disputes arising out these failure to open will likely require analysis under the doctrines of impossibility, commercial impracticability, and force majeure. (See Sections V.C, below.)

For another group of franchisees, it may be financially possible to open the unit, but the franchisee may have understandable concerns about increasing his/her investment in the face of a worsening economy (either locally or nationally) and desire to delay or cancel opening, with or without an explicit agreement from the franchisor modifying the franchise agreement’s requirements.

In some cases, the franchisees may have a claim that they cannot open due to actions on the part of the franchisor that prevent them from opening. This was the basis for one of the claims made against Quizno’s in recent litigation. The claim was that Quizno’s sold franchises knowing the franchises would never be opened and intending to receive “something for nothing” from the franchisee that could not open because of a variety of circumstances created by the franchisor.\(^8\)

From the franchisee’s perspective, both circumstances may provide ample justification for delaying the opening of franchised unit. From the franchisor’s perspective, both circumstances (and particularly the latter) create a Catch-22. If the deadlines are strictly enforced, the franchisor can expect to be blamed (and perhaps sued) if the franchised unit fails. If deadlines are extended, then the franchisor’s obligations under anti-discrimination laws to treat similarly-situated franchisees equally may hamstring the franchisor’s ability to enforce deadlines for openings in the future. As the title of a 1998 article on the subject\(^9\) correctly phrased it, “Hanged if you do, Hanged if you don’t.”

2. Abandonment And Closure

Voluntary abandonment and closure of the franchised business creates less of an issue for the franchisor, since the franchisor has likely not taken any affirmative steps that could be later scrutinized as discriminatory - the franchisee has itself elected to close. However, to the extent that the franchisor elects to seek liquidated damages and lost future profits, discrimination issues may arise.

D. System Standards Violations

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When the cash flow decreases but the bills don’t, like any business a franchisee will look for ways to survive and keep the lights on. A diminished cash flow prompts the franchisee to re-configure its budget and spread the money where the franchisee believes it will do the most good. Royalties, ad fees, mortgages, electric bills and other necessary liabilities must be addressed in the budget and timely paid. However, with no available credit, the franchisee may be tempted to disregard certain franchise obligations it may now view as unnecessary. Such items often include the postponement of regular maintenance work, franchise improvements or otherwise ceasing system standards compliance altogether.

Even as franchisors seek to reduce costs in today’s economy, franchisors must continue funding compliance monitoring and continue with their periodic quality assurance evaluations, mystery shoppers, customer surveys and property inspections. A quality assurance program is critical to any franchise system as a means to monitor franchisee operations and ensure that franchisees comply with system standards. During difficult economic times, quality assurance programs take on heightened importance as franchisees may either be cutting costs in order to maintain profitability or are in financial distress. In these economic times, it is imperative for the franchisor to continue conducting periodic system standards and quality inspections, whether such are announced or unannounced, of franchisees on a regular basis as part of a comprehensive system standards assurance program. If a franchisor conditions its system to expect regular inspections, franchisees that want to be in compliance are far more likely to maintain system standards on a consistent basis. Those franchisees that do not maintain system standards will easily be identified by regular inspections, periodic quality assurance evaluations, mystery shoppers and customer surveys.

1. Failure To Comply With Brand Standards And Perform Required Maintenance

Although it is a basic system obligation of every franchisee to maintain the facility, trade dress and meet operational standards, the economy today is impacting those basic requirements and raising some interesting issues and decision making for the franchisor. Failure of the franchisee to comply with brand standards, including maintenance, is a very serious matter because it impacts the entire system in the consumers’ eyes. System standards are what the public perceives the brand is and what customers expect from the brand. A strict maintenance of system standards enforces consistency throughout the franchise system insuring similarity and familiarity among franchise units. Without similarity and consistency, consumers lose the brand identity and business wanes. The failure of franchisees to comply with brand standards, keep the property in good repair and appearance and perform other maintenance sets a very bad example that can have a lasting adverse effect on the franchise unit and the brand as a whole.

Of course, when the franchisor points out deficiencies in brand standards one normal response from the franchisee is, “Well, my franchise isn’t in any worse condition than the rest of the stores in this city - or in the system.” Such a response may be viewed by the franchisor as, “So, what are you going to do about it?” Of course when such occurs the franchisor must make a decision as to what action to take against the franchisee. Often such conduct on the part of the franchisee is mere posturing and a complete bluff, but with the economic pressures of today franchisees may push the envelope to a confrontation. In troubled economic times when franchisees are in genuine financial distress they may attempt to avoid spending to maintain system standards citing the doctrines of impossibility of performance and frustration of purpose as a defense to any enforcement action.
Absent the franchisee, after proper notice, taking steps to comply with important brand standards, especially those which involve quality control, safety and health, the franchisor may be left with no alternative but to move for termination. When the termination notice goes out, the franchisee will probably raise a claim that franchisor’s decision to terminate or take adverse action against a franchisee for failure to comply with brand standards or failure to complete required facility upgrades, is in reality motivated by a desire to discriminate against or single out the franchisee. The franchisee will make the argument that the franchisor has not enforced brand standards against other franchisees, is merely singling this franchisee out because it wants the franchisee out of the system, does not like the franchisee or because of some other improper and discriminatory motive. Claims like these are frequently made by the franchisees but fortunately such claims generally have not found much success in the courts. The courts have held fast to the principle that where there is an objective violation of the franchise agreement, an allegation of improper, discriminatory motive is irrelevant.

In *McDonald’s Corp. v. Robertson*, the franchisee argued that McDonald’s termination of the franchise agreement for violations of health and safety standards was merely “an excuse” for the franchisor’s real motive, which allegedly was to relocate the store to another area. The Eleventh Circuit rejected this argument, holding that the franchisee’s failure to comply with McDonald’s QSC (quality, safety and cleanliness standards) and food safety standards constituted a material breach of the franchise agreement sufficient to justify termination, and thus, it does not matter whether McDonald’s also possessed an ulterior, or improper motive for terminating the franchise agreement. The Eleventh Circuit further explained that, “a franchisor’s right to terminate a franchisee exists independently of any claims the franchisee might have against the franchisor. The franchisor has the power to terminate the relationship where the terms of the franchise agreement are violated."

This same conclusion has been reiterated by other courts in various jurisdictions. In *Major Oldsmobile, Inc. v. General Motors Corp.*, the court stated “[S]ince defendant had the right to terminate the Agreement upon plaintiff’s breach, it is legally irrelevant whether defendant was also motivated by reasons which would not themselves constitute valid grounds for termination of the contract.” In *Big Apple Car, Inc. v. City of New York*, the court found that a “party has an absolute, unqualified right to terminate a contract on notice pursuant to an unconditional termination clause without court inquiry into whether the termination was activated by an ulterior motive”.

Another issue that will arise in tough economic times regarding systems standards is the franchise agreement provisions that require the franchisee to carry a variety of insurance. Interestingly, and solely to the franchisee’s detriment, when the cash flow tightens the insurance premiums are one of the first items to not get paid by the franchisee. Most jurisdictions have held that failure to maintain insurance on property is tantamount to a threat of decline in value of the franchise and the property. In the case of *Shaffer v. Domino’s Pizza, Inc.*, the court found that the termination of franchisee Shaffer for failure to maintain liability insurance was proper.

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10 *McDonald’s Corp. v. Robertson*, 147 F.3d 1301 (11th Cir. 1998).

11 Id.


under the franchise agreements. Another case, *In Re Jones*,\(^{15}\) held that if the franchisee opted for bankruptcy after letting insurance lapse, such lapse will give the franchisor relief from the automatic stay as most courts have ruled that lack of insurance does not provide the creditor (franchisor) with adequate protection and such creditor (franchisor) is entitled to relief from the stay.

2. **Non-Uniform Enforcement And/Or Termination**

“Uniform” treatment of franchisees is rarely the same as “fair” treatment. To sustain a system a franchisor must be able to treat franchisees differently without risking undue exposure in the form of a discrimination lawsuit from a disgruntled franchisee. While the franchisor should endeavor to treat its franchisees fairly and in good faith, the concepts of “fairness” and “good faith” are not synonymous with uniformity. The franchisor needs to be aware of the discrimination and franchise relationship laws in the states that specifically or otherwise contain some anti-discrimination and/or good faith provisions. This is discussed in more detail in Sections IV and V below.

When franchisees are on the receiving end of selective enforcement they may react by asserting unlawful discrimination as a defense or as an original claim or counterclaim for damages. So long as there is a “good cause” for the decision, the franchisor, even in the states with specific discrimination and relationship statutes, can rely on the courts to allow differential treatment of similarly situated franchisees. Generally the case law supports the position that franchisors may discriminate among franchisees, so long as the discrimination is not “unfair” or is justifiable; nor is it simply arbitrary or capricious. See *Canada Dry v. Nehi*\(^ {16}\) and *McDonald’s v. Werve*\(^ {17}\) where the courts stated that “proof of ‘discrimination’ requires a showing of arbitrary disparate treatment among similarly situated individuals or entities”. Termination of the franchise relationship must be a legitimate business decision, not an exercise in emotion or punishment. In *Charts v. Nationwide Mutual Insurance Co*\(^ {18}\), the Connecticut court reminded franchisors of their franchise relationship statute and the fact that a “good cause” is required in finding that the insurance company wrongfully terminated the insurance agency.

If the franchisor cannot demonstrate a good business or contractual reason for termination, “good cause”, which is well documented, the jury or trial court will find a poor reason at trial when none is apparent. Conversely and in the general scheme of things, as long as the franchisor has a well documented legitimate business reason for its disparate treatment, its decision will seldom be second-guessed by a judge or jury. A franchisee resisting termination has a menu of claims and defenses to chose from and will often allege that the franchisor’s selective enforcement or termination violated federal or state civil rights statutes, federal antitrust statutes, federal or state industry-specific statutes, state relationship laws, state anti-discrimination statutes, the implied covenant of good faith and fair dealing and/or other common law and equitable principles.

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\(^{16}\) *Canada Dry v. Nehi* 723 F. 2d 512, (7th Cir. 1983).

\(^{17}\) *McDonald’s Bus. Facilities Corp. v. Werve*, 392 N.W.2d (Wis.Ct.App. 1986)

An interesting case involving the covenant of good faith and fair dealing is *D&K Foods, Inc. v. Bruegger's Corp.*, wherein the court found that the implied covenant of good faith and fair dealing might preclude disparate treatment of franchisees. One of the plaintiff franchisees argued that the franchisor had violated the implied covenant of good faith and fair dealing by extending financial assistance to some franchisees but not to it. The court held that whether the implied covenant had been breached "depends largely on the outcome of other factual inquiry" and denied Bruegger's motion to dismiss the claim.

Fortunately for franchisors, most courts follow a more restricted view of the covenant and uniformly reject any claim that the covenant prohibits discrimination among franchisees. The prevailing view is expressed in the Seventh Circuit's decision in *Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies Ltd.* The court considered the termination of a franchise agreement for what the court concluded were a number of material breaches by the franchisee. The court held that, although the franchisor may have treated other franchisees more leniently, disparate treatment was no defense. In Judge Posner's memorable eloquent formulation, the Judge stated: "The fact that the Cookie Company may... have treated other franchisees more leniently is no more a defense to a breach of contract than laxity in enforcing the speed limit is a defense to a speeding ticket." In the cases of termination for systems standards violations, the franchisor should always make certain it has good documentation supporting the termination and good business reasons before implementing such definitive action.

These decisions notwithstanding, with respect to any adverse franchisee treatment that is arguably discriminatory, franchisors are well-advised to carefully analyze the reasoning and justification for the differential treatment. In *Wright-Moore v. Ricoh*, the court rejected blanket "business reasons" as "good cause" for terminating a franchisee, stating that "internal economic reasons of the franchisor are not, by themselves, good cause for termination or nonrenewal of a franchisee, [...] even absent opportunistic behavior, a franchisor could virtually always claim a plausible business reason for termination." A distributor of office copiers sued its supplier/manufacturer for refusing to renew the parties' distribution agreement, claiming that the manufacturer lacked the requisite "good cause" for refusing to renew and that the manufacturer had discriminated against the distributor because it offered other distributors regional distribution agreements. The court held that generic "business reasons" relating solely to the manufacturer could not alone create "good cause," requiring instead that "good cause" must relate in some way to the particular franchisee or its performance. Nonetheless, the court rejected the "discrimination" claim. Because the plaintiff was the only distributor that the manufacturer had that was national in scope, there existed no "similarly situated" franchisees therefore the discrimination claim could not be proven. Thus, the existence of similarly situated franchisees is key to proving unfair discrimination.

3. Impact Of Defaults On The Brand

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21 *Id.* at 278.

22 *Id.*


24 *Id.* at 137-138.
Defaults within a system create two major problems, one with the current franchisees and the other with potential franchisees and expansion of the brand. If a default leads to a termination or a closure, and it is multiple and continuous, such will have an adverse impact on the brand. Franchisors must always consider the effect of any plan for addressing defaults with any particular franchisee in the system as a whole and the impact defaults will have on other individual franchisees. “Going easy” on one franchisee without a demonstrable business justification while strictly enforcing the terms of the franchise agreement on other franchisees with respect to the same or similar defaults can create resentment within the franchisee system or could be a violation of applicable anti-discrimination laws as discussed herein, and ultimately may harm the brand as a whole. Also the franchisor, even in the states with specific discrimination and relationship statutes, can rely on the courts to allow differential treatment of similarly situated franchisees so long as there is a valid business reason. The impact the default may have on other franchisees is a concern but is usually tied to the franchisee leaving the system. Other franchisees in the same geographical region may be pleased to see that particular franchise exit, or not. If the terminated defaulting franchisee is likely to be disruptive to the point of a lawsuit and apt to engage in negative publicity regarding the franchisor and the system on Twitter, Facebook and otherwise generally, the franchisor must be prepared to address the same.

Defaults have to be dealt with and cannot be left to linger without attention from the franchisor. Doing nothing is almost worse than coming down hard and terminating, of course depending on the type default. Other franchisees in the system watch the actions of the franchisor with a keen eye as to how defaults are handled. If a franchisor allows a franchisee default to continue it may be surprised just how quickly that news spreads throughout the system and the franchisor suddenly finds itself with the same or similar defaults increasing weekly.

The franchisor must also consider the impact of a default ending in termination on the franchise customer base and the consuming public. If the worst circumstances of a default occur, termination, the franchisor does not want to lose customers and should have a plan to handle any inconvenience to the terminated franchisee’s customers.

Defaults which lead to terminations require that the franchisor annually publish terminations in the franchisor’s FDD for all the world to read. Having a large number of terminations/closures can be a kiss of death for development, expansion and general franchise system cohesiveness. A rise in the number of defaults in a system or brand can and will have a negative impact on the ability of that brand to sell new franchises and maintain its market share, especially if it is a new system in its infancy.

IV. Legislative And Regulatory Considerations For Franchisors Regarding Disparate Franchisee Treatment

A. State Franchise Laws With Express Antidiscrimination Provisions

Ten states (Arkansas, Connecticut, Hawaii, Illinois, Indiana, Iowa, Michigan, Minnesota, Washington and Wisconsin) have enacted laws that specifically prohibit franchisors from various types of “discrimination” against franchisees. The Arkansas and Michigan laws only

25 See the Summary of Franchise Termination laws attached as Appendix A.
apply to non-renewals, while the Iowa law only applies to terminations.\footnote{Id.} The laws in the other seven states are broader and (except for Illinois) generally apply not only to terminations and non-renewals, but also to the ongoing relationship between a franchisor and its franchisees. Connecticut, Hawaii, Illinois, Minnesota and Washington have laws that specifically prohibit discrimination between franchisees in the charges offered and made for royalties, goods, services, equipment, rentals, advertising services or in any other business dealings (except for Illinois), unless there is a reasonable and non-arbitrary distinction for doing so. In contrast, Indiana simply prohibits franchisors from “discriminating unfairly” among franchisees. Finally, Wisconsin limits a franchisor’s right to terminate, cancel, fail to renew or substantially change the competitive circumstances of a dealer (or franchisee), if such action is the result of a dealer’s failure to meet a requirement that is discriminatory as compared with requirements imposed on other similarly situated dealers, either by their terms or in the manner of their enforcement. For the other 40 states, the discrimination issue is generally governed by common law. The following section summarizes each of these laws. (For the reader’s reference, we have also included a summary chart of the relevant statutory provisions, including applicable statutory language and a quick-reference chart indicating whether the express anti-discrimination/anti-differentiation provision applies to terminations, non-renewal, franchisor offerings in general, or some combination of all of these.)

1. **Arkansas** (Franchise Practices Act §4-72-204).

   The Arkansas Franchise Practices Act makes it unlawful for a franchisor to fail to renew a franchise except for good cause and according to “the current policies, practices, and standards established by the franchisor which in their establishment, operation, or application are not arbitrary or capricious.”\footnote{Ark. Code § 4-72-204(2) (2011).}

2. **Connecticut** (Franchises §42-133I)

   Connecticut law makes it a deceptive act or an unfair method of competition for a franchisor to discriminate between franchisees with respect to “the charges offered or made for royalties, goods, services, equipment, rentals, advertising services, or in any other business dealing,” unless such discrimination is necessary to allow the benefited franchisee to “fairly meet competition in the open market,” or unless the discrimination is reasonable in light of material differences between franchisees, and is not “arbitrary.”\footnote{Conn. Gen. Stat. § 42-133I(f) (2011).}

3. **Hawaii** (Franchise Investment Law §482E-6)

   The Hawaii Franchise Investment Law prohibits franchisors from discriminating between franchisees with respect to “the charges offered or made for royalties, goods, services, equipment, rentals, advertising services, or in any other business dealing.” The Hawaii law, however, creates several unique exceptions from this general rule. In addition to permitting discrimination that is reasonably related to material differences between franchisees, the Hawaii law exempts differentiation between franchisees when: (a) it relates to a special program “for making franchises available to persons with insufficient capital, training, business experience, education or lacking other qualifications”; (b) relates to geographic “experimentation” with or
variations in product or service offered; (c) concerns franchisee efforts to cure a breach of the franchise agreement; or (d) is “based on other reasonable distinctions... [and] not arbitrary.”

4. **Illinois (Franchise Disclosure Act §705/18)**

The Illinois statute prohibits discriminating between franchisees in the “charges offered or made for franchise fees, goods, services, equipment, rentals or advertising services.” The Illinois law has been interpreted by one federal court such that it does not apply to discrimination in termination or any actions taken other than the express prohibitions listed.

5. **Indiana (Deceptive Franchise Practices §23-2-2.7-2)**

The Indiana Deceptive Franchise Practices succinctly prohibits franchisors from “[d]iscriminating unfairly among its franchisees.” In the widely cited *Wright-Moore v. Ricoh*, the 7th Circuit (as discussed further in Section III.D above), interpreted this provision to require at least one similarly-situated franchisee, as a basis for comparison, to state a claim for franchisee discrimination.

6. **Iowa (Franchises §523H.7 & §537A.10)**

The first Iowa franchise law (applicable to agreements signed before July 1, 2000), requires “good cause” for termination, and defines that term as the failure to comply with a material and lawful requirement of the franchise agreement provided, however, that the termination may not be “arbitrary or capricious when compared to the actions of the franchisor in other similar circumstances.” Nonetheless, the burden of proving that the franchisor’s termination was arbitrary or capricious in light of the treatment of other franchisee is on the franchisee. Notably, the Iowa statute applicable to agreements entered into after July 1, 2000 (§537A.10) deletes the operative language referencing a comparison to the franchisor’s actions in “other similar circumstances.” However, the Post-2000 statute retains the requirement that terminations not be “arbitrary and capricious” and therefore likely still prohibits some types of discrimination in the absence of a legitimate business reason.

7. **Michigan (Franchise Investment Law §445.1527)**

The Michigan Franchise Investment Law contains a very narrow discrimination provision, which prohibits franchisors from including any provision in the franchise agreement “that permits the franchisor to refuse to renew a franchise on terms generally available to other franchisees of the same class or type under similar circumstances.”

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35 Mich. Camp. Laws § 445.1527(d) (2011). In *General Aviation v Cessna Aircraft Co.*, 13 F.3d 178, (6th Cir. 1983), the Sixth Circuit Court of Appeals held that although a grantor need not directly show “good cause” to not renew, it was prohibited from failing to offer renewal to one dealer when renewal was allegedly offered to other, similarly
8. Minnesota (Franchises Law §80C)

Minnesota Rule 2860.4400 (administratively adopted under the statutory authority provided for in Minn. Stat §80C.18), uses language similar to statutes adopted outright in other jurisdictions and prohibits franchisors from discriminating between franchisees “in the charges offered or made for royalties, goods, services, equipment, rentals, advertising services, or in any business dealing” unless such discrimination is “based on franchises granted at different times, geographic, market, volume or size differences, costs incurred by the franchisor, or other reasonable grounds.”

9. Washington (Franchise Investment Protection Act §19.100.180)

Similar to other statutes and the Minnesota rule, the Washington Franchise Investment Protection Act prohibits discrimination between franchisees “in the charges offered or made for royalties, goods, services, equipment, rentals, advertising services, or in any other business dealing.” The Washington statute however permits discrimination between franchisees when it is “reasonable,” “not arbitrary,” based on and related to material differences between franchisees, or is “based on other proper and justifiable distinctions.” The Washington law also contains a provision explicitly permitting franchisor and franchisee to negotiate terms at the initiation of a franchise relationship.

10. Wisconsin (Fair Dealership Law §135.03, §135.02)

The Wisconsin Fair Dealership Law prohibits termination or non-renewal of a franchise or dealership relationship, or a change in competitive circumstances of the relationship, except for “good cause.” Good cause, in turn, is defined to include the failure to comply with the grantor’s “essential and reasonable requirements…which requirements are not discriminatory as compared with requirements imposed on other similarly situated dealers either by their terms or in the manner of their enforcement…” The Wisconsin Fair Dealership Law has been found repeatedly not to prohibit a market withdrawal if executed in a non-discriminatory manner.

11. Summary

As the above discussion indicates, statutory prohibitions on differential treatment will generally permit franchisors to treat franchisees differently provided such differing treatment is “fair” (i.e., related to reasonable and justifiable distinctions) and not arbitrary or capricious. Even similarly situated franchisees may be treated differently, although this analysis may depend on how one defines “similarly situated.” An easy determination to make on the “similarly situated” question is also a relatively rare occurrence. Most would agree that with respect to two (or more) franchisees that are identical in every respect (e.g., same form of franchise

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36 Minn. R. 2860.4400(2010).
38 Wis. Stat. §§ 135.02-.03(2011).
agreement, same or similar opening date, same city, same size premises, same financial performance, same payment history, etc.), it will be difficult for a franchisor to argue (particularly in the states discussed above) that it is “fair” to treat them differently. It will be rare, however, that two franchisees are identical in every respect. Instead, in almost all cases, there will be distinguishing characteristics between franchisees. For example, two franchisees may be considered similarly situated because they signed the same form of franchise agreement, opened on the same day, are in the same region of the country and have the same size unit. These franchisees may be very different; however, when considering their markets, revenues, financial situations and histories of compliance and, as a result of these differences, it may be “fair” to treat them differently. Accordingly, franchisors must balance and apply that test on a consistent basis.

Of the ten state statutes summarized above that prohibit discrimination amongst franchisees, half of them\(^{40}\) include an explicit mechanism for civil or criminal enforcement by the state. Because the anti-discrimination provisions discussed in this Section are part of each state’s broader franchise disclosure or relationship law, the penalties for violation of those laws are at play in claims of franchisee discrimination. These penalties include criminal penalties,\(^{41}\) civil damages recoverable by aggrieved franchisees,\(^{42}\) attorneys’ fees shifting,\(^{43}\) injunctive relief awarded to the franchisee,\(^{44}\) civil fines,\(^{45}\) rescission,\(^{46}\) and even personal liability of franchisor personnel.\(^{47}\)

Notably, however, our research turned up no instances of a state suit actually being brought against a franchisor or dealer for discriminatory treatment of franchisees. While certainly there is a first for everything (including state enforcement actions based on franchisee discrimination) and no franchisor wants to be the pioneer defendant, the primary enforcement concern will come in connection with franchisee civil suits, class actions and as defenses to termination.

Each of the statutes described above, however, do provide civil enforcement by an aggrieved franchisee. Frequently such claims will be raised as a defense to termination, although certain of the statutes summarized above also provide for a variety of damages and remedies for aggrieved franchisees, including rescission, damage multipliers, and fee-shifting.

\(^{40}\) Hawaii, Illinois, Michigan, Minnesota and Washington.

\(^{41}\) See, e.g., Ark. Code § 42-72-207 (“Any violation of this section shall be a Class B felony”); Minn. Stat. § 80C.16 (up to 5 years imprisonment).

\(^{42}\) See, e.g., Wis. Stat. § 135.06 (grantee entitled to “damages sustained by him as a consequence of the grantor’s violation”).

\(^{43}\) See, e.g., Iowa Code § 523H.13 (“A person who violates a provision of this chapter or order issued under this chapter is liable for damages caused by the violation, including, but not limited to, costs and reasonable attorneys’ and experts fees”).

\(^{44}\) See, e.g., Conn. Gen. Stat. § 42-133g(a) (franchisee may “recover damages sustained by reason of such violation…and, where appropriate, may apply for injunctive relief”).

\(^{45}\) See, e.g., Minn. Stat. § 80C.16 (violators “shall be subject to a fine of not more than $25,000…fines authorized by this subdivision shall be imposed in a civil action brought by the attorney general on behalf of the state of Minnesota, and shall be deposited into the state treasury”).


\(^{47}\) See Minn. Stat. § 80C.17(“every principal executive officer or director of a corporation” is liable under statute unless they had “no knowledge of or reasonable grounds to know” of the violation).
B. Industry-Specific State Laws

A number of states have enacted industry-specific statutes that protect the right of franchisees, distributors, and dealers to be treated consistent with “similarly-situated” dealers and protecting the right to participate in dealer or distributor associations. There are numerous statutes in the 50 states addressing various types of dealers and distributors and their statutory rights. This paper is not intended to provide a comprehensive summary or analysis of the dozens of statutes that exist. However, some of the more important types of statutes to look for are addressed below.

1. Auto Dealers

All 50 states have some sort of automobile dealer protection statute. While the definition of “good cause” for termination varies from state to state, certain states include in the definition of “good cause” a requirement that any termination may not be based upon criteria that is discriminatorily imposed upon the dealer at issue.48


The Petroleum Marketing Practices Act (PMPA),49 was enacted “to protect franchisees from arbitrary or discriminatory termination or non-renewal of their franchisees.”50 The PMPA addresses three specific concerns: (1) that franchisee independence may be undermined by the use of actual or threatened termination or nonrenewal to compel compliance with franchisor marketing policies; (2) that gross disparity of bargaining power may result in franchise agreements that are or tend to become contracts of adhesion; and (3) that termination or nonrenewal may disrupt the reasonable expectation of the parties that the franchise relationship will be a continuing one.51 Given this congressional intent, courts must grant the PMPA a liberal construction consistent with its overriding purpose to protect franchisees.52 The statute “prohibits termination of any franchise agreement or nonrenewal of any franchise relationship except on the basis of specifically enumerated grounds and upon compliance with certain notification requirements.”53

However, in adopting the PMPA, Congress struck “an explicit statutory balance between the interest of franchisees in freedom from arbitrary and discriminatory franchise terminations and the interest of franchisors in freedom to transfer motor fuel marketing assets in response to changing marketing conditions.”54 Thus, “although Congress . . . intended strong protection of the interest of franchisees, . . . in an age of increasing corporate competition, the major petroleum firms must retain the freedom to seek greater economic efficiency through corporate reorganizations, mergers and acquisitions.”55

48 See e.g., Ohio Rev. Code § 4517.55(B)(5); Wis. Stat. §135.02(4)(a).
50 Mobil Oil Co. v. Karbowski, 879 F.2d 1052, 1055 (2d Cir. 1989)
51 Brach v. Amoco Oil Co., 677 F.2d 1213, 1216 (7th Cir. 1982)
52 See Unocal Corp. v. Kaabipour, 177 F.3d 755, 762 (9th Cir. 1999)
53 Id.
54 DV Midwest Refining, LLC v. Armada Oil and Gas Co., 305 F.3d 498, 506-07 (6th Cir. 2002)
55 Id.
Under the PMPA, when a franchisor sells its interest in the real estate where the franchise is located, the purchaser must offer to the existing franchisee, in good faith, a franchise on terms and conditions not discriminatory to the franchisee as compared to franchises then being offered by the purchaser.

3. Beer, Wine and Liquor Distributors

Several states have laws that protect the rights of beer and wine distributors and wholesalers.56

4. Farm and Construction Equipment Dealers

Similar to auto dealers, in most states farm and construction equipment dealers may not be terminated unless the manufacturer has “good cause,” which generally is defined as failure to comply with a reasonable contract term or requirement that is “not different from those requirements imposed on other similarly situated dealers by their terms.”57 The statutes at issue may have additional provisions that prohibit other types of discrimination as well.58

C. Disclosure Issues That Impact Discrimination

Although not the primary consideration when analyzing the risk associated with differential franchisee treatment, franchisors should nevertheless be mindful of certain disclosure obligations that impact franchisee discrimination. This is important both as a reminder of the relevant disclosure obligations and in light of the fact that the franchisor’s FDD statements could be used against the franchisor in litigation over discrimination. Several disclosure obligations under the revised FTC Franchise Rule and the revised NASAA Guidelines59 come to mind:

1. Franchisor Initiated Litigation. Item 3 of the revised Franchise Rule and NASAA guidelines now each require franchisors to disclose certain types of franchisor-initiated litigation against franchisees. The information thus disclosed may serve as a basis for franchisees to begin investigating the uniformity of the franchisor’s enforcement actions. Franchisors should be mindful of this obligation when considering enforcement actions.

2. Fees. Items 5 and 6 require disclosure of the fees to be charged by the franchisor under the franchise relationship, including a range of initial fees (if applicable).60 In general, fees should be uniformly imposed with respect to all similarly-situated franchisees. Franchisors have an affirmative obligation to disclose whether, and under what circumstances fees are not uniformly applied. If it is the franchisor’s practice to negotiate deviations from the standard initial fee, the franchisor should explicitly reserve the right in Item 5 to negotiate fees and charge different or lower fees from what any individual franchisee has agreed to pay.

56 The Business Franchise Guide at ¶ 5,001 lists all 50 states and the details of statutory provisions in them.

57 See, e.g., Minn. Stat. §325E.0681, Subd. 1 (heavy, utility and construction equipment); Minn. Stat. §325E.062 (agricultural equipment).

58 See, e.g., Minn. Stat. §325E.063(3) (no discrimination in pricing between similarly-situated dealers).

59 One state—California—additionally requires that negotiated deviations from the standard franchise offering be disclosed in a filing with the state.

60 16 C.F.R. 436.5 (e), (f).
3. Financing. Some fee deferral programs may require treatment under Item 10, which requires disclosure of “the terms of each financing arrangement, including leases and installment contracts, that the franchisor, its agent, or affiliates offer directly or indirectly to the franchisee.” Although the Item 10 financing disclosure requirement is most often associated with franchisors that arrange for or provide loans for a franchisee’s initial investment in the franchised business (including initial franchise fees, build-out costs, purchase of initial inventory, etc.), the text of the rule is not limited to start-up funds. Thus, a franchisor that routinely finds itself offering a standardized financial assistance program to distressed franchisees (and especially if the program includes disclosure-worthy features such as interest, execution of a note, waiver of presentment, assignment of the debt, etc.) should strongly consider whether the program warrants disclosure under Item 10.

4. Marketing Fees and Marketing Fund Expenditures. Item 11 requires franchisors to disclose whether franchisees are required to contribute to a marketing fund or advertising cooperative at rates different from other franchisees. Item 11 also requires franchisors to make disclosures regarding the expenditure of marketing funds. In this regard, franchisors should take the opportunity to state that marketing funds are not required to be spent equally between franchisees’ geographic regions.

V. Common Law Claims Typically Raised By Franchisees In Connection With Disparate Treatment

A. Good Faith and Fair Dealing

Nearly all states recognize that there is implied in every contract a covenant of good faith and fair dealing which requires honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade. The Uniform Commercial Code also contains a similar covenant of good faith and fair dealing. The Restatement (Second) of Contract, at Section 205, sets forth the basic rule that “every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.”

As noted above, franchisors have successfully argued that the fact that one breaching franchisee may be terminated while other breaching franchisees are not terminated is not a

61 16 C.F.R. 436.5 (j)(1)-(4).
62 Id. Notably, the Interpretive Guides to the 1978 FTC Franchise Rule state that neither “open account financing payable within 90 days” nor “franchise fees payable, without interest, over a period of time” are required to be disclosed in Item 10. F.T.C., Final Interpretive Guides, 44 FR 49966 (Aug. 24, 1979); Bus. Franchise Guide (CCH) ¶ 6,200 (emphasis added.) This position was reiterated in the 2008 NASAA Commentary to the updated Franchise Registration and Disclosure Guidelines. See North American Securities Administrators Association, Inc., Commentary on 2008 Franchise Registration and Disclosure Guidelines, Bus. Franchise Guide (CCH) ¶ 5,706 (2008) (despite the lack of an explicit exclusion in the language of the rule, “payments due from a franchisee to a franchisor within 90 days on an open account financing arrangement need not be disclosed under Item 10.”) The fact that both the FTC and NASAA have stated that open account financing less than 90 days without interest need not be disclosed, suggests that in certain circumstances longer financing arrangements and those that include interest, including those associated with distressed franchisee deferral programs, may require disclosure.
64 See, e.g., Restatement (Second) of Contracts §205.
65 See U.C.C. § 2-103.
66 Restatement (Second) of Contracts § 205(1981).
violation of the common law covenant of good faith and fair dealing because one franchisee’s breach does not justify the subsequent breach by another franchisee. 67

In Bonanza Int’l, Inc. v. Rest. Mgmt. Consultants, Inc., 68 the court addressed whether the franchisor had dealt with the franchisee in a manner consistent with the covenant of good faith and fair dealing. After the franchisor terminated the agreement for failing to remit timely payments and failing to adhere to standards of sanitation and cleanliness, the franchisee alleged that the franchisor had breached the covenant of good faith and fair dealing by selectively enforcing the default and termination provisions of the agreement. 69 The court cited the hornbook rule that, in every agreement, the parties have an implicit covenant of good faith, requiring them to treat the other party fairly and not “hinder” or “prevent” the other party from performing under the contract. More important, however, the court also concluded that, whether the franchisor treated other franchisees differently had no bearing on whether the franchisor had acted in good faith and dealt fairly with the aggrieved franchisee under its particular contract. 70 The court explained that, “Regardless of the relevancy or irrelevancy of Bonanza’s dealings with third parties, any evidence of good faith and fair dealing cannot be used to override express provisions of the written contract.” 71

However, despite this general rule, bad faith actions by franchisors and suppliers have, at times, resulted in legal victories for franchisees and dealers. 72 For example, in Vylene Enterprises, Inc. v. Naugles, Inc., 73 is perhaps the best example of treating a franchisee in “bad faith” by treating the franchisee worse than other franchisees. After a failed romantic relationship with the franchisee (Ms. Vylene), one of the franchisor’s male employees, took aggressive steps to run Ms. Vylene out of business by encroaching upon her store and aggressively couponing in her trade area. The court eventually found that, even though Ms. Vylene had no exclusive territory and no right to renew her contract, the franchisor’s bad faith conduct was actionable.

With respect to the covenant of good faith and fair dealing, an obligation implied by the common law of most states, it is important to note that this common law principle may give rights to the parties not found in the written agreements themselves. 74

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67 See Section III.D.2 above and discussion of Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies, 970 F.2d 273 (7th Cir. 1992).
69 Id. at 1445.
70 Id.
71 Id. at 1448. See also Bauer, Inc. v. Yorkshire AMOCO, Bus. Franchise Guide (CCH) ¶ 11,344 (E.D.Mo. 1998) (explaining that there was no violation of implied duty of good faith and fair dealing where oil company did not make substantial capital improvements to plaintiff’s service stations, even though it had done so for other franchisees).
72 See e.g., Phillips v. Crown Central Petroleum Corp., 1977 Trade Cas. (CCH) ¶ 61, 526 (D.Md. 1976) aff’d 602 F.2d 616 (4th Cir. 1979) (supplier could not enforce termination rights based upon a retaliatory motive where similar “defaults” did not result in termination of other dealers); Dunafon v. Taco Bell Corp., Bus. Franchise Guide ¶ 10,919 (W.D.Mo. 1996) (franchisor acted in bad faith by not honoring oral expansion agreement due to franchisee’s position in franchise association); Town & Country Equip. v. Deere & Co., 133 F. Supp.2d 655 (W.D.Tenn. 2000) (manufacturer acted in bad faith by rejecting dealer relocation where manufacturer understood the proposed relocation site would likely help the dealer avoid termination for poor market share).
73 90 F.3d 1472 (9th Cir. 1996).
74 See, e.g., Sons of Thunder, Inc. v. Borden, Inc., 1997 WL 104592 (N.J.) (holding that a jury can look beyond the letter of the contract and consider a company’s long-term behavior in determining whether the company acted in good faith); Dunafon v. Taco Bell Corp., Bus. Franchise Guide (CCH) ¶ 10,919 (D.C. Mo. 1996) (Finding the plaintiffs had
One decision where the court squarely found that the implied covenant of good faith and fair dealing might preclude disparate treatment of franchisees is *D&K Foods, Inc. v. Bruegger’s Corp.*. One of the plaintiff franchisees in *D&K Foods* argued that the franchisor had violated the implied covenant of good faith and fair dealing by extending financial assistance to some franchisees but not to it. The court, following a Vermont case adopting the Restatement definition of the covenant of good faith and fair dealing, held that whether the implied covenant had been breached “depends largely on the outcome of other factual inquiry” and denied defendants’ motion to dismiss the claim.

**B. Fraud**

It is not unusual for a franchisee to believe that, while the franchise agreement does not prevent the franchisor from acting in a certain manner, the franchisor has orally promised that the franchisor will not act in that manner. For example, a franchisee may be told that the franchisor generally does not allow another store within 3 miles of a franchisee. The franchisor then places a store 2 miles from the franchisee. A franchisee in this situation may attempt to sue for fraud in the inducement. Fraud may in some states be a more viable claim than breach of contract, since many states will not allow the “parol evidence rule” to bar fraud claims. See, e.g., the discussion of this issue in *Randall v. Lady of America Franchise Corp.* and in *Randall v. Lady of America Franchise Corp.*

Another “fraud” claim that may arise is that the franchisee was promised a long-term franchise relationship, terminable only for good cause, and now the franchisee is actually being terminated for a bad-faith reason.

**C. “Impossibility” of Performance**

In poor economic times, there may be situations where a franchisee’s performance is, literally, “impossible” for that franchisee. A franchisee may owe $400,000 in royalties and have no way to obtain the money. Another franchisee, for example, may have $2,000,000 in remodeling obligations arise in the worst economic times since 1929, and neither cash nor credit may be available.

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alleged sufficient facts to avoid dismissal of their claim that Taco Bell has acted in bad faith to prevent plaintiffs from enjoying the fruits of an oral expansion agreement with the defendant Taco Bell because franchisee’s involvement in an independent franchise association); *U.S. Genes v. Vial*, Bus. Franchise Guide (CCH) ¶ 11,031 (Ore.Ct. App. 1996) (holding that the supplier was required to act in good faith when it terminated its agreement with a dealer, even though the agreement provided that it could be terminated on thirty (30) days notice; this was particularly the case where the agreement included a provision imposing an obligation of good faith and fair dealing on both parties); *Mid-Land Equip. Co. v. John Deere Co.*, Bus. Franchise Guide (CCH) ¶ 11,035 (D. S.D. 1996) (finding breach of covenant of good faith and fair dealing, despite the at-will nature of the parties’ agreement, where manufacturer gave distributor only four days notice of termination); *Vylene Enterprises, Inc. v. Naugles, Inc.*, 90 F.3d 1472 (9th Cir. 1996) (holding that although the franchisor could not “act to destroy the fruits of the contract, by opening a competing restaurant).

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76 2005 WL 2709641 (D.Minn. 2005) (boilerplate merger and integration clauses do not prohibit the introduction of pre-contractual misrepresentations to establish fraud).

77 2007 WL 2128180 (D. Minn. 2007) (franchisor cannot escape potential statutory liability for illegal earnings claims based on contractual merger and integration clauses).

78 See e.g., *Central Microfilm Service Corp. v. Basic Four Corp.*, 688 F.2d 1206 (8th Cir. 1982) (applying fraud, breach of contract and estoppel theories to award damages).
At the same time, 50% of the entire system may not be able to pay royalties in a timely manner or remodel on time. Should a franchisor in these situations be allowed to terminate one or two franchisees while leaving everyone else in place?

The doctrine of “impossibility” states:

It is the general rule that, "if the agreement to perform is absolute, impossibility of performance arising after the contract is made is not an excuse for non-performance where it might reasonably have been anticipated or foreseen and guarded against in the contract, even though it results from . . . some circumstances over which the parties have no control. If the contract could reasonably be interpreted as being based upon the continued existences of the subject-matter, the subsequent cessation of existence will excuse the performance".


A franchisee hoping to prevail upon an impossibility argument due to tough economic times would be well advised to locate language in the franchise agreement or FDD indicating that the franchisee’s performance was intended to be conditional on reasonable economic opportunities. The decision of a franchisor to enforce similar obligations against very few franchisees could be used as evidence that the parties understood that the franchisee’s performance was not absolute.

1. **Commercial Impracticability and “Commercial Frustration”**

The doctrine of “impossibility” today is more commonly referred to as “commercial impracticability” or “commercial frustration,” it being understood by the courts that very little in the world is technically “impossible.”

One court recently examining the doctrine of “commercial frustration” indicated that the law is generally as follows:

1. the doctrine is extremely disfavored;
2. commercial frustration is a question of law;
3. the party’s main purpose must be completely or almost completely frustrated;
4. the doctrine cannot be used to compel performance, it can only be used to excuse nonperformance; and
5. the “frustrating” event at issue cannot be reasonably foreseeable at the time of contracting.

*Wal-Mart Stores, Inc. v. AIG Life Ins. Co.*

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80 See *Bartlett Commons Shopping Center v. Schultz Sav-o-Stores, Inc.*, 1992 WL 345052 at *1 (N.D.Ill. 1992). (Illinois recognizes these doctrines); *Sirrah Companies v. Budget Rent-A-Car Corp.*, 2009 WL 563654 (W.D.Tex. 2009) (Franchisor was excused from performing due to these doctrines).
The doctrine of “commercial impracticability,” while very difficult to distinguish from “commercial frustration,” states that performance may be excused where an increased difficulty is not only unanticipated, but “inconsistent with facts that the parties obviously assumed would likely continue to exist.” The unanticipated event must impose an “unreasonable difficulty, expense, injury or loss.”

A franchisee who will be bankrupt if he remodels his six stores certainly can claim “unreasonable difficulty, expense, injury or loss.” The only remaining issue will be whether when the franchisee agreed to do six remodels he could not have anticipated such an event (recession, lack of credit, etc.). Certainly, to the extent that no other franchisee is able to perform, the franchisee’s factual basis for its argument becomes far better.

2. Force Majeure

A party attempting to use the defense of “force majeure” must overcome the general reluctance of courts to excuse non-performance based upon purely economic events. A great deal of the analysis of whether economic recession or depression is “force majeure” comes down to the language used by the parties in their written agreement. For example, in Route 6 Outparcels, LLC v. Ruby Tuesday, Inc., the parties had a force majeure “catch all” that stated, “or any other cause, whether similar or dissimilar to the foregoing, not within the control of the Lessor and/or Ruby Tuesday.” The Court determined that severe economic recession arguably fell within that broad phrase, however, Ruby Tuesday still lost its argument because (1) the downturn was foreseeable; and (2) Ruby Tuesday did not demonstrate that it was impossible for it to perform as required.

D. Waiver

Waiver is the intentional relinquishment of a known right. Waiver of a contractual right may be written, oral, or by conduct or course of dealing. When a waiver occurs, the law generally states that the waiver may only be withdrawn after a reasonable notice and a reasonable opportunity has been provided for performance.

A “no oral modifications” clause is often disregarded by courts. For example, in Truhe v. Turnac Group, Inc., the South Dakota Supreme Court followed the law of 16 states and four

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83 Id.
84 In re Miller Cove Energy Co., 62 F.3d 155, 158 (6th Cir. 1995).
86 27 Misc.3d 122(A), 910 N.Y.S.2d 408 (N.Y.Sup. 2010).
87 Id. at *2.
88 Id. at *4.
89 Burger King Corp. v. E-Z Eating, 41 Corp., 572 F.3d 1306, 1315 (11th Cir. 2009).
90 See e.g., Truhe v. Turnac Groups, Inc., 599 N.W.2d 378, 382, n.7 (S.D. 1999).
93 599 N.W.2d 378 (S.D. 1999).
federal circuits in holding that an oral agreement can modify a written agreement, even in the face of a clause requiring all modifications to be in writing.\textsuperscript{94}

Even more directly on point is \textit{Flavors of Greater Delaware Valley, Inc. v. Bresler’s 33 Flavors, Inc.},\textsuperscript{95} in which a franchisor argued that a “no waiver” clause could be used to override actual waiver by the franchisor. The court disagreed:

The T.L. Agreement did contain a [no waiver] clause . . . Nevertheless, the Court concludes that Illinois courts would give no effect to [this] clause in the circumstances of this case.\textsuperscript{96}

The \textit{Bresler’s} court found the law of waiver to be as follows:

Waiver is a term that is used by courts and attorneys to refer to a variety of legal principles. See, 5 Williston on Contracts s 676 (3rd ed. 1961); 3A Corbin on Contracts s 752 (2nd ed. 1960) (hereinafter cited as “Corbin”). The type of “waiver” that is claimed to have occurred in this case is that which arises when a party to a contract learns of a breach by the other party that gives him the right to terminate the contract and he does not exercise his right to do so within a reasonable period of time. Such a decision to continue with the contract is viewed by the Illinois courts as a waiver of the right to terminate the contract on that ground.\textsuperscript{97}

In a non-franchise context, courts have followed the same rule as stated in \textit{Bresler’s}. For example, in reviewing a self-help repossession based upon untimely payments, the Georgia Court of Appeals has stated:

“[I]f [the creditor] has given the debtor the reasonable impression that late payments will be accepted or that an arrearage need not be paid immediately, then the creditor may be estopped to engage in self-help repossession until he has given notice, demanded payment or otherwise indicated to the debtor that he is considered to be in default.”\textsuperscript{98}

What sort of demand and notice was necessary was more fully described by the Georgia Supreme Court as follows: “[W]here there has been a failure to comply with the time stipulated, the other party may, by notice, fix upon and assign a reasonable time for completing the contract, and may call upon the party in default to do the act to be done by him within this period.”\textsuperscript{99}

\textsuperscript{94} \textit{Id.} at 382 n.7.
\textsuperscript{95} 475 F. Supp. 217 (D. Del. 1979).
\textsuperscript{96} \textit{Id.} at 229 n. 38.
\textsuperscript{97} \textit{Id.} at 229-230.
LaGuardia Assoc. v. Holiday Hospitality Franchising, Inc.,\textsuperscript{100} is another case in which the franchisor chose not to adhere to the letter of the contract. In LaGuardia Associates, the franchisee was habitually late in the payment of royalties and other fees over the course of a ten-year period. As a result of a change in franchisor management, a notice of default was sent to the franchisee demanding immediate payment of over $800,000 in fees. The franchisee failed to remit payment. The franchisor did not terminate the agreement and continued to permit the slow payment of royalties and other fees over the course of the next year. The franchisor then terminated the franchise relationship based on the earlier notice of default.

The court held that the franchisor’s delay of one year between the threat of termination and actual notice of termination was a waiver. The court further noted that, irrespective of the anti-waiver language in the franchise agreement, the franchisor was estopped from the “unilateral revocation of its long-standing history of waiving the accrual” given that the franchisor had “induced” the franchisee’s detrimental reliance on the franchisor’s continued indulgence. Although the franchisor was free to withdraw its prior waiver of fees, it could only do so after providing notice to the franchisee and giving it a reasonable time to alter its conduct. But see Truglia v. KFC Corp.,\textsuperscript{101} (the franchisor with better documentation had not waived) and Dunkin Donuts, Inc. v. Gav-Stra Donuts, Inc.,\textsuperscript{102} (anti-waiver and no modification provision upheld). In McDonald’s Corp. v. C.B. Mgmt., Inc.,\textsuperscript{103} the court held that the franchisor was not required to subordinate its interests to a lender or grant a grace period prior to termination even though it had done so routinely in the past for other franchisees, given the express terms of the franchise agreement.

E. Estoppel

Estoppel is similar to waiver, except that estoppel requires a change of position by the party in reliance upon the actions of the party to be estopped.\textsuperscript{104} The conduct of one party over an extended period of time may be enough, for example, to estop that party from claiming that a contract is terminable at will.\textsuperscript{105} Unlike a waiver (which may generally be withdrawn), there may be situations in which an estopped defendant may never be allowed to exercise his contractual rights because the plaintiff has relied upon the defendant’s conduct or promises.\textsuperscript{106}

Promissory or equitable estoppel may also prevent a manufacturer from invoking a clause in its written contract where the manufacturer has, by its conduct, led its dealer to believe it would not rely on the clause against that dealer.\textsuperscript{107}

\textsuperscript{100} 92 F. Supp.2d 119 (E.D.N.Y. 2000).
\textsuperscript{101} 692 F. Supp. 271 (S.D.N.Y. 1988), aff’d, 875 F.2d 308 (2nd Cir. 1989).
\textsuperscript{103} Bus. Franchise Guide (CCH) ¶ 11,388 (N.D. Ill. 1998).
\textsuperscript{105} Miskimen v. Kansas City Star Co., 684 S.W.2d 394 (Mo.App. W.D. 1984) (publisher could not claim newspaper routes were terminable at will); Hendrick Delivery Service, Inc. v. St. Louis Post-Dispatch, LLC, 2007 WL 3071827 at *4 (E.D. Mo. 2007) (same).
\textsuperscript{106} See Miskimen v. Kansas City Star Co., 684 S.W.2d 394 (Mo.App. W.D. 1984).
\textsuperscript{107} Central Microfilm Service Corp. v. Basic1Four Co., 688 F.2d 1206 (8th Cir. 1982) (applying fraud, breach of contract and estoppel theories to award compensatory and punitive damages); Lano Equipment, Inc. v. Clark Equipment Co., 399 N.W.2d 694 (Minn. Ct. App. 1987) (holding that a manufacturer may be estopped to deny the existence of a long-term dealer relationship despite the existence of eighteen (18) successive one (1) year contracts with integration clauses)
F. Laches

Laches is an equitable defense arising out of the untimely exercise of contract rights. In this way, laches is similar to waiver or estoppel. Generally, laches applies when the plaintiff is attempting to exercise an equitable right. An excellent description of the doctrine is contained in *LaSalle Bank, N.A. v. Reeves.*\(^{108}\) A franchisor seeking to enjoin trademark infringement or other franchisee misconduct should be concerned that the passage of time will strengthen a franchisee’s laches defense.

G. Contract Modification

While franchisors have had some success in limiting contract modifications by “no oral modification” clauses, the general rule is that parties may always modify their contracts by oral agreement or course of dealing after the date of the initial contract. As mentioned above, in *Truhe v. Turnac Group, Inc.*,\(^{109}\) the South Dakota Supreme Court followed the law of 16 states and four federal circuits in holding that an oral agreement can modify a written agreement, even in the face of a clause requiring all modifications to be in writing. More general authorities have stated the law similarly – in most instances and in most states, a “no oral modifications” clause does not actually prevent oral modifications.\(^{110}\)

VI. Differential Treatment Of Franchisees In The Enforcement Of Contractual Obligations

A. Selective Enforcement Of Non-Compete Agreements

Parties defending claims of breach of a post-term covenant not to compete have presented “selective enforcement” evidence, especially in a preliminary injunction proceeding, to avoid enforcement. Proof of the defense of waiver is the customary rationale for admitting the evidence. In *Surgidev Corp. v. Eye Tech., Inc.*,\(^{111}\) “selective enforcement” of the non-compete was admitted. The plaintiff had countenanced violations of its covenants not to compete, had never sued anyone except the defendant, and the defendant was told that he would be free to work with a competitor.\(^{112}\) The court concluded that, “Under the circumstances, it would be inequitable to permit plaintiff to now rely on a non-compete agreement which it has so blithely ignored in the past.”\(^{113}\)

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\(^{109}\) 599 N.W.2d 378 (S.D. 1999).

\(^{110}\) See Am. Jur. 2d §514 Modification of simple contract – stipulation against oral modifications (2011) (recognizing some cases and state statutes to the contrary of the general rule); Williston on Contracts §73:22, Variation of written contracts by subsequent oral agreement – Effect of “no oral modification” clause; waiver of provision at common law and under the Uniform Commercial Code (2011) (expressing same rule and noting that the Uniform Commercial Code does not allow oral modifications, but permits the agreement to be considered as a “waiver” under appropriate circumstances).

\(^{111}\) 648 F. Supp. 661 (D. Minn. 1986), **aff’d**, 828 F.2d 452 (8th Cir. 1987).

\(^{112}\) **Id.** at 697-98.

\(^{113}\) **Id.** at 698.
In Bandag v. Jack's Tire & Oil, Inc., the defendant franchisee used disparate treatment of franchisees in another way to defeat enforcement of a post-term noncompete. The Eighth Circuit Court of Appeals found that failure to enforce the covenant would not cause irreparable harm because Bandag had not included the provision in many of its franchise agreements. According to the court, "Bandag’s contention that failure to enjoin Jack’s defection will irreparably injure its entire franchise system is belied by the fact that Bandag has not included such covenant in many of its franchise agreements, including its agreements with two of Jack’s affiliates.”

Other courts have enforced non-competes despite disparate treatment of franchisees. In Precision Enterprises, Inc. v. Precision Tune, Inc., the court stated:

Precision Tune made reasonable business decisions when it chose not to sue other former franchisees for violating the noncompete clauses in the franchise agreements. These were rational business decisions based on the cost of bringing such suits when compared with the possible recovery in such actions. The fact that Precision Tune now seeks recovery against Precision Enterprises is not discriminatory under the terms of the FTPA because Precious Enterprises brought the instant action and Precision Tune merely raised related counterclaims against Precision Enterprises. The decision to sue a franchisee with multiple franchises while foregoing suit against a franchisee with a single franchise under the facts of this case is not arbitrary and does not amount of discrimination under R.C.W.A. § 19.100.180(2)(c) [the Washington Franchise Act].

B. Staying In The Boundaries Of Franchisor's Contractual Rights And Remedies While Balancing System Discipline With System Goals

A key method for limiting the franchisor’s risk exposure in connection with allegations of differential treatment (particularly as it relates to termination and non-renewal) is to carefully draft franchise agreement language that very clearly communicates the franchisee’s obligations and the remedies that the franchisor may have in the event of a breach. As noted in Section III.D.2 above, courts have typically upheld the franchisor’s right to terminate a franchise agreement in the face of a clear breach.

This, however, is often easier said than done. Few franchisors would willingly draft a franchise agreement in which the franchisor volunteers to treat every franchisee the same. However, a savvy franchisee or franchisee attorney will often attempt to negotiate such a provision into an amendment — a “treat me no worse” provision. Further, it is common for franchise agreements to incorporate or at least imply some degree of equal treatment. Consider the following hypothetical franchise agreement term:

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114 190 F.3d 924 (8th Cir. 1999).
115 Id. at 926. See also NBC, Inc. v. Pilarski, 520 N.W.2d 93, 97 (Wis. Ct. App. 1994) (employer did not uniformly require non-competes, so it had no irreparable harm); Metropolitan Medical group, P.C. v. Eaton, 546 N.Y.S.2d 90, 92 (N.Y. App. Div. 1 Dept. 1989) (no irreparable harm since employer allowed another employee to violate non-compete).
The Franchisee is obligated to adopt all future standards and requirements that the Franchisor designates for the franchise system.

It is certainly not hard to imagine reading this clause in a franchise agreement; but nor is it hard to imagine a good franchisee lawyer, in a given circumstance, arguing that this language creates an affirmative obligation for the franchisor to apply all system-wide requirements equally among franchisees.

Conversely, individual franchisees may have succeeded in securing special and unique accommodations in their franchise agreements, such as a cap on capital expenditures. Will honoring the terms of a negotiated change to one franchisee’s agreement create a differential treatment problem if the same cap is not permitted with respect to other franchisees?117

Finally, a franchisor must consider the variety within its portfolio of franchise agreements. A franchisor that has been in operation for several years (or several decades) is likely to have several different forms of franchise agreement in use at any given time. These forms of agreement may be vastly different from one another in terms of how they approach enforcement of system standards and how they address differential treatment of franchisees.

Before taking any large-scale, system-wide actions that may be unpopular or lead to legal challenge, a franchisor should undertake to understand exactly what its various franchise agreements permit or require, what the differences are between its franchise agreements, and what impact state law has on the enforcement of its franchise agreements. Armed with this knowledge, a franchisor can more easily develop a rational plan for applying and enforcing its standards in a “reasonable” and “fair” way.

C. Franchisee Association Issues

Franchisors should be particularly careful when considering intentionally discriminating against leaders of franchisee associations. One cautionary tale comes from the mid-1990s. At that time, Taco Bell’s executives decided that franchisees who were leaders in the independent franchisee association (the “IATBF”) were acting inconsistent with the best interests of the Taco Bell system. As a result, these leaders were branded as “scum” and “renegades” and were not allowed to take advantage of Taco Bell’s program for franchisee store unit growth. This course of action, while it probably made Taco Bell executives happy, resulted in litigation by one of the leaders of the franchisee association, Darrell Dunafon. Taco Bell defended its actions, stating

117 The answer to this question likely lies in whether the statute or the court interpreting it deems franchisees with different contract provisions to be nonetheless “similarly situated.” See, e.g., Canada Dry, 723 F.2d at 521 (interpreting anti-discrimination provisions of Illinois Franchise Disclosure Act). The question of whether any “similarly situated” franchisees or dealers exist, or whether other franchisees pointed to by an aggrieved franchisee are truly “similarly situated” is necessarily a fact intensive, case-by-case determination. Franchisors and franchisees advocating that certain other franchisees in the system either are or are not similarly situated should be prepared to address similarities (or lack thereof) between franchisees concerning factors such as: opening date or length of operation, geographic location, demographic factors, status as single or multi-unit operator, the form of the franchise agreement signed, revenue history, payment history, system compliance history, etc. There has even been debate in the Wisconsin courts on the question of whether the “similarly situated” determination must be limited to franchisees within the purview of the law (i.e., Wisconsin dealers only) or whether dealers outside the state may be considered. Compare Gentile v. Nissan, ¶14,626 Bus. Franchise Guide (CCH) (Wis. Ct. App. 2001) (citing negative commerce clause concerns as justification for limiting “similarly situated” analysis to Wisconsin dealers only), to Wisconsin Music Network, Inc. v. Muzak Ltd. Partnership, 822 F. Supp. 1332, 1337 (E.D. Wis. 1992), aff’d 5 F.3d 218 (7th Cir. 1993) (assuming without holding that dealers outside Wisconsin may be considered).
that it had no obligation to allow any franchisee to expand, and, as a backup position, stating that being a leader in the IATBF was a proper reason for denying Dunafon expansion opportunities. In Dunafon v. Taco Bell Corp., the court determined that neither position was correct as a matter of law and that the franchisor could, in fact, be found liable if, due to Dunafon’s position in the franchisee association, Taco Bell had acted in bad faith by not honoring Taco Bell’s implied expansion agreement that it had with all of its franchisees. Dunafon was bolstered in his efforts by California’s statutory right protecting the free association of franchisees.

In states where franchisees have statutory protection from discrimination and/or statutory freedom of association, a franchisor is engaging in extremely risky behavior when it decides to discriminate against franchisee association leaders. The presence of such statutes basically provides a per se prohibition against discriminating against franchisees for such a reason. Under the new FTC Franchise Rule, a franchisor is required to advise all prospective franchisees of the presence of an independent franchisee association that represents a substantial portion of existing franchisees. This provision seems to indicate an FTC policy in favor of independent franchisee associations, which would also discourage a reasonable franchisor from discriminating against leaders of those associations.

VII. Conclusion

Whether tough economic times or not, the ultimate question in discrimination cases under the various state anti-discrimination and relationship laws is not simply whether a franchisee has been treated differently than others or has been discriminated against, but rather whether the alleged disparate treatment is unfair, arbitrary and capricious. In the franchise world, disparate treatment or differential treatment of franchisees that is based on solid and valid business reasons and is not unfair, arbitrary or capricious, is lawful and appropriate. Unfair, arbitrary and capricious discrimination among similarly situated franchisees will be unlawful if such discrimination is the result of bad business logic or simply no logic at all on the part of the franchisor.

Franchisees who believe they have their backs against the wall through no fault of their own and who are on the receiving end of such selective enforcement, will in all probability raise unlawful discrimination as a defense to a termination. In fact, such franchisee may even take the offensive with an original action alleging that the franchisor’s selective enforcement violated federal or state civil rights statutes, federal antitrust statutes, federal or state industry-specific statutes, state relationship laws with antidiscrimination or good cause standards, other common law principles and of course, the implied covenant of good faith and fair dealing. Almost all jurisdictions, either by statute or case law, make discrimination unlawful only if it is “unfair, arbitrary and capricious.” If the franchisor has legitimate and sound business reasons to engage in disparate treatment the franchisor may in fact be entitled to do so. On such franchisee claims for disparate treatment, the burden of proof varies among the states but generally lies with the complainant.

In today’s economic recession, franchisors have had to reach in their pockets and braintrusts in approaching financing, defaults within the system, transfers and all other material elements of operating a franchise system. Today, franchise systems are faced with poor consumer spending, little or no available credit and tight cash flow. Many franchisors find

119 16 C.F.R. 436.5(t)(8).
themselves engaging in unheard of policies such as royalty reductions and deferrals, lowering standards for prospective franchisees, deferring upgrades and even waiving initial franchisee fees. All of these would be unthinkable in good economic times.

However there are obvious pitfalls for a franchisor actively engaging in reducing its own income by attempting to help the franchisees. The franchisor must be careful not to implement or announce a system-wide royalty reduction, abatement or deferral program without careful planning or the franchisor may unwittingly stop its entire revenue stream which would be catastrophic for the system. As discussed herein, uniform treatment is rarely the same as fair treatment. For system survival, a franchisor must be able to treat franchisees differently without risking undue exposure from a franchisee discrimination lawsuit. For this reason, almost all courts generally agree that the discrimination, in whatever form, must be arbitrary, capricious and/or in bad faith to be viable. Generally, as long as the franchisor has a legitimate business reason for its disparate treatment, it will be on safe ground.
### APPENDIX A

#### STATE DISCRIMINATION STATUTES

<table>
<thead>
<tr>
<th>STATE</th>
<th>STATUTORY PROVISION</th>
<th>General Offerings</th>
<th>Termination</th>
<th>Non-Renewal</th>
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</table>
| ARKANSAS  
(Franchise Practices Act §4-72-204) | (a) It shall be a violation of this subchapter for a franchisor to: 

1. Terminate or cancel a franchise without good cause; or 
2. Fail to renew a franchise except for good cause or except in accordance with the current policies, practices, and standards established by the franchisor which in their establishment, operation, or application are not arbitrary or capricious.  

120 (Emphasis added). All bolding or italics to statutory provisions are added throughout the document to emphasis specific sections. |                       |             | X          |
| CONNECTICUT  
(Franchises §42-133l) | ….(f) No franchisor, directly or indirectly, through any officer, agent or employee, shall do any of the following: 

1. (9) discriminate between franchisees in the charges offered or made for royalties, goods, services, equipment, rentals, advertising services, or in any other business dealing, unless: 
   - (A) any such type of discrimination between franchisees would be necessary to allow a particular franchisee to fairly meet competition in the open market, or 
   - (B) to the extent that the franchisor satisfies the burden of proving that any classification of or discrimination between franchisees is reasonable, is based on franchises granted at materially different times and such discrimination is reasonably related to such difference in time or on other proper and justifiable distinctions...and is not arbitrary. | X | X | X |
| HAWAII  
(Franchise Investment Law §482E-6) | Without limiting the other provisions of this chapter, the following specific rights and prohibitions shall govern the relation between the franchisor or subfranchisor and its franchisees: 

1. (2) For the purposes of this chapter and without limiting its general application, it shall be an unfair or deceptive act or practice or an unfair method of competition for a franchisor or subfranchisor to: 

   - (C) Discriminate between franchisees in the charges offered or made for royalties, goods, | X | X | X |
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<tr>
<th>STATE (Name of Statute &amp; Cite)</th>
<th>STATUTORY PROVISION</th>
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<th>Term-ination</th>
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<tr>
<td>ILLINOIS (Franchise Disclosure Act §705/18)</td>
<td>It shall be an unfair franchise practice and a violation of this Act for any franchisor to unreasonably and materially discriminate between franchisees operating a franchised business located in this State in the charges offered or made for franchise fees, royalties, goods, services, equipment, rentals or advertising services, if such discrimination will cause competitive harm to a franchisee who competes with a franchisee that received the benefit of the discrimination, unless and to the extent that any classification of or discrimination between franchisees is:</td>
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<td>(a) based on franchises granted at different times, and such discrimination is reasonably related to such differences in time;</td>
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<td>(b) related to one or more programs for making franchises available to persons with insufficient capital, training, business experience or education, or lacking other qualifications;</td>
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<td>(c) related to local or regional experimentation with or</td>
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<td>services, equipment, rentals, advertising services, or in any other business dealing, unless and to the extent that any classification of or discrimination between franchisees is:</td>
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<td>(i) Based on franchises granted at materially different times, and such discrimination is reasonably related to such differences in time;</td>
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<td>(ii) Is related to one or more programs for making franchises available to persons with insufficient capital, training, business experience, education or lacking other qualifications;</td>
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<td>(iii) Is related to local or regional experimentation with or variations in product or service lines or business formats or designs;</td>
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<td>(iv) Is related to efforts by one or more franchisees to cure deficiencies in the operation of franchise businesses or defaults in franchise agreements; or</td>
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<td>(v) Is based on other reasonable distinctions considering the purposes of this chapter and is not arbitrary.</td>
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<td>variations in product or service lines or business formats or designs; (d) related to efforts by one or more franchisees to cure deficiencies in the operation of franchise businesses or de-faults in franchise agreements; or (e) based on other reasonable distinctions considering the purposes of this Act and is not arbitrary.</td>
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<tr>
<td>INDIANA (Deceptive Franchise Practices §23-2-2.7-2)</td>
<td>It is unlawful for any franchisor who has entered into any franchise agreement with a franchisee who is either a resident of Indiana or a nonresident operating a franchise in Indiana to engage in any of the following acts and practices in relation to the agreement: ..... (5) Discriminating unfairly among its franchisees or unreasonably failing or refusing to comply with any terms of a franchise agreement.</td>
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<td>X</td>
<td>X</td>
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<tr>
<td>IOWA – Pre-JULY 1, 2000 (Franchises §523H.7)</td>
<td>Except as otherwise provided by this chapter, a franchisor shall not terminate a franchise prior to the expiration of its term except for good cause. For purposes of this section, “good cause” is cause based upon a legitimate business reason. “Good cause” includes the failure of the franchisee to comply with any material lawful requirement of the franchise agreement, provided that the termination by the franchisor is not arbitrary or capricious when compared to the actions of the franchisor in other similar circumstances. The burden of proof of showing that action of the franchisor is arbitrary or capricious shall rest with the franchisee.</td>
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<td>IOWA – Post-JULY 1, 2000 (Franchises §537A.10)</td>
<td>No specific “discrimination” language. Post-2000 language deletes “when compared to the actions of the franchisor in other similar circumstances” from the definition of “good cause.” Arguably, the “not arbitrary or capricious” language could be read to require the franchisor to treat franchisees similarly.</td>
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<td>STATUTORY PROVISION</td>
<td>General Offerings</td>
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| MICHIGAN (Franchise Investment Law §445.1527) | Sec. 27. Each of the following provisions is void and unenforceable if contained in any documents relating to a franchise: 
(e) A provision that permits the franchisor to refuse to renew a franchise on terms generally available to other franchisees of the same class or type under similar circumstances. This section does not require a renewal provision. |  |  | X |
| MINNESOTA (Franchises Law §80C.14, Rule 2860.4400) | All franchise contracts or agreements and any other device or practice of a franchisor, shall conform to the following provisions. It shall be unfair and inequitable for any person to: 
B. discriminate between franchisees in the charges offered or made for royalties, goods, services, equipment, rentals, advertising services, or in any business dealing, unless any classification of or discrimination between franchisees is based on franchises granted at different times, geographic, market, volume, or size differences, costs incurred by the franchisor, or other reasonable grounds considering the purposes of Minnesota Statutes 1973 Supplement, sections 80C.01 to 80C.22 … | X | X | X |
| WASHINGTON (Franchise Investment Protection Act §19.100.180(c)) | Without limiting the other provisions of this chapter, the following specific rights and prohibitions shall govern the relation between the franchisor or subfranchisor and the franchisees: 
(c) Discriminate between franchisees in the charges offered or made for royalties, goods, services, equipment, rentals, advertising services, or in any other business dealing, unless and to the extent that the franchisor satisfies the burden of proving that any classification of or discrimination between franchisees is: (i) Reasonable, (ii) based on franchises granted at materially different times and such discrimination is reasonably related to such difference in time, or is based on other proper and justifiable distinctions considering the purposes of this chapter, and (iii) is not arbitrary. However, nothing in (c) of this subsection precludes negotiation of the |  |  | X |

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<th>STATE (Name of Statute &amp; Cite)</th>
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<td>terms and conditions of a franchise at the initiative of the franchisees.</td>
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<td>WISCONSIN (Fair Dealership Law §135.03, §135.02)</td>
<td>135.03. No grantor, directly or through any officer, agent or employee, may terminate, cancel, fail to renew or substantially change the competitive circumstances of a dealership agreement without good cause. The burden of proving good cause is on the grantor.</td>
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<td>135.02…(4) “Good cause” means:</td>
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<td>(a) Failure by a dealer to comply substantially with essential and reasonable requirements imposed upon him by the grantor, or sought to be imposed by the grantor, which requirements are not discriminatory as compared with requirements imposed on other similarly situated dealers either by their terms or in the manner of their enforcement…</td>
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JEFFERY S. HAFF

Jeff Haff is a partner at Dady & Gardner, P.A. In his 22 years of practice, Jeff has represented franchisees, dealers and distributors throughout the United States. Over the course of his career, Jeff has been honored to receive numerous accolades including “Best Lawyers in America” in the field of Franchise Law for the years 2010 and 2011; Minnesota “Super Lawyer” for 10 consecutive years, and “Legal Eagle” by Franchise Times on multiple occasions. Jeff has been a regular speaker at the ABA Forum on Franchising, and has written publications and made presentations for the Franchise Law Journal, the ABA Annual Forum on Franchising, AFA Legal Symposium, and Leader’s Franchising Business and Law Alerts.

Jeff was one of 20 Presidential Honors Scholars in his graduating class at the State University of New York at Buffalo (B.A. summa cum laude 1986). Jeff graduated from Duke University School of Law (J.D. With Honors 1989).

KEVIN J. MORAN

Kevin is a principal at Gray Plant Mooty, practicing in the Franchise & Distribution practice group. Kevin represents franchisors and product manufacturers in regulatory compliance and transactional matters. He regularly works with franchise systems of varying sizes, from emerging to mature systems, on matters such as FDDs, registration and exemption, franchise disclosure, negotiation of franchise agreements and area development agreements, and franchise defaults and terminations. Kevin has expertise and experience with start-up systems, trademark selection, area development programs, retail distribution, and franchise litigation. Kevin also works with product manufacturers and distributors on matters such as distribution agreements, sales representative agreements, terms and conditions of sale and dealership default and termination issues. He has been a regular speaker and writer on franchise law issues, including writing for the Franchise Law Journal and The Franchise Lawyer.

Kevin received his B.A. from the University of Wisconsin-Madison in 1997 and his J.D., cum laude, from the University of Wisconsin Law School in 2000.

ROGER SCHMIDT

Mr. Schmidt is the Senior Vice President and the Chief General Counsel for Curves International, Inc., the largest fitness, health and wellness franchise in the world. He manages Curves legal affairs and supervises Curves’ legal department which deals with over 9,000 franchise locations in 86 countries. In an administrative capacity for Curves, Mr. Schmidt serves as Senior Vice President and sits on its Board of Directors. Mr. Schmidt maintained a law practiced in Houston beginning in 1975 and immediately prior to joining Curves International, Inc. was general counsel and shareholder in The Olajuwon Group/Hospitality Restaurants, Inc. in Houston, Texas, which was a multi-unit/multi brand franchisee in the food industry. Mr. Schmidt received his B.A. from Bemidji State University in 1970 and his Doctorate of Jurisprudence from South Texas College of Law in 1975. Thereafter he formed and maintained a law practice in Houston, Texas until joining The Olajuwon Group and thereafter Curves in 2001. Mr. Schmidt currently serves on the ABA Corporate Counsel Committee; is an editor on the ABA Franchising Textbook project; has served on the International Franchise Association’s (IFA) Legal Symposium Task Force; and, is a frequent speaker at legal and franchise seminars.
and functions. Also active in academia, he is currently an Adjunct Professor of Law at Baylor University Law School where he has taught Franchise Law since spring of 2003.