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CHANGES IN SYSTEM STANDARDS -- WHAT IS THE EXTENT OF THE FRANCHISOR'S LATITUDE?

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I. INTRODUCTION

System standards are the lifeblood of a franchise system. These standards regulate everything in the franchise relationship from methods of operation, to the products sold by the franchisee, the equipment used in the franchise operations, and even the look of the franchised outlet. For the franchise system to remain competitive and viable, it is essential that these standards be modified from time-to-time to address ever-changing market conditions and advances in technology. Take for example a franchise with a twenty-year term. When that franchise relationship was entered into in 1992, e-commerce, websites, and e-mail were virtually non-existent. Fast forward twenty years to 2012, and it is difficult to imagine a system that does not have an on-line presence of some kind. Without the flexibility to respond to such changes in the business environment, it is unlikely that the franchise system will be successful long-term.

This paper examines both the legal and practical aspects of the implementation of changes to a franchise system. Part II discusses the franchisor's legal responsibilities and the limitations on the franchisor's discretion to implement systems changes, and provides recommendations for drafting the franchise documents to ensure system flexibility. Part III examines certain practical considerations for implementing the change to the system, including the examination of the market implications for the change, obtaining franchisee support, and properly communicating the change to ensure it is legally binding. Finally, Part IV discusses various legal challenges brought both by franchisors to enforce systems changes, and franchisees to avoid them.

II. LEGAL AUTHORITY TO MODIFY THE FRANCHISE SYSTEM

The franchise relationship is inherently dependent on the contractual and extra-contractual (i.e., statutory) obligations of the parties. It should then come as no surprise that the legal limitations on a franchisor's authority to implement system changes are primarily found in three documents: (A) the franchise agreement; (B) the operations manual; and (C) the franchise disclosure document ("FDD"). This section discusses provisions and disclosures for the franchisor to consider when preparing these documents to ensure that it has the flexibility necessary to address and adapt to changes in the business environment over the course of a long-term franchise relationship.

A. <u>The Franchise Agreement</u>

The franchise agreement is the starting point when assessing the extent of the franchisor's ability to implement system changes. Arguably, the franchisor's express rights in the franchise agreement to modify the system may be among the most important provisions in the entire agreement. These rights to change operating systems and standards are necessary to enable the franchisor to implement needed changes to keep the system viable.

These rights are also important to enforce systems standards. Franchising is unique in that decisions about when and how to change the business' operations are made by someone

* The authors wish to thank Andrew P. Beilfuss (a partner at Quarles & Brady LLP, Milwaukee, WI) for his contributions to this paper.

other than the business owner. That business owner may be hesitant to implement the proposed changes for any number of reasons. For instance, it is often the business owner, not the franchisor, who must incur the expense of the contemplated change; at least at the operational level. The franchisee may be very comfortable (and profitable) operating the business, as is, and feel the change is unnecessary. Conversely, in tough economic times, the franchisee may not have easily available funds to implement the change. Likewise, even if the franchisee believes that a change is necessary, it may have drastically different views than the franchisor on what that change should be.

Whatever the franchisees' reasons for resisting change, it is important that the franchise agreement be drafted properly so that both parties understand their rights and responsibilities regarding the uniform application of the system, and the circumstances under which the system may be changed.

1. <u>General Changes</u>

Most franchise agreements have, at a minimum, a provision (or provisions) in the agreement that: (1) explains the franchisor's system; (2) requires the franchisee to acknowledge the importance of strict compliance with, and uniform application of, the system; and (3) reserves the franchisor's rights to modify the system periodically. Most franchise agreements also require that the franchisee promptly comply with the modification, at the franchisee's sole expense. An example of a general contractual reservation of rights to modify standards of operation is as follows:[1]

> Franchisor reserves the right, from time to time, by adoption or amendment of System Standards to add, amend, modify, delete or enhance any portion of the System (including any of the Marks and System Standards) as may be necessary in the franchisor's sole judgment to change, maintain, or enhance the System or Marks or the reputation, efficiency, competitiveness and/or quality of the system, or to adapt it to new conditions, materials or technology, or to better serve the public. Franchisee will, at its expense, fully comply with all such additions or modifications reasonably designated by Franchisor as applicable to the then-existing System.

As discussed in greater detail below, these general reservation provisions are essential to ensuring the viability and competitiveness of a system over the course of a long-term franchise relationship.

2. <u>Material Changes</u>

Although general reservations of rights provisions – such as the one above – have been held to provide the franchisor with sufficient authority to implement many system changes, that authority is not without limitation.[2] When the change implemented by the franchisor is deemed to be a material change (i.e., one that will have a significant financial impact on the franchisee, like a new or increased fee), additional, more specific, reservations of rights provisions are

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[1] Martin D. Fern ET AL., FRANCHISING LAW: PRACTICE AND FORMS Ch.12, p. 11 (SPECIALTY TECHNICAL PUBLISHERS, 2010).

[2] *See Bird Hotel Corp. v. Super 8 Motels, Inc.*, 246 F.R.D. 603 (D. S.D. 2007) (recognizing franchisor's right to require the implementation of a new reservations system, but denying the franchisor the ability to implement a fee, when that fee was not specifically reserved or otherwise disclosed).

advisable. These specific reservation provisions may be necessary to defend (or hopefully avoid) later arguments by franchisees that the change was somehow unlawful. As discussed in greater detail in section II.A.5 below, franchisees have attempted to avoid compliance with material changes through one of three claims: (A) breach of contract; (B) breach of the duty of good faith and fair dealing; or (C) violations of relationship and/or disclosure statutes.[3] Because each of those challenges fundamentally hinges on the express language of the franchise agreement, the franchisor should give special consideration to portions of the system that may require amendment over the course of the long-term franchise relationship.[4] The franchisor would be well advised to then include provisions specifically reserving rights to implement changes to such areas.

Although it is impossible to predict every change to the franchise system that may be necessary to keep the brand viable over the course of the entire, relatively long, term of a franchise agreement, there are several areas that will likely need modification. Those areas generally include trademark rights, technology requirements, facilities' standards, methods of distribution, training, service or product standards, insurance requirements, and/or advertising. Because each of these modifications will likely require a larger capital outlay – or potentially additional on-going fees – the franchise agreement should include language specifying who must pay for the modifications, and whether additional on-going fees or costs associated with the change can be assessed and recovered by the franchisor. An example of a specific reservation of rights related to the modification of a trademark related standard follows:

> We will have the right at any time and from time to time, upon notice to Franchisee, to make additions to, deletions from, and changes in the Marks, or any of them, all of which additions, deletions, and changes will be immediately effective and binding on Franchisee as if they were incorporated in this Agreement. Any fees, costs, or other expenses related to the additions, deletions, or changes in the Marks will be the sole responsibility of Franchisee.

Anticipating that open-ended changes to system standards may result in lack of marketability of the franchise and, in order to give franchisees more budget planning opportunities, some franchise agreements place limits on a franchisor's ability to modify system standards based on certain monetary or investment requirements. Typically, these limiting provisions relate to capital improvements to the franchised business, and either place limitations during certain time periods or give franchisees additional time to make the capital improvements. An example of a provision that limits a franchisor's requirement to impose system standards resulting in additional capital expenditures is as follows:

> We may periodically modify System Standards, which may accommodate regional or local variations as we determine, and any such modifications may obligate you to invest additional capital in the Restaurant ("Capital Modifications") and/or incur higher operating costs; provided, however, that such modifications will not alter your fundamental status and rights under this Agreement. We agree to give you 90 days to comply with Capital Modifications we require, but if a

[3] *Stuller v. Steak N Shake Enterprises, Inc., et al.*, 2012 U.S. Dist. LEXIS 97414 (C.D. Ill. July 12, 2012).

[4] *La Quinta Corp. v. Heartland Prop., LLC,* 603 F.3d 327, 338 (6th Cir. 2010) (stating that "where the contracting party complains of acts of the other party that are specifically authorized in their agreement, we cannot see how there can be any breach of good faith and fair dealing. Indeed, it would be a contradiction in terms to characterize an act contemplated by the plain language of the parties' contract as a bad faith breach of that contract").

> Capital Modification requires an expenditure of more than $10,000, we agree to give you 6 months from the date such request is made to comply with such Capital Modification. You are obligated to comply with all modifications to System Standards within the time period we specify. Capital Modifications are in addition to the cost you will incur to repair, replace or refurbish your equipment and furnishings from time to time. Capital Modifications do not include any expenditures you must, or choose to make, solely in order to comply with applicable laws, or governmental rules or regulations (e.g., ADA compliance).

Sometimes these limiting provisions condition the requirement to spend money on capital improvements to certain time periods, or after a certain threshold number of franchised or company-owned operations have met the standards. An example of this type of provision follows:

> At the earlier of: (i) 5 years after the Agreement Date; or (ii) the time that a majority of the XYZ Stores then operated by us or our affiliates have made or are in the process of making similar capital improvements or modifications, you will make the capital improvements or modifications ("Capital Modifications") to the XYZ Store directed by us in order to bring the XYZ Store to our then-current standards and specifications for new XYZ Stores. The types of Capital Modifications covered may include (at our discretion) those needed to modernize the premises of the XYZ Store, and other changes to the equipment (including computer systems), signs, interior and exterior décor items, fixtures, furnishings, supplies, and other products and materials required for new XYZ Stores. Capital Modifications are in addition to costs you incur to repair, replace or refurbish obsolete or worn-out equipment and fixtures. Capital Modifications do not include any expenditures you must make or choose to make in order to comply with applicable laws, governmental rules or orders.

Franchise agreements may also vary over time. A franchisor evaluating changing system standards must evaluate all forms of agreement that are in existence at the time it wants to implement the change. It may find that some forms of the franchise agreement permit the franchisor to impose the system change, while others may either be silent on the topic, condition the ability to do so or forbid it. Franchisors faced with varying terms in their franchise agreements may not be able to impose the system standards on a uniform basis and may be forced to either negotiate changes to the franchise agreement with those franchisees with franchise agreements that prevent the change, or wait for other opportunities to impose the requirements, like on a transfer or renewal.[5] Carvel Corp. was faced with this prospect when it wanted to distribute ice cream products within other retail venues. Some of the contracts provided for exclusive distribution only in ice cream stores with territorial protection, while others permitted alternative distribution and eliminated territorial exclusivity.[6]

B. <u>The Operations Manual</u>

When assessing the franchisor's discretion to modify the system, special attention should also be given to the provisions of the franchise agreement related to the operations manual. The operations manual is, after all, the document that commonly describes the system

[5] *See* discussion at Notes 69-71, *infra.*

[6] *Carvel Corp. v. Baker*, 79 F.Supp.2d 53 (D. Conn. 1997). *See* discussion at note 97, *infra.*

which is the subject of the contemplated change, and is often the document through which the change is ultimately memorialized. At a minimum, the franchise agreement should include: (1) a definition of the manual; (2) a reservation of rights to modify the manual and system; (3) a contractual obligation of the franchisee to follow the manual at all times; and (4) a duty on the part of the franchisee to monitor the manual for changes and to immediately comply with all changes once implemented.[7]

1. <u>Definition of the Manual</u>

The operations manual can take many forms and names. Some systems use a paper copy while others use an electronically accessed version.[8] Still others will include multi-media materials (video and/or audio files) that include specifications on the system.[9] Some utilize multiple volumes with different manuals for different subject matter. Whatever form the manual may take, the franchise agreement should include a provision broadly defining all of the various materials that comprise the franchisor's manuals.[10]

2. <u>Reservation of Rights to Modify the System and Manual</u>

The franchise agreement should also include a reservation of the franchisor's right to unilaterally add to, subtract from, or modify the system through changes to the manual or otherwise. The following is an example of a clause authorizing Burger King Corporation to change its systems as enforced by the Eleventh Circuit in *Burger King Corp. v. E-Z Eating, 41 Corp.*:

> Franchisee "agrees that changes in the standards, specifications and procedures may become necessary and desirable from time to time and agrees to accept and comply with such modifications, revisions, and additions to the MOD Manual which BKC in the good faith exercise of its judgment believes to be desirable and reasonably necessary."[11]

This language was later again upheld by the United States District Court for the Southern District of Florida in *National Franchisee Association v. Burger King Corp*.[12] This example is noteworthy because it contains limiting language on the franchisor's discretion in adopting system changes. In fact, the good faith limitation on the exercise of Burger King's judgment was extensively litigated in the case.[13]

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[7] For an expanded discussion on operations manuals, including the role of operating manuals in implementing system changes, *see* Amy Cheng, Craig Dietz & David W. Oppenheim, *Operating Manuals – The Devil is in The Details*, A.B.A. 31st ANNUAL FORUM ON FRANCHISING (2008).

[8] *See Id*. at 13.

[9] *See Id*.

[10] *See Id*.

[11] *Burger King Corp. v. E-Z Eating, 41 Corp.*, 572 F.3d 1306 (11th Cir. 2009).

[12] *Nat'l Franchisee Ass'n v. Burger King Corp.,* 2010 U.S. Dist. LEXIS 123065 (S.D. Fla. Nov. 19, 2010). *See* discussion accompanying notes 82-83, *infra*.

[13] *Id.; see also King v. GNC Franchising, Inc.*, CIV.A.04-5125(SRC), 2006 WL 3019551 (D. N.J. Oct. 23, 2006).

3. An Obligation to Follow the Manual at All Times

Uniformity of experience by the customer across locations is essential to the success of the franchise system as a whole. The failure to enforce uniform standards may also have adverse consequences to the franchisor's intellectual property rights.[14] Accordingly, to ensure the ability to enforce system standards, it is critical that the franchise agreement obligate the franchisee to comply with the operations manual at all times. An example of such a provision from an auto parts franchise agreement reads:

> You agree that throughout the term of this Agreement, you will operate Your Franchised Business in strict accordance with the terms of this Agreement and the Manual. The Manual may be revised in the future to continue to meet changing conditions of the marketplace. You shall comply, at your expense, with all modifications made to the system. A failure on your part to comply with the system requirements in the Agreement or Manual will be considered a material default and just cause for termination of this Agreement.

There are numerous cases, discussed in greater detail below, generally upholding the franchisor's right to enforce system standards based on language similar to the language quoted above.

4. Provisions Requiring Monitoring of the Manual

When system standards are modified, it is important to show that the modified standards have been communicated to the franchisee. Historically, updated pages of the manual were provided to the franchisee with instructions to replace the superseded pages with those documents. Or, franchisors would mail policy notices and updates. Today, it is more common for the system to be updated electronically, with notice provided via e-mail. The franchise agreement should, therefore, include a provision reserving the right to electronically provide and alter the operations manual. As discussed below, even with these reserved rights, franchisors nevertheless need to be careful to ensure that electronic communication is an effective means to notify franchisees of the system change.[15]

In addition to providing the franchisee express notice of the change, it is advisable for the franchisor to include a provision in the franchise agreement that places a duty on the franchisee to monitor the sources that may contain the manual or system standards for any updates that may be implemented from time-to-time. The inclusion of such a notice will not necessarily replace the need to provide notice of system or manual changes, but it may be helpful if an enforcement dispute arises where the franchisee attempts to excuse non-

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[14] For a more advanced discussion on the importance of enforcing system standards, *see* Joseph Schumacher, Edward Wood & Adam G. Schweickert III, *Retaining and Improving Brand Equity by Enforcing System Standards*, FRANCHISE L. J. at 10-17 (Summer 2004).

[15] *See Grosso Enterprises, Inc. v. Domino's Pizza, LLC,* No. 11-1484, 2011 WL 816620 (E.D. Penn. March 9, 2011). In a challenge to a franchise termination, the court ruled that certain e-mail notifications to the franchisee were not sufficient to inform it of changes to specifications and standards. The notice provision of the franchise agreement also specified the means for delivering notice of changes of the operating manual, not just the franchise agreement itself. Although it allowed for notice "by facsimile or other electronic system," it also specified that the notice had to be addressed to the franchisee. Domino's had sent the e-mail notification of the system changes through blast e-mails that did not specifically identify the franchisee as the recipient.

compliance with a claimed lack of knowledge. Many electronic manuals can also alert the franchisor if a franchisee has not accessed the new information.

C. <u>Franchise Disclosure Document</u>

The third document to review when considering the franchisor's authority to implement a system change is the FDD. The FTC Rule includes several obligations related to the franchisor's disclosure of the system modification rights reserved in the franchise agreement and operations manual.

Item 6 of the FDD requires disclosure of all fees, other than the initial fees, that a franchisee must pay to the franchisor or its affiliates, or that the franchisor or its affiliates impose or collect in whole or in part for a third party. The Item requires disclosure that fees may change and, in the case of increases, any formula that determines the increase or the maximum amount of the increase.[16]

Item 8 requires disclosures of the franchisee's obligations to purchase or lease various goods and services and equipment that are restricted by the franchisor.[17] These restrictions apply whether the items are to be acquired from the franchisor, its affiliate, from an approved or designated supplier, or pursuant to the franchisor's specifications. Item 8 further requires disclosure of how the franchisor grants and revokes approval of alternative suppliers.[18]

Item 9 of the FDD requires a summary of the franchisee's obligations under the franchise agreement. Within the table is a specific section relating to system standards, with the following excerpt from a portion of the example in the FTC Compliance Guide[19]:

Item 9: FRANCHISEE'S OBLIGATIONS

This table lists your principal obligations under the franchise and other agreements. It will help you find more detailed information about your obligations in these agreements and in other items of this disclosure document.

Obligation	**Section and Agreement**	**Disclosure Document Item**
g. Compliance with standards and policies/operating manual.	Section 8A of Franchise Agreement	Item 11
i. Restrictions on products/ services offered	Section 12 of Franchise Agreement	Item 16
n. Maintenance, appearance and remodeling requirements	Sections 8C and 10 of Franchise Agreement	Item 11

[16] 16 C.F.R. §436.5(f).

[17] 16 C.F.R. §436.5(h).

[18] *Id.*

[19] *Id*. at 57-58.

Unless the franchisor allows a prospective franchisee to review the whole operations manual prior to signing the franchise agreement, Item 11 requires franchisors to disclose the table of contents of the system's operating manual. That table of contents may be included as one of the exhibits in Item 22 of the FDD.[20] Because the operations manual often contains the specifics of the franchisor's system, and is often the vehicle through which the modifications are implemented, it is advisable that the table of contents include some language indicating that the manual is subject to change to avoid later arguments about the lack of sufficient disclosure.

Item 11 also requires disclosures related to potential modifications to computer systems, training, and advertising. For instance, Item 11 requires the franchisor disclose certain computer systems requirements, including "any obligation of the franchisee to upgrade or update any such system, and any contractual limits on the frequency and cost of that obligation."[21] Similar disclosures are required for advertising and training, including the costs of initial and future training.

Item 12, addressing territorial rights, requires the disclosure of restrictions relating to alternative distribution channels, like the internet, catalog sales, etc. To the extent that a franchisor reserves the right to change these methods of distribution, then that should be disclosed in Item 12.[22]

Items 13 and 14 of the FDD, that deal with intellectual property, require certain disclosures relating to changes in trademarks, patents or copyrights.[23] Item 13 (8)(vi) requires the franchisor to disclose the franchisee's rights under the franchise agreement if the trademark is modified or discontinued.[24] Likewise, the same disclosure is required if the franchisor requires the franchisee to modify or stop using any patent or copyright.[25] In addition, this Item requires disclosure of the franchisor's obligation to protect and defend the franchisee against infringement claims and whether that obligation is contingent upon the franchisee modifying or discontinuing use of the patent or copyright.[26]

Item 16 requires the disclosure of restrictions on what the franchisee may sell. It specifically requires disclosures of the franchisee's obligation to sell all or only goods or services authorized by the franchisor.[27] The Item specifically requires disclosure of "whether the franchisor has the right to change the types of authorized goods or services and whether there are limits on the franchisor's right to make changes."[28] An example of this disclosure from the FTC's Compliance Guide is as follows:

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[20] 16 C.F.R. §436.5(k)(6).

[21] 16 C.F.R §436.5(k).

[22] 16 C.F.R. §436.5(l).

[23] 16 C.F.R. §436.5(n)(v)-(vi).

[24] 16 C.F.R. §436.5(n)(8)(vi).

[25] 16 C.F.R. §436.5(n)(5)(vi).

[26] 16 C.F.R. §436.5(n)(5)(v).

[27] 16 C.F.R. §436.5(p).

[28] 16 C.F.R. §436.5(p)(3).

We require you to offer and sell only those goods and services that we have approved (see Item 9).

You must offer all goods and services that we designate as required for all franchisees. These required services are muffler inspection, repair, and replacement. Parts, supplies and equipment used in your Belmont Muffler business must be approved by us (see Item 8).

We have the right to add additional authorized services that a franchisee is required to offer. There are no limits on our right to do so except that the investment required of a franchisee for equipment, supplies, and initial inventory will not exceed $5,000 per year.[29]

Item 17(s) requires the franchisor to disclose the provisions of the franchise (or other) agreement and a summary of the reserved rights. The following is a sample of the related disclosure taken from the FTC Compliance Guide: [30]

Item 17: THE FRANCHISE RELATIONSHIP

Provision	**Section in franchise or other agreement**	**Summary**
s. Modification of agreement	Section 8A	No modifications generally, but Operating Manual is subject to change.

III. IMPLEMENTING CHANGES IN SYSTEM STANDARDS

The legal right to impose a system change is just one component of the franchisor's analysis of a potential systems modification. The franchisor must also consider the practical effects, both financial and otherwise, of the change itself and its franchisee business partners. This necessarily includes a careful analysis of the business reasons for the change, consultation with the franchisees, garnering franchisee support, and – if the franchisor ultimately decides to implement the change – communicating it properly to the franchisees so that it is legally binding.

A. <u>Analysis of Market Reasons for the Change</u>

The goal of any system change should be to better the system as a whole. While implementing any change to an established system provides an element of market risk, there are steps that the franchisor can take to minimize that risk before deciding to implement the change system-wide. For example, if the franchisor operates company-owned outlets, it may be possible to implement the change for a period of time at such outlets. The franchisor can then evaluate and document the effect of the change before requiring its franchisees to make an additional capital investment, or significant changes to their operating methods.

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[29] *See Franchise Rule 16 C.F.R. Part 436 Compliance Guide*, Bureau of Consumer Protection: Business Center, 79-80 (June 2012), http://business.ftc.gov/sites/default/files/pdf/bus70-franchise-rule-compliance-guide.pdf.

[30] 16 C.F.R. §436.5(q)(s).

If the franchisor does not have company-owned outlets, it may be able to incentivize a select group of franchisees to voluntarily implement the modification for a period of time to evaluate its effect. Or, if quantification of the effects of the change is possible, the franchisor may be able to commission a third-party to evaluate the pluses and minuses of the change.

Regardless of which method of testing is used, as with any information provided to franchisees, franchisors should ensure that the data shared with the franchisees is accurate. This will avoid claims that the franchisor painted too rosy a picture to induce support, or hid negative results. The franchisor should include an express disclaimer that, by providing such data, it is in no way guaranteeing the franchisee's performance, or making any promise, express or implied, that the franchisee will experience similar results.

In any event, the fact that a franchisor considered the business effects of the change prior to implementation and attempted to quantify the risk-reward of the change for the franchisees should be seen as a gesture of partnership and good faith by the franchisee community. Moreover, from a legal perspective, these studies can be also powerful evidence if the systems change is challenged under a good faith and fair dealing claim, or a relationship statute that requires "good cause" for changing the competitive circumstances.[31] In fact, the failure to conduct market research on the potential effects of a system change could itself be dispositive evidence against the franchisor in the event of such litigation.[32]

B. Franchisee Consultation and Support

After the franchisor has considered the market effects of the potential change, it is advisable to consult the franchisees to assess their feelings on the change and gather any suggestions about how the change may be improved. The franchisees, after all, will be the ones that are responsible for implementing the change and making it successful. Communication with the franchisees is critical to ensure harmony in the system, prevent needless litigation, and maximize the market potential for the change. By listening to its franchisees, the franchisor can determine whether the change will meet wide – spread approval, or require the franchisor to incentivize the franchisees to implement the change. The franchisor can also determine the best way to implement the change by perhaps providing some financial assistance or – at the very least – providing a reasonable period of time within which the change will take full effect.

1. The Role of a Franchise Advisory Council, Franchise Associations, and Other Franchisee Leadership

Depending on the system, there may be a select group of leaders who act as the collective voice for the franchisees. Often times, these groups come in the form of either a franchisee advisory council or a franchise association. Communication with these groups is essential to garnering franchisee support with system changes. Franchisee representatives act as intermediaries to communicate the change to the franchisees. They can also assist in gathering feedback from the franchisees, and in communicating the message to the franchisees.

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[31] For a discussion on such challenges, *see* notes 137 to 140, *infra*.

[32] *Amos v. Union Oil Co. of California*, 663 F.Supp. 1027 (D. Or. 1987) (court found in favor of franchisee because franchisor failed to conduct and consider necessary preliminary research); *Beilowitz v. Gen. Motors Corp.*, 233 F.Supp.2d 631, 644 (D. N.J. 2002) (court favored franchisee where franchisor failed to conduct research before implementing a change).

If such leadership groups do not exist within the system, the franchisor would be well advised to communicate to the prospective change to its franchisees in advance of implementation and invite the franchisees to share any concerns or ideas they may have.

2. <u>Incentives for Implementation</u>

Any time there is change to a business, there is risk. It is therefore understandable that a business owner would be apprehensive about making changes to his or her business. That apprehension is multiplied significantly in the franchise relationship where the franchisee has little, if any, ability to decide if that risk is appropriate for his or her business. Moreover, even if a franchisee is in favor of the change generally, he or she may believe that the additional capital investment required to implement the change is not worth the risk.

In such situations, the franchisor has a hard decision to make. On the one hand, it could stand firm and exercise its legal rights to implement the change. Doing so, however, will undoubtedly sour its relationships with its franchisee business partners, deflate any enthusiasm that the people ultimately charged with making the change successful may have, and could generate litigation.

On the other hand, the franchisor could decide to incentivize the franchisee for making the system change a success. Such incentives could take the form of some reimbursement of the franchisee's costs to implement the change, a bonus program, royalty holidays, or additional operational or marketing support. Even recognition as a quality franchisee within the franchise community is a powerful motivator for strict compliance with system standards.[33]

C. <u>Communication of System Change</u>

Once the decision is made to implement a system change, the franchisor must take proper steps to ensure that the franchisees receive effective notification of the change. Without such notice, the change may not be legally binding on the franchisee. For example, in Gro*sso Enterprises, Inc. v. Domino's Pizza, LLC,* the franchisor implemented a system change through a mass e-mail notification to the franchisees, followed by multiple reminder e-mails.[34] When the franchisee failed to implement the change, the franchisor sought to terminate the relationship. The franchisee responded by seeking equitable relief to enjoin the termination.

The court entered a temporary injunction in favor of the franchisee after determining that the mass e-mail notifications of the system change were insufficient notice. The court explained its reasoning as follows:

> The Agreement requires that, in order for the "provisions of the operating manual … and the mandatory specifications, standards and operating procedures and rules prescribed from time to time by [Domino's]" to constitute provision of the Agreement, they must be communicated [by Dominos] to [Franchisee] in writing.

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[33] Patrick McGovern, Brian H. Schmidt & Peter Sheldon, *Raising the Bar of Your Franchise System Through Standards Enforcement* (*Advanced Session*), I.F.A.: Legal Symposium Sessions (2010) (*citing* Melanie Hansen, Heather Smedstad & David Worthen, *Basic Tracks – Complying with System-Wide Standards*, I.F.A.: Legal Symposium Sessions (2006).

[34] No. 11-1484, 2011 WL 816620 (E.D. Penn. March 9, 2011). *See* note 15, *infra*.

> Section 22.7 of the Agreement, the provision regarding "Notices," provides that "[a]ll written notices permitted or required to be delivered by the provision of this Agreement or of the Operating Manual shall be deemed so delivered …. one (1) day after transmission by facsimile or other electronic system, and addressed to … [Franchisee] at the most current principal business address or home address of which [Domino's] has been notified in writing."[35]

The court further noted that individual notification of important terms (such as system modifications that could lead to default) should be communicated to ensure that they are "distinguished from mass e-mails covering less important subjects."[36]

The *Grosso* case emphasizes two important things when considering the communication of system modifications: (1) be sure to communicate the change in accordance with the notification provisions within the franchise agreement; and (2) it is a good practice, even if the franchise agreement allows you to communicate a systems change by mass e-mail, that a separate notice also is sent which is specifically addressed to the franchisee and distinguishable from everyday business communications.

IV. RESISTANCE TO CHANGES

A. Legal Options for Franchisors to Enforce System Standards

The hallmark of a franchise brand is uniformity of customer experience across outlets. That uniformity promotes the goodwill that the customer associates with the brand and the franchisor's associated marks. When the franchisor determines that a change to the system is necessary, the franchisor has both business and legal reasons for ensuring that those system standards are implemented and enforced. If the franchisor is unsuccessful in obtaining franchisee support using the methods described above, it may be required to resort to the legal system to enforce the change. The following section describes potential options for the franchisor to compel franchise compliance with systems change.

1. Alternative Dispute Resolution

Many franchise agreements contain specific provisions regarding dispute resolution procedures. A careful review of those procedures is necessary to determine any pre-requisites to filing a lawsuit (e.g., mandatory mediation), and how and where the proceeding will be filed. If mediation is a pre-requisite to filing suit, the franchisor should explore exceptions to the requirement, or seek to satisfy that requirement as soon as possible. Voluntary mediation may also be useful to resolve the dispute if both parties participate in good faith and want to resolve the conflict. But, while mediation may be an appealing option for certain types of disputes, system standards disputes generally involve a sole issue: does the franchisee need to comply? This leaves little room for compromise and – in turn – little chance of reaching a mutual informal resolution.[37]

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[35] *Id*. at *8.

[36] *Id*.

[37] For an expanded discussion on the uses of mediation in franchise disputes, *see* Peter Klarfeld, Michael Lewis & Peter Silverman, *Mediating Franchise Disputes*, A.B.A. 32ND ANNUAL FORUM ON FRANCHISING (2009).

If the franchise agreement includes an arbitration clause, the parties should evaluate whether the clause itself carves out the ability to seek injunctive relief outside of arbitration, or if the arbitration tribunal selected has the authority to award injunctive relief or expedite resolution. This is especially important if the system change was implemented to address an issue that needs immediate attention, such as an updated system standard regarding a health or safety issue.

2. Injunctions

When a franchisee refuses to comply with a system standard, the franchisor may consider seeking injunctive relief. Injunctive relief proceedings have several benefits for the franchisor:

- Injunctions offer a prompt resolution of the dispute. In the federal court system, a mandatory temporary restraining order ("TRO") can be issued within days (or even hours) of a TRO petition. Many state courts offer similar relief. Although a TRO is always of a limited duration, it can ensure compliance with the system change until the court considers the franchisor's motion for preliminary injunctive relief.[38] If the court issues a preliminary injunction, the matter is often resolved informally shortly thereafter.
- Immediately seeking an injunction against a non-complying franchisee sends a strong message throughout the system that the franchisor will aggressively enforce its system standards. That message can be helpful to encourage participation in future system changes, even if they are not popular with all franchisees in the system.

- While injunction proceedings are not cheap, they are often more cost effective than litigating a termination action. Moreover, many franchise agreements will contain a fee shifting provision allowing the franchisor to recover its expenses incurred when enforcing system standards.

If the franchisor decides to seek injunctive relief, it should evaluate its ability to establish the elements necessary for the grant of such relief. In almost all jurisdictions, the moving party must show that: (a) there is substantial likelihood of success on the merits; (b) an irreparable injury will result unless the injunction is issued; (c) the threatened injury to the movant outweighs the potential harm to the non-movant; and (d) the public interest would favor injunctive relief.[39]

An example of the effective use of injunctive relief to enforce system standards is the Eleventh Circuit's decision in *Dunkin*' *Donuts Franchised Restaurants LLC, et al. v. D & D Donuts, Inc.*[40] After a lengthy notice and cure process, and several attempts to bring the franchisee into compliance, Dunkin' Donuts filed an action seeking to enforce termination of the franchise agreement and enjoin the franchisee from using Dunkin Donut's intellectual property

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[38] Pursuant to Fed. R. Civ. Pro. 65(b), a TRO can only be issued for an initial duration of 14 days. The TRO can be extended upon a showing of good cause, such as the inability to schedule a preliminary injunction proceeding or the need for expedited discovery. As a general rule, most courts will decide a motion for preliminary injunction relatively quickly.

[39] *See e.g., Church v. City of Huntsville,* 30 F.3d 1332, 1341-42 (11th Cir. 1994).

[40] 566 F.Supp.2d 1350 (M.D. Fla. 2008).

following termination. Dunkin' Donut's complaint alleged nine separate defaults by the franchisee of the franchise agreement and system standards, including: the failure to timely pay franchise fees; the failure to enroll in mandatory Dunkin' Donuts programs and use designated software; unauthorized wholesale sales to third-party vendors; uncured violations of health, safety, and sanitation standards; and the failure to produce required business records.

The court granted Dunkin Donuts' request for a preliminary injunction after determining that Dunkin' Donuts had met each of the necessary elements. In addressing the likelihood of success element, the court found that the franchisee's failure to adhere to company standards "is likely sufficient to justify termination by Dunkin', [and] the Defendants . . . breached their franchise agreements by repeatedly violating Dunkin's health, sanitation, and safety standards."[41] The court went on to hold that, despite the franchisee's argument that any breaches were minor, in the food business "unsatisfactory sanitary practices – such as failing to clean food preparation equipment – in a business selling food to the public can [never] be considered *de minimus.*"[42]

The court next found that Dunkin' Donuts had made a sufficient showing of irreparable injury based on the franchisee's continued use of Dunkin' Donuts' trademarks, trade dress, and methods post-termination. Specifically, the court found that:

> Plaintiffs have established that the franchise agreements were properly terminated following Defendants' repeated material breaches of the agreements. It is also undisputed that Defendants' continued to operate all three shops utilizing the Dunkin' Donuts trademarks and trade dress. Pursuant to the executed franchise agreements, Defendants agreed that unauthorized use of Plaintiffs' trademark constitutes irreparable harm. Thus, the Court finds that Plaintiffs have established a substantial threat of irreparable injury if the preliminary injunction is not issued.[43]

In weighing the potential harms of the two parties, the Eleventh Circuit turned to the oft-cited reasoning that "[a]lthough the Court recognizes that Defendants will suffer financial losses if a preliminary injunction issues, that harm is a result of Defendant's own failure to comply with numerous requirements of their executed franchise agreements. Weighing Defendants' self-inflicted injury against Plaintiffs' immeasurable losses to its hard-earned goodwill, the Court finds that the balance of harms weighs decisively in favor of granting the requested injunctive relief."[44] Finally, the court cited the public's interest in preventing customer confusion as a basis to satisfy the final element of the injunctive relief analysis.[45]

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[41] *Id.* at 1357.

[42] *Id.* at 1358.

[43] *Id.* at 1361. While the court in *Dunkin' Donuts* found that trademark infringement, by its very nature, results in irreparable injury, there are other cases which do not find such a categorical presumption. *See eBay, Inc. v. Mercexchange, LLC*, 547 U.S. 388 (2006) (rejecting the use of a categorical presumption of irreparable injury in a permanent injunction analysis for a Patent Act case). Courts have since applied the reasoning in *eBay* to other intellectual property suits. S*ee, e.g., Salinger v. Colting,* 607 F.3d 68, 76 (2d Cir. 2010) (vacating an injunction in a copyright case relying on *eBay*).

[44] *Dunkin' Donuts*, 566 F.Supp.2d. at 1361-62.

[45] *Id.* at 1362.

GNC Franchising LLC, et al. v. Sala[46] is another good example of injunctive relief provided to a franchisor, as the necessary leverage to effect system change. In that case, in response to the Federal Food, Drug and Cosmetic Act, all GNC stores were required to stop selling products that contained ephedrine.[47] After having received several notices that ephedrine-containing products were no longer to be sold at GNC franchise locations, one franchisee continued to sell such products "under the table." GNC terminated the franchisee and requested a preliminary injunction. The court confirmed that the franchise agreements contained provisions stating the franchisee would not "do or perform, directly or indirectly, any other act injurious or prejudicial to the good will associated with [GNC's] Proprietary Marks and System."[48] By selling the banned products, the franchisee was violating the franchise agreement because "publicity of such sales could harm the reputation of GNC and diminish its standing with customers."[49] Following the general preliminary injunction analysis as outlined in *Dunkin*' *Donuts*, discussed above, the court held that GNC was entitled to injunctive relief to enforce termination of the contract.[50]

As demonstrated by the *Dunkin' Donuts* and *GNC* cases, albeit in the termination context, a franchisee's failure to comply with a franchisor's system standards and modifications maybe strong grounds for injunctive relief.

3. <u>Declaratory Judgment</u>

Another option for resolving disputes on system changes is filing a declaratory judgment action. For instance, in *Trail Burger King, Inc. v. Burger King of Miami, Inc.,*[51] when Burger King changed its standards to increase the quality and quantity of meat to be used in making hamburgers, one franchisee refused to go along. The franchisee filed a declaratory judgment action seeking a judgment that Burger King did not have the contractual right to implement the change. On a motion for judgment on the pleadings, the lower court agreed with the franchisor that it had the right to set and maintain standards and specifications for the operation of the restaurant and to change them from time to time. The appellate court affirmed.

The franchisee argued that the changes in system standards were essentially modifications or amendments to the agreement itself. Because amendments to the agreement had to be in writing signed by both parties, the franchisee asserted that Burger King could not enforce the changes in system standards. The appellate court, however, agreed with the lower court that the franchisor was acting pursuant to its right in the agreement, and not trying to amend the contract. It held that the modifications in system standards were "not modifications or amendments to the agreement, but were provided for in the agreement."[52] Accordingly, the appellate court affirmed the lower court's decision.

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[46] No. 06-00191, 2006 U.S. Dist. LEXIS 11320 (W.D. Pa. Mar. 20, 2006).

[47] *See* 21 C.F.R. §119.1.

[48] 2006 U.S. Dist. LEXIS 11320 at *10.

[49] *Id.* at *14.

[50] *Id.* at *22.

[51] 187 So.2d 55 (Fla. Dist. Ct. App. 1966).

[52] *Id.* at 55. *See* discussion at notes 58-67, *infra*.

While in this case the franchisee sued for declaratory judgment, there is no reason that a franchisor could not follow the same strategy.

4. **Termination**

Unfortunately, there are times when a franchisee is unwilling or unable to comply with newly implemented system standards. When these situations occur, a franchisor must ask itself whether termination is necessary or advisable. The franchisor-franchisee relationship should be at the top of a franchisor's list of considerations. The loss of a revenue generating entity, as well as any potential backlash and associated expenses from the ensuing litigation, are just a few of the issues a franchisor must consider when faced with the possibility of terminating a franchisee.

The franchisor must also be ready to defend against any counter-claims that will be asserted by the terminated franchisee. More often than not, counter-claims will be based on allegations of wrongful termination, the breach of the implied covenant of good faith and fair dealing, and/or statutory violations. This is where a strong franchise agreement will be handy. The franchisor will be in a much better position to act if it can successfully argue that (a) the franchisor had the right to implement system changes, (b) the changes were implemented for a valid business purpose, and (c) the franchisee failed to comply with the changes despite having ample opportunity and notice.

Before considering termination as an option, however, a franchisor must make certain that it complies with all of the procedural prerequisites outlined in the franchise agreement, as well as any applicable state relationship laws.[53] Each of these laws may provide a required notice and cure period and often limit termination to situations in which a franchisor has "good cause."[54] But, assuming those obligations are met, courts have generally upheld franchisors' decisions to terminate a franchisee based on the failure to comply with changing system standards.[55] Some states, like Arkansas, New Jersey, and Wisconsin specifically state that a franchisee's failure to meet the franchisor's standards constitutes good cause for termination.[56] Sometimes the statutory support simply references the franchisee's failure to follow the franchisor's requirements in the contract.[57]

[53] *See, e.g.,* Section IV(A)(3)(a).

[54] *See* Ark. Code Ann. §4-72-204; Cal. Bus. & Prof. Code §20020-20021; Conn. Gen. Stat. §42-133(f); Del. Code Ann. §2552; Haw. Rev. Stat. §482E-6; 815 Ill. Comp. Stat. §705/19; Ind. Code §23-2-2.7-1; Iowa Code Ann. §523H.7; Mich. Comp. Laws §445.1527; Minn. Stat. Ann. §80C.14; Neb. Rev. Stat. §87-404; N.J. Stat. Ann. §56:10-5; Va. Code. Ann. §13.1-564 (requiring "reasonable cause" for termination); Wash. Rev. Code §19.100.180(2)(j); and Wis. Stat. §135.03.

[55] *See, e.g., Remus v. Amoco Oil Co.,* 611 F.Supp. 885 (E.D. Wis. 1985), *aff'd*, 794 F.2d 1238 (7th Cir. 1986) ("Common sense suggests that when a company has determined that an aspect of its business should be changed in order to stay competitive, it has good cause to make the change provided that it does so in a non-discriminatory manner") and *Petereit, et al. v. S.B. Thomas, Inc., et al.,* 63 F.3d 1169 (denying a claim that a territorial realignment effectively terminated a franchise agreement and holding that such realignment was a "legitimate business need to increase sales" and, thus, constituted "good cause" within the meaning of the Connecticut Franchise Act); *but see, Beilowitz v. General Motors Corp.,* 233 F.Supp.2d 631 (D.N.J. 2002).

[56] *See* Ark. Code Ann. §4-72-202(7)(A); N.J. Stat. Ann. §56:10-5; and Wis. Stat. §135.02(4)(a).

[57] *See, e.g.,* Conn. Gen. Stat. §42-133(f)(a) ("No franchisor shall, directly, or through any officer, agent or employee, terminate, cancel or fail to renew a franchise, except for good cause which shall include, but not be limited to the franchisee's refusal or failure to comply substantially with any material and reasonable obligation of the franchise

For example, termination by virtue of the failure to maintain operation standards was found to be within a franchisor's right, as provided for in the franchise agreement, in *La Quinta Corp. v. Heartland Properties, LLC.*[58] In *La Quinta,* the franchisor adopted a new system standard for computerized reservations known as L.I.S.A.[59] The new system required the franchisee to install upgraded computer hardware and software at a cost of approximately $35,000.[60] The franchisor required franchisees to sign a license agreement for the new software, which allowed the franchisees to amortize the expense of the system over the term of the license agreement.[61] If the license agreement was terminated prior to the expiration of the term, the franchisee would be required to pay any unamortized costs at the time of termination.[62]

The franchisee refused to implement the system upgrade, arguing that the system upgrade was a breach of contract and a breach of the duty of good faith.[63] The franchisee's claim was based on the franchisee's contractual right to terminate the agreement, at its option, at its ten-year anniversary.[64] Because the system change was implemented shortly before the franchisee could execute its non-renewal option, and the license agreement accelerated all unamortized amounts remaining at the time of termination, the franchisee argued that it "would be charged for a reservation system that it was no longer using."[65]

The franchisor notified the franchisee that it was in violation of the franchise agreement. After several unsuccessful attempts at resolution, the franchisor terminated the franchise agreement. In affirming the United States District Court for the Western District of Kentucky's grant of summary judgment in favor of the franchisor, the Sixth Circuit stated:

> Heartland contends that the L.I.S.A. Agreement effected "significant changes" and imposed additional demands on franchisees such as it, beyond those contained in the License Agreement. Because these material changes were imposed without its written consent, Heartland asserts that Baymont anticipatorily breached the License Agreement, thereby excusing further performance on Heartland's part. Heartland focuses on several discrete provisions in the L.I.S.A. Agreement: the ten-year amortization period, the forum selection clause, a

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agreement"); 815 Ill. Comp. Stat. §705/19 ("'Good cause' shall include, but not be limited to, the failure of the franchisee to comply with any lawful provisions of the franchise or other agreement"); and Wash. Rev. Code §19.100.180(2)(j) ("Good cause shall include, without limitation, the failure of the franchisee to comply with lawful material provisions of the franchise or other agreement between the franchisor and the franchisee").

[58] *See La Quinta Corp.*, 603 F.3d at 338; *see also* discussion note 4, *supra*.

[59] *See La Quinta Corp.*, 603 F.3d at 338.

[60] *Id*. at 331.

[61] *Id*.

[62] *Id*.

[63] *Id*. at 331-32.

[64] *Id*. at 333.

[65] *Id*. at 336.

> disclaimer of warranties and limitation of liability pertaining to the software, and Baymont's right to disable the software should the franchisee be in default.
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> We agree with the district court, however, that Baymont's implementation of the L.I.S.A. System with its attendant costs was fully contemplated and permitted under the unambiguous terms of the License Agreement. Sections 5.a and 7.d of the License Agreement expressly gave Baymont the right to add, amend, and/or delete System Standards, including the reservation system, and required Heartland to participate in and bear such costs[.]
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> . . . .
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> Section 3.a of the License Agreement allowed Baymont to, by adoption or amendment of its "Systems Manuals" and/or "Policy Statements," amend, modify, delete or enhance any portion of the System, including any of the Marks, System Standards and the Prototype Package, as may be desirable, in the sole judgment of [Baymont], to maintain or enhance the reputation of the System or improve System license marketability."
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> Consistent with these provisions, Baymont had the right to institute changes to its reservation system and require Heartland to conform to this new System Standard "at its sole expense." Indeed, David Adams admitted so during his deposition, conceding that under the terms of the License Agreement, Baymont had the right to charge Heartland for upgrades to the reservation system.
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> In sum, we reject Heartland's assertion that Baymont breached the License Agreement through its implementation of the L.I.S.A. System and insistence that Heartland adopt its new reservation system. Baymont did not breach the License Agreement, but Heartland did when it failed to comply with its contractual obligation to adopt new System Standards. The district court therefore did not err in granting summary judgment in favor of Baymont, and denying Heartland's motion, regarding the parties' respective breach of contract claims.[66]

In light of its decision that Baymont had exercised its rights under the franchise agreement to modify system standards, Baymont also could not be liable for their breach of the implied covenant of good faith and fair dealing or for intentional inference with a contractual relationship.[67]

5. Non-Renewal

While often seen by franchisees as the impermissible exercise of contractual rights, non-renewal as a basis for exercising a franchisor's right to effect system change can provide

[66] *Id*. at 335, 336-37, 338.

[67] *Id*. at 338. *See discussion* accompanying notes 86-90, *infra*.

considerable leverage to a franchisor. Again, franchise relationship laws, often, override many contractual rights reserved by franchisors in the franchise agreement relating to renewal. Because franchisees typically invest substantial amounts of time and money in developing and operating their franchises, many relationship laws, in an effort to curb "arbitrary" decisions, require good cause, among other requirements, prior to non-renewal. Thus, a franchisor may encounter unexpected hurdles, or outright walls, when seeking to require a franchisee to renew their agreement which now may contain substantially different terms than that which they were operating under previously. So, before proceeding down this path, a franchisor must make certain that any decisions to not renew a franchisee's agreement are well-grounded under a "good cause" analysis, meet required notice and cure periods and otherwise comply with existing franchise relationship laws.[68]

In the context of system-wide changes, the renewal process presents a unique opportunity for a franchisor to force compliance with changes to its franchise system that have taken place over the years. A franchisor can remind a franchisee that any non-compliance with proposed system changes will be reviewed when considering whether to extend to the franchisee a renewal to the franchise agreement. Franchisees who have expended considerable sums to develop and maintain their franchised business, oftentimes, may feel as if they have no choice but to agree to the terms of the new renewal agreement. In many cases, this may be true. As a precondition to renewal, most franchise agreements require the franchisee to be in compliance with the contract – including system standards. Also, many franchise agreements require franchisees to sign the then-current form of agreement. In doing so, presumably they also agree to meet the franchisor's current system standards. Thus, franchisors, through the renewal process can force a franchisee to implement system-wide changes a variety of ways if the contract allows.

For example, in the recent unpublished decision in *G.I. McDougal, Inc. v. Mail Boxes Etc., Inc.,*[69] a California appellate court upheld Mail Boxes, Etc.'s and UPS' right to require its existing franchisees to sign a then-current version of the franchise agreement which required a major system change – one to the brand name itself. Specifically, the court noted:

> Defendant franchisor was not required to renew the existing franchise agreement intact and without change. Pursuant to the franchise agreement, the franchisor did change the business name and the proprietary marks of the franchise. Consequently the franchisor did not offer franchise agreements for the sale of "new MBE Centers" at renewal, and instead offered franchise agreements for the sale of "The UPS Store" franchises. The "then current Franchise Agreement" offered was for the sale of "The UPS Store" franchises.
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> . . . .

[68] *See, e.g.*, Ark. Code Ann. §4-72-204; Cal. Bus. & Prof. Code §20020, 20025; Conn. Gen. Stat. §42-133(f); Del. Code Ann. §2552; Haw. Rev. Stat. §482E-6; 815 Ill. Comp. Stat. §705/20; Ind. Code §23-2-2.7-1; Iowa Code Ann. §523H.8; Mich. Comp. Laws §445.1527; Minn. Stat. Ann. §80C.14; Neb. Rev. Stat. §87-404; N.J. Stat. Ann. §56:10-5; Va. Code. Ann. §13.1-564 (requiring "reasonable cause"); Wash. Rev. Code §19.100.180(2)(i); and Wis. Stat. §135.03.

[69] No. B226112, 2012 WL 90083 (Cal. Ct. App. Jan. 12, 2012), unpublished/non-citable (Jan. 12, 2012), *review denied* (Apr. 25, 2012).

> Defendants, by requiring renewal of the franchise agreement by executing a document extending the term of the franchise agreement on the same terms and conditions as were contained in the then current franchise agreement for the sale of The UPS Store, did not breach the contract.[70]

If that were not enough, in an added victory to franchisors, the court went on to hold that the requirement to renew did not breach the implied covenant of good faith and fair dealing.[71]

As *Mail Boxes Etc., Inc.* demonstrates, requiring a franchisee to comply with certain system standards as a prerequisite for renewal and/or the signing of the then-current franchise agreement is, generally, permitted. However, franchisors must still make sure they meet the necessary "good cause" requirements imposed by their respective states' franchise relationship laws.[72]

6. **Trademark Actions**

Franchisors are not only entitled, but required to monitor and protect the goodwill inherent in their trademarks and other intellectual property. Where a franchisee is unwilling or unable to implement changes required by the franchisor, customer confusion, loss of goodwill, and damage to reputation may result.[73] Accordingly, in an effort to ensure brand uniformity throughout its system, a franchisor may bring an action for trademark infringement.

Franchise agreements commonly contain very specific provisions on how a franchisee may use a franchisor's marks and intellectual property. System standards are implemented to achieve the uniformity and replication of experience that a customer associates with businesses operated under the franchisor's marks. A franchisee who fails to conform to system standards is therefore often not only in breach of contract, but potentially violating federal laws related to the protection of a franchisor's intellectual property rights, including the Lanham Act.[74] Trademark claims can be powerful tools for the franchisor in the event of breach, given that the Lanham Act includes substantial penalties, including fee shifting and a statutory damages enhancer in certain circumstances.

One such example of a franchisor successfully using a trademark action to enforce system standards is *Dunkin' Donuts, Inc. v. Albireh Donuts, Inc.*[75] In that case, the franchisor obtained an injunction after the franchisee refused to comply with system standards. The

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[70] *Id.* at *8, 9.

[71] *Id.* at *10 ("The renewal provision contains no express contractual obligation to renew the franchise on the same terms as in the original franchise agreement. Instead the renewal provision expressly grants renewal 'on the same terms and conditions as are contained in the then current Franchise Agreement for the sale of new MBE Centers.' There was no express, specific contractual obligation upon which to imply a covenant of good faith and fair dealing, and thus no breach of that covenant when defendants offered renewal of the franchise to McDougal on the same terms and conditions as were contained in the then current franchise agreement").

[72] *See* note 56, *supra*; *see also* Section V(A)(8), *infra*.

[73] For a more advanced discussion on the legal significance of protecting trademarks by enforcing system standards, *see* Schumacher, note 14, at 10-17 *supra*.

[74] *See* Lanham Act, 15 U.S.C. §1051 *et seq.*

[75] 96 F.Supp.2d 146 (N.D. N.Y. 2000).

franchisor argued that the franchisee's failure to comply was a non-conforming and "unlicensed" use of the franchisor's trademark. The court agreed with the franchisor, holding that:

> One of the most valuable and important protections afforded by the Lanham Act is the right to control the quality of the good manufactured and sold under the holder's trademark . . . because [the franchisees] are selling products under [Dunkin' Donuts'] trade name that do not conform to [Dunkin Donuts'] quality, safety, and health specifications, it is likely that there will be confusion as to the source of [the franchisees'] products or that the value of [Dunkin' Donuts'] trade name will be diminished, and [Dunkin' Donuts] will succeed on one or all of its Lanham Act claims."[76]

Trademark actions related to systems standards may not only be a powerful tool to promote compliance, but may also be required to avoid the risks of "naked licensing" or cancellation of its trademark protections.

B. Franchisee Challenges to Resist System Modifications

Franchisees are at times placed in the unenviable position of being presented with changes in systems standards with which they fundamentally disagree. The system modifications may carry a significant capital expense, increase operating costs and require additional staffing. The franchisee may dispute the change because it simply considers the proposed change to be a poor business strategy.

When a franchisor attempts to implement such changes, the franchisee may benefit from legal protections limiting the extent of the franchisor's discretion. Over the years, franchisees have challenged systems modifications based on claims for breach of contract, breach of good faith and fair dealing, and violations of state and federal laws governing the franchise relationship.

1. Breach of Contract / Declaratory Judgment

Franchisees seeking to avoid compliance with system changes often challenge the franchisor's ability to implement the changes based on the language in the franchise agreement. These challenges have met with little success over the years, and depend significantly on the rights reserved by the franchisor.

The first reported breach of contract case was *Trail Burger King, Inc. v. Burger King of Miami, Inc*.,[77] which dates back nearly sixty years. In that case, the franchise agreement included a provision requiring the franchisee to "insure uniformity" with the system and to sell only products made in compliance with the then-current formula prescribed by the franchisor. The franchisor made certain modifications to its formula for the production of hamburgers (the amount of meat in the burger).[78] The franchisee failed to comply with the new burger formula which resulted in the franchisor sending a notice of default. Rather than implementing the changes, the franchisee filed suit seeking a judicial declaration that the franchisor did not have

[76] *Id.* at 151.

[77] *Trail Burger King, Inc. v. Burger King of Miami, Inc.,* 187 So. 2d 55 (Fla. 3d DCA 1966).

[78] *Id.*

the contractual authority to implement the changes.[79] The franchisee argued that "any changes in standards and specifications in the operation of the restaurant from those in existence at the time of the execution of the agreement would be a modification and amendment to the agreement, which would require written consent of both parties."[80]

The Florida Court of Appeals disagreed with the franchisee, finding that the change to the systems standards was not an amendment or modification to the agreement, but was instead reserved in the agreement. The court went on to state that "one of the objects is to provide uniformity among all franchised 'Burger King' restaurants. A review of the clauses of the agreement . . . reveals that this uniformity is accomplished by providing that the defendant set and maintain standards and specifications which the [franchisee] must follow or suffer termination of the agreement."[81]

Many years later, Burger King's franchise agreement was again challenged in *Nat'l Franchisee Ass'n v. Burger King Corp.*[82] Since the late 1960s, Burger King had allowed its franchisees to set prices on the products they sold in their franchised businesses. However, in 2002, Burger King, in response to market demands, instituted a "99 cent BK Value Menu Policy Statement" wherein Burger King declared it had the right to set a maximum price that a franchisee could sell certain products. In 2005, Burger King instituted a new $1.00 Value Menu system-wide. After twice being rejected by a vote of the franchisees, Burger King unilaterally required all franchisees to place a double cheeseburger on the Value Menu for $1.00. Many franchisees disagreed with this decision, arguing that selling the double cheeseburger for $1.00 would result in a net loss on the sale.[83]

The court found that the express language of the franchise agreements permitted Burger King to require its franchisees to submit to the proposed pricing schedule:

> Even under an independent analysis of Section 5 by this Court, the third court to do so, the NFA's claim that Section 5 does not grant BKC the authority to impose maximum prices still fails as a matter of law.[84]

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[79] *Id.* at 57.

[80] *Id*.

[81] *Id.* at 58.

[82] *Nat'l Franchisee Ass'n v. Burger King Corp.,* 715 F. Supp. 2d 1232 (S.D. Fla. 2010).

[83] Although Burger King had the contractual authority to act, the court did not immediately agree that Burger King honored its duty of good faith and fair dealing. The sale of the double cheeseburger did, after all, result in a net loss to the franchisee. However, in a subsequent challenge to the pricing schedule the court found "nothing inherently suspect about such pricing strategy for a firm selling multiple products." *Id.* at *15. The Court further noted that Burger King had a legitimate business reason for implementing the pricing strategy, namely, building goodwill and customer loyalty, and increasing sales by diverting customer traffic away from competitor locations. *Id*.

[84] A year earlier in *Burger King Corp. v. E-Z Eating*, *infra*, note 11, the Eleventh Circuit affirmed a District Court's determination that Section 5(A) provided Burger King the authority to impose the Value Menu: "[w]e agree with the district court on this point. Section 5(A) of the Franchise Agreements provided that the franchisee 'agrees that changes in the standards, specifications and procedures may become necessary and desirable from time to time and agrees to accept and comply with such modifications, revisions, and additions to the MOD Manual which BKC in the good faith exercise of its judgment believes to be desirable and reasonably necessary.' There is simply no question that BKC had the power and authority under the Franchise Agreements to impose the Value Menu on its franchisees."

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> Where the language of the contract is clear and unambiguous, its proper interpretation must be garnered from the language of the contract.
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> . . . .
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> [Section 5] clearly grants BKC the authority to establish and make changes in its comprehensive restaurant format and operating system, including product specifications.[85]

Thus, Burger King did not breach the franchise agreement, as it had specifically reserved the right to impose product specifications and standards, which the court found extended to requiring franchisees to sell products at specified prices. Notably, the franchise agreement did not specifically allow the franchisor to set prices. Broad authority to set system standards was enough.

The express reservation of rights in the franchise agreement was also at issue in *Economou v. Physicians Weight Loss Centers of America.*[86] In that case, the franchisor's system involved weight loss programs, including very low caloric diets. Approximately three years after the plaintiff franchisees entered the system, a report surfaced questioning the medical safety of the low calorie diets. In response, the franchisor required the franchisees to distribute an information sheet, which informed potential customers of certain risks associated with the diet.[87] A short time later, the franchisor modified the very low caloric diet, increasing its calorie total from 700 calories to 900.[88] As a result, the weight loss guaranty offered by the system decreased. The franchisees asserted that this change breached the franchise agreement.

In considering the franchisees' claim, the court examined the following reservation of rights contained in the franchise agreement:

> Franchisor reserve the right to modify or change the System, Marks, the various training programs offered to Franchisee and their employees, and the Manuals at any time, and from time-to-time by addition, deletion, or other modification to the provisions thereof, and such modification shall be made in the sole judgment of Franchisor to protect Franchisor Marks and goodwill, to comply with any applicable law, statutes or judicial or administrative decision, or to improve the quality of services, training or products offered.[89]

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[85] 715 F. Supp. 2d 1232, *infra*, note 82.

[86] 756 F.Supp. 1024 (N.D. Ohio 1991).

[87] *Id*. at 1028.

[88] *Id*.

[89] *Id.*

Following that examination, the court denied the franchisees' claim, finding that the "franchise agreement specifically allows [franchisor] to make such changes. These contractual clauses serve to defeat plaintiffs' breach of contract claim."[90]

Turning back to the food world, the franchisee in *Bores v. Domino's Pizza* was initially successful in challenging the franchisor's authority to implement a system change – only to have that success overturned by the Eighth Circuit.[91] Domino's implemented a modification requiring all franchised locations to install and use its proprietary PULSE computer system. The PULSE system was designed to "allow better communication, service, information gathering and reporting, and coordination."[92] Franchisees were required to purchase the new system directly from Domino's. Certain franchisees filed suit alleging breach of contract, fraud, negligent misrepresentation, and breach of the implied covenant of good faith and fair dealing, arguing that the required use and installation of the PULSE system was merely a pretext for Domino's to generate additional revenues from its franchisees.[93] The franchisees alleged that Section 8.2 of the franchise agreement expressly prevented Domino's from requiring them to install the PULSE system because it did not specifically say that Domino's could be the supplier:

> We will provide you with *specifications* for pizza, other authorized food and beverage preparation, dispensing, storage and display equipment, delivery and related motor vehicles, other equipment, fixtures, furniture, *computer hardware and software,* exterior and interior signs and decorating required by the Store. *You may purchase items meeting our specifications from any source.*[94]

The franchisees argued that Section 8.2 should be interpreted merely to permit Domino's to provide them with the "specifications" for the PULSE system. The franchisees suggested they should be free to purchase the requisite hardware and software "from any source," including sources other than Domino's.

The District Court of Minnesota agreed with the franchisees, relying on a curious interpretation of the word "specification" and phrase "from any source" and granted summary judgment on their breach of contract claim:

> Having reviewed the Franchise Agreements in their entirety, giving them a fair, reasonable, and practical construction, [citation omitted] the Court determines that the Agreements are clear and unambiguous, and do not permit Domino's to mandate the installation of PULSE by franchisees, unless Domino's provides the "specifications" for PULSE and permits franchisees to obtain computer hardware and software meeting those specifications "from any source."
>
> As noted above, Section 8.2 *expressly* states that Domino's will provide its franchisees with "specifications" for "computer hardware and software," and

[90] *Id*. at 1037.

[91] *Bores V. Domino's Pizza, LLC,* 530 F.3d 671, 673 (8th Cir. 2008). On appeal from *Bores v. Domino's Pizza, LLC,* 489 F.Supp.2d 940 (D. Minn. 2007).

[92] *Bores*, 489 F.Supp.2d 940 at 943.

[93] *Id.*

[94] *Bores*, 530 F.3d 671 at 673.

> *expressly* gives franchisees the right to purchase computer hardware or software meeting those specifications "from any source." Clearly, then, Domino's cannot require its franchisees to purchase computer equipment directly from it (or from any other source that Domino's designates). Yet, that is precisely what would occur if Domino's were allowed to foist the PULSE system onto its franchisees, because PULSE is only available through IBM (for hardware) and Domino's (for software). Dominos' PULSE mandate, therefore, runs afoul of Section 8.2.
>
> . . . .
>
> At bottom, it cannot seriously be disputed that Domino's may change computer systems or require franchisees to update those systems from time to time – that much is abundantly clear from the Franchise Agreements. Yet, it is equally clear that Domino's cannot force its franchisees to purchase updated computer hardware or software *only from Domino's* (or from another source of Domino's choosing). Because PULSE can only be purchased from Domino's (and IBM), Domino's cannot, consistent with the Franchise Agreements, mandate the installation of that system by its franchisees. Instead, if it insists upon mandating PULSE, it must provide the franchisees with PULSE's specifications and allow them to purchase computer equipment meeting those specifications "from any source." Insofar as Domino's refuses to do so, the Court determines that the corporate Plaintiffs are entitled to summary judgment on their breach-of-contract claim.[95]

Domino's appealed to the Eighth Circuit, claiming the District Court misinterpreted the language of the franchise agreement. The Eighth Circuit, in a battle of the dictionaries, clarified the meaning of the term "specification" and phrase "from any source" and held:

> Plaintiffs contend specification, as used in the franchise agreements, can only mean the list of the parts and technology from which Domino's PULSE system is constructed. Applying the above definitions, however, it is apparent the plain and ordinary meaning of specification includes both a list of the component parts necessary to construct or describe an item, as well as a single, finished, product. For example, specification encompasses a detailed description of the particular characteristics desired in an automobile or simply identifying a particular make and model; in each instance specifications are provided. Thus, we conclude the plaintiffs' arguments unreasonably focus on only one of the commonly understood definitions of specification; nothing in the franchise agreements limits the meaning of specification to a single usage. Applying the commonly understood definition of specification, the agreements permit Domino's to specify a computer system with comparable capabilities or the PULSE system.
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> We further conclude Section 8.2's language permitting franchisees to obtain the specified computer software and hardware "from any source" does not change the meaning of specification. Plaintiffs argue "any" means multiple sources, and interpreting specification to include items only available from one source would

[95] *Bores v. Domino's Pizza LLC,* 489 F. Supp. 2d 940, 946, 948 (D. Minn. 2007) *enforcement denied,* CIV. 05-2498 RHK/JSM, 2007 WL 3312272 (D. Minn. Nov. 6, 2007) and *rev'd and remanded sub nom. Bores v. Domino's Pizza, LLC*, 530 F.3d 671 (8th Cir. 2008).

> render "from any source" meaningless. We disagree. From any source is necessarily limited to available sources, and, as Domino's points out, the definition of "any" includes "one, some, every or all." American Heritage Dictionary 81 (4th ed. 2000). Thus, the franchise agreements merely allow plaintiffs to purchase the specified computer system-PULSE-from any available sources, be they one or many. Further, plaintiffs' assertion they are not permitted to purchase the PULSE system from multiple sources is factually unsupported. Domino's is the most likely source from which the PULSE system could be obtained, but not necessarily the only source. For example, the franchise agreement would not preclude franchisees from obtaining a used PULSE system from another franchisee.[96]

The Eighth Circuit reversed the District Court and remanded with instruction to enter a dismissal in Domino's favor. Again, broad and general contractual language provided the necessary support.

While several breach of contract claims brought by franchisees were unsuccessful, that is not always the case.[97] In *Bird Hotel Corporation v. Super 8 Motels, Inc*.,[98] the franchisor apparently overstepped its bounds when, in addition to changing system standards, it imposed a new fee. Here, the plaintiff franchisee filed a class action lawsuit after the franchisor implemented a new customer rewards program, under which franchisees were "invoiced by the franchisor for five percent of any motel room sold to a customer."[99] The plaintiff franchisee claimed that the 5% fee was an additional fee that the franchisor had no contractual authority to impose.

The franchisor brought a motion for judgment on the pleadings alleging that system wide operation revisions were expressly authorized by the following language in the franchise agreement:

> Franchisor and Franchisee recognize that the wisdom and practicality of all rules for the operation of the System may require amendment from time to time as a result of experience, and they therefore agree that Franchisor may, from time to time, make revisions in or amendments to such rules of operation which franchisor shall apply uniformly to all Super 8 Motels, including those owed and operated by Franchisor, and franchisee agrees to comply with all such revisions and amendments.[100]

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[96] *Bores v. Domino's Pizza, LLC*, 530 F.3d 671, 675-76 (8th Cir. 2008).

[97] *See* 246 F.R.D. 603; *see also Carvel Corp. v Baker*, 79 F. Supp.2d 53 (D. Conn. 1997) (dealing with a franchisor's attempt to implement an alternative mode of distribution, despite the express language in early versions of its franchise agreements stating that its products would only be sold through stores operated pursuant to the franchisor's system. Although this matter did not deal with a systems modification with which existing franchisees were forced to comply, it demonstrates the importance of the express contract terms when assessing a franchisor's ability to take actions affecting the franchised system).

[98] *Bird Hotel Corp.*, 246 F.R.D. 603.

[99] *Id*. at * 3.

[100] *Id.* at * 4.

The court denied the franchisor's motion, finding that although the language of the franchise agreement allows for unilateral imposition of system changes, the "limited record before the court does not allow for a ruling on whether Super 8's 5% charge for room sales to Trip Rewards members is a franchise fee."[101] Thus, unless explicit, the right to impose system standards may not authorize charging an additional fee.

The change to system standards to institute the rewards program was not the issue. But the imposition of the additional fee was apparently tantamount to changing the fee provisions of the franchise agreement. Thus, the court decided on the record before it, it could not rule on the issue and refused to dismiss the claim.

Likewise, in *Stuller, Inc. v. Steak N Shake Enterprises, Inc., et al.*, the franchisor attempted to implement a policy requiring all franchisees to "follow set menu and pricing . . . and to offer all company promotions as published."[102] The franchisor claimed that this policy was part of the "System" as the term was defined in the franchise agreements. Stuller, a multi-unit franchisee, refused to comply, asserting that "the policy was contrary to 'long-standing custom, practice, policy, agreement, and representation,' that franchisees could set their own prices for menu items, maintain custom menus, and choose whether to follow promotions."[103] Stuller further asserted that the franchise agreements were ambiguous as to whether pricing was part of the "System."[104]

In response to Stuller's refusals to comply, the franchisor sent default notices threatening to terminate each of Stuller's franchises. Stuller subsequently filed a complaint (1) seeking a judicial declaration that it was not required to comply with the Franchisor's policy under the terms of the franchise agreement, and (2) alleging breach of contract. Stuller also sought, and obtained, a preliminary injunction to prevent the franchisor from taking any adverse action against Stuller for refusing to implement the policy. Stuller later filed a first amended complaint, which added a third claim, plead in the alternative, that if Stuller was required to comply with the franchisor's new policy, then the franchisor violated the Illinois Franchise Disclosure Act ("IFDA").

After engaging in discovery, Stuller and the franchisor filed cross motions for summary judgment. In considering the cross motions, the court first determined that the franchise agreements were ambiguous on the issue of whether pricing was part of the "System" that the franchisor reserved the right to modify.[105] The court explained that the express definition of the "System" in the agreement made no mention of either pricing or promotions.[106] Accordingly, the court determined it was proper to resort to extrinsic evidence to determine the parties' intent.

The court then looked at the extrinsic evidence provided by each party. The franchisor made three arguments in support of its contention that the parties intended the "System" to

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[101] *Id*. at * 6.

[102] 2012 U.S. Dist. LEXIS 97414 (C.D. Ill. July 12, 2012).

[103] *Id*. at * 2.

[104] *Id*. at * 3.

[105] *Id*. at * 37.

[106] *Id.* at 38-39.

include pricing and promotional obligations: (1) the term “System” in the franchise industry (including in the IFDA) is commonly defined to include price and promotion; (2) the parties removed a provision that allowed the franchisee to determine whether to follow the franchisor’s suggested pricing and promotional efforts when the franchise agreements were renewed in 1995; and (3) documents evidencing negotiations leading up to the revised franchise agreements, which showed the right to set prices was discussed and not included.[107]

Stuller countered the franchisor’s position by citing to: (1) language in the 1995 Uniform Franchise Offering Circular (“UFOC”) that expressly stated that franchisees had the ability to set their own prices; (2) the prior course of dealing and course of performance between the parties; (3) trade usage of the term “System”; and (4) memoranda during the negotiations of the 1995 agreements which indicated that Stuller would continue to have the ability to control its pricing.[108]

After considering the evidence, the court granted summary judgment to Stuller. The court first determined that, although the IFDA’s definition of a “marketing plan or system” does include pricing and promotion, those elements are not <u>required</u> under the statute.[109] Accordingly, the court determined that even though “the IFDA allows a marketing plan or system to include specification of price, this fact does not shed light on the parties’ intent when drafting the agreements at issue ….”[110]

The court next rejected the franchisor’s contention that the parties’ intent to reserve the right for the franchisor to set prices was shown by the fact that the 1995 agreements excluded a reservation of rights, included in prior agreements allowing the franchisee to set prices at its discretion.[111] The court stated that, although this exclusion was significant, the parties’ intent was more clearly shown in memoranda exchanged between the parties when they were negotiating the 1995 agreements (including memoranda in 1993 specifically stating Stuller would still have the ability to determine its own prices).

The court also found it significant that the UFOC (provided to Stuller prior to entering into the 1995 agreements) specifically stated that franchisees were free to set their own prices, and that many did so. The court recognized that, although the UFOC was not a contract between the parties, it was evidence of the parties’ intent.[112]

Finally, the court noted that Stuller had been a Steak N Shake franchisee since 1939, and was allowed to set its own prices for over 70 years.

The *Stuller* case is an interesting contrast to the *National Franchisee Association v. Burger King Corp.* case.[113] In *Stuller*, the direct negotiations and course of dealing between the

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[107] *Id*. at * 42-43.

[108] *Id*. at 43.

[109] *Id*. at * 45.

[110] *Id*. at * 46.

[111] *Id*. at * 47.

[112] *Id*. at * 48.

[113] *See* discussion at notes 72-75, *supra*.

parties negated the franchisor's ability to mandate pricing and promotional strategies. The court found that the term "System" did not include pricing. But in the *Burger King* case, the court ruled that broad language giving the franchisor the right to set system standards included promotions and pricing.

2. <u>Breach of Good Faith and Fair Dealing</u>

Even when a franchise agreement gives the franchisor discretion to modify the system, that franchisor still must "exercise that discretion reasonably and with proper motive, and may not do so arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties."[114] The implied covenant of good faith and fair dealing is another common challenge raised by the franchisee attempting to resist system change. As discussed below, franchisee success with good faith and fair dealing challenges has been only marginally better than that with breach of contract actions.

Like breach of contract actions, the express language in the franchisor's reservation of rights is a critical factor in assessing a good faith and fair dealing analysis. Generally speaking, the more specific the reservation of rights, the more likely that the court will determine that the franchisor honored its good faith duty owed to the franchisee. For example, in the *Laquinta* case discussed above, the franchisor had not only reserved the general right to modify the system from time to time, but also expressly served the right to "add, amended and/or delete System Standards, including . . . inn technology . . . and reservation system participation . . ."[115] *Laquinta* implemented new software related to an updated reservation system, which it required its franchisees to implement. The franchisee attempted to avoid compliance with the system based on a good faith and fair dealing challenge. The Sixth Circuit denied the franchisee's challenge, citing to a succinct analysis provided by the Wisconsin Court of Appeals:[116]

> where the contracting party complains of acts of the other party that are specifically authorized in their agreement, we cannot see how there can be any breach of good faith and fair dealing. Indeed, it would be a contradiction in terms to characterize an act contemplated by the plain language of the parties' contract as a bad faith breach of that contract.[117]

Even when the contract does not reserve rights as specifically as the agreement in *Laquinta*, the courts have still been hesitant to find a breach of good faith absent some showing that the franchisor acted arbitrarily and capriciously. For example, in *In re Sizzler Restaurants International Inc.*, Sizzler allowed third parties to operate Sizzler restaurants pursuant to a license agreement.[118] That license agreement provided in relevant part that:

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[114] *Burger King v. Agad*, 941 F.Supp. 1217, 1221 (N.D. Ga. 1996).

[115] *La Quinta Corp.*, 603 F.3d at 338; *see also* discussion note 4, *supra*.

[116] *Id*.

[117] *Id*.

[118] 225 B.R. 466 (C.D. Cal. 1998).

> Licensor covenants and agrees
>
> . . .
>
> To provide Licensee with the use of books, manuals and other written materials relating to product specifications, advertising and promotion, operations and training, including additions and updates thereto as published by Licensor from time to time. Licensor reserves the right to periodically review these publications, collectively known as the Management Guide, and make additions and deletions as Licensor deems necessary; and
>
> To provide assistance and advice in the promotion of the general business welfare of Licensee as Licensor deems necessary from time to time for the maintenance of the Sizzler method of operation."[119]

Sizzler's concept was comprised of two primary components: (a) buffet court and (b) a grill menu.[120] Although the buffet court concept historically generated the bulk of the sales at Sizzler restaurants, it was less profitable than the grill menu.[121] As a result, Sizzler made a business decision to change its marketing emphasis away from the buffet court and focus on the grill menu.[122] Sizzler did not tell its franchisees that they could not continue to offer the buffet court.[123] The plaintiff franchisee nevertheless alleged that Sizzler breached the license agreement and the implied covenant of good faith and fair dealing by abandoning its support of the buffet court.

The Court rejected the franchisee's claims, reasoning that Sizzler's reorientation of its marketing focus did not breach the implied covenant of good faith because it was motivated by a commercial strategy.[124] The Court noted that the franchisee failed to produce any evidence showing that Sizzler acted dishonestly or outside accepted commercial practices when deciding on the strategy.[125] The Court also noted that when entering the franchise relationship, a franchisee is knowingly dependent on the franchisor's judgment on the future direction of the business.[126] While the franchisee may disagree on the merits of the strategy, there is no violation of the duty of good faith if the franchisor had legitimate business reasons for its decision to refocus its business.[127] The court stated that its role was not to second-guess

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[119] *Id*. at 470.

[120] *Id*. at 471.

[121] *Id*.

[122] *Id*.

[123] *Id*.

[124] *Id.* at 476.

[125] *Id.*

[126] *Id.* at 474.

[127] *Id.*

business strategies reached by an independent business in the pursuit of a legitimate business interest and rejected.[128]

Carvel Corp. v. Noonan represents a stark contrast to *Sizzler.*[129] The franchisor in *Carvel Corp.* sought to change how its products were distributed by expanding into local supermarkets. Among other evidence, the franchisee was able to demonstrate that the franchisor not only rejected its consulting firm's recommendation to study the impact of the supermarket decision, but that the franchisor even instructed its consulting firm *not* to study the impact.[130] The franchisee further introduced testimony that in response to a question regarding the impact of the program on franchisees, the chief-executive-officer said that he "didn't give a f--k about the franchisees."[131] Not surprisingly, on these facts, the franchisee was able to demonstrate a breach of the duty of good faith and fair dealing.[132]

3. Statutory Challenges

The third category of claims commonly alleged by franchisees attempting to avoid compliance with a system change involve claims under a state or federal statute. For instance, several states have statutes that govern the franchise relationship and place extra-contractual obligations on the franchisor.[133] These statutes are often based on public policy considerations, and generally prevent things like unjust terminations or non-renewals. Moreover, these statutes generally cannot be waived or modified by contract. Further, some relationship statutes prohibit the franchisor from changing the competitive circumstances of the parties' relationship.[134] Thus, even when the franchisor acts in good faith and has a contractual right to act, counsel should nevertheless consult any potentially applicable state or federal relationship law.

Franchisees have attempted to bring suit either directly under these statutes, or to assert that the system change lead to a constructive termination of the franchise agreement. The Second Circuit's decision in *Petereit v. S.B. Thomas, Inc.*,[135] is an example of a prolonged battle over claims of "constructive termination" in the wake of system-wide changes. Connecticut-based distributors of S.B. Thomas' ("Thomas") muffins successfully convinced the District Court,

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[128] S*ee also*, *Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd*., 970 F.2d 273 (7th Cir. 1992) (denying the franchisee's good faith and fair dealing claim after the franchisee failed to present any evidence of opportunistic behavior or overreaching on the part of the franchisor).

[129] 818 N.E.2d 110 (N.Y. App. Div. 2004).

[130] *Id*.

[131] *Id.*

[132] *Id*. at 8. Other courts have also refused to dismiss cases when the franchisee alleged that the franchisor's motivation for implementing the change was arbitrary. *See Nat'l Franchisee Ass'n*, *infra*, note 12 (refusing to immediately dismiss the franchisee's breach of good faith and fair dealing claims based on allegations related to Burger King's motives in implementing a pricing strategy that could cause the franchisees to sell products at a loss); *see also Bonfield v. AAMCO Transmissions, Inc.*, 708 F.Supp. 867 (N.D. Ill 1989).

[133] *See, e.g.,* Ark. Code Ann. §4-72-204; Cal. Corp. Code §31001; HRS §482E; Ind. Code §23-2-2.7-1; Mich. Comp. L. §445; N.J. Stat. Ann. Ch. 56; Minn. Stat Ch. 2860; RCW §19.100; and Wis. Stat. Ch. 135.

[134] *See* Wis. Stat. Ch. 135; *see also* discussion at notes 43 and 56, *infra*.

[135] 63 F.3d 1169 (2d Cir. 1995).

following an eight-day bench trial, to enjoin Thomas from reorganizing their allegedly haphazard distribution routes.[136] The distributors alleged, among other claims, that Thomas had constructively terminated their relationships in violation of the Connecticut Franchise Act. The District Court agreed, and permanently enjoined Thomas from unilaterally altering the distributors' routes and territories.

The Second Circuit did not agree, at least not fully, with the conclusions of the District Court. To the aid of the distributors, the Second Circuit held that the distributors constituted "franchisees" as defined in Section 42-133e(b) of the Act, and further held that claims for constructive termination may arise under the Act where actions are taken by the franchisor that "result in a *substantial decline* in franchisee net income." However, the Second Circuit also provided comfort to Thomas, adopting the argument that its legitimate business reasons could potentially constitute "good cause" for termination -- or constructive termination -- under the Act.[137] Based on the text of the statute, the legislative history, and the interpretation of other states' distributorship relationship laws, the Second Circuit held that a "seller of goods in the marketplace is justified in identifying untapped opportunities or unutilized potential and adjusting its distribution network to realize greater profits." The matter was remanded back to the District Court, for further findings consistent with the Second Circuit's interpretation of the Act.

There is no question that *Petereit v. S.B. Thomas, Inc.* supports the proposition that, under certain circumstances, a franchisor's system-wide changes, which are not arbitrary and are implemented to increase performance, may be permitted under relationship laws. That said, the decision turns in part on the broad definition of "good cause" in the Act, a definition that permitted the possibility for cause to arise other than for a distributor's misfeasance and malfeasance. Not all such laws define cause so favorably for the supplier.[138]

Franchisees have also attempted to assert claims based on allegedly undisclosed facts (the extent of the modifications) in violation of state or federal registration and/or disclosure laws, or premised claims on deceptive trade practice acts and other consumer protection laws ("Little FTC Acts"). For example, in the *Stuller v. Steak N Shake Enterprises, Inc*. case discussed above, Stuller pled in the alternative, that even if Steak N Shake had contractual authority to require Stuller to follow a newly implemented pricing policy, the implementation of that policy would nevertheless violate of the Illinois Franchise Disclosure Act.[139] Specifically, Stuller alleged that the policy violated Sections 6 and 16 of the IFDA by: (i) attempting to force Stuller to implement the policy, despite the lack of affirmative language in its franchise agreement permitting the policy, and contrary to the representations in Stuller's UFOC; and (ii) falsely stating in the UFOC that franchisees could establish their own prices and choose to participate (or not) in marketing programs. Steak N Shake contended that the claim should be dismissed at the pleading stage for defects that included the failure to allege actual damages, the IFDA's three-year statute of limitations, and the failure to adequately plead fraud.

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[136] *Petereit v. S.B. Thomas, Inc.*, 853 F. Supp. 55 (D. Conn. 1993).

[137] The Act provided in relevant part: "[n]o franchisor shall . . . terminate, cancel or fail to renew a franchise, except for good cause which shall include, *but not be limited to* the franchisee's refusal or failure to comply substantially with any material and reasonable obligation of the franchise agreement . . ." Section 42-133f(a), emphasis in original.

[138] *See Ziegler Co., Inc. v.* Rexnord, 433 N.W.2d 8, 10 (Wis. 1988) (finding in a non-franchise matter that a claim could arise related to the unilateral change of business methods, but only if the changes are non-essential, unreasonable, or discriminatory).

[139] 2011 U.S. Dist. LEXIS 57704.

The District Court had little difficulty denying Steak N Shake's Fed. R. Civ. P. 12(b)(6) pleading motion, in large part due to the great deference accorded to pleadings, even in the era of *Bell Atlantic Corp v. Twombly*.[140] With respect to the statute of limitations, the District Court noted that the defense was an *affirmative defense of Steak N Shake*, one which Stuller was not required to anticipate at the time of the filing of its First Amended Complaint. Stuller was saved by the fact it had not plead facts sufficient to establish Steak N Shake's defense and -- the District Court wondered aloud -- Stuller might also have been the beneficiary of equitable tolling. Likewise, the District Court rejected Steak N Shake's argument that Stuller could not plead the existence of compensatory damages; Stuller had requested its attorneys' fees and rescission, both available under the IFDA. Finally, taking Stuller at its word, as it was required to by Rule 12(b)(6), the District Court held that Stuller had properly alleged untrue statements of material facts and material omissions in violation of the IFDA.

In sum, it would be tempting to conclude from *Stuller v. Steak N Shake Enterprises, Inc.* that a franchisor's system-wide policy changes will always pose a significant risk pursuant to state-enacted disclosure laws like the IFDA. However, it must be remembered that the franchisee was merely permitted to *file* its First Amended Complaint stating IFDA claims. At the pleadings stage of the case, the District Court did not hold (and was not in a position to determine) whether the pleadings would survive a further challenge. Moreover, as the case proceeded, the court never even addressed the statutory challenge (it became moot when the court determined that Steak N Shake could not enforce the policy). Accordingly, Stuller serves as little more than a precautionary reference, demonstrating that statutory challenges are becoming more commonly plead when franchisees seek to avoid system changes.

VI. CONCLUSION

The flexibility to change the system to address changes in the market place is essential to the long-term success of both the franchisor and its franchisees. The franchisor's ability to implement system changes is largely based on the rights it reserves in the franchise agreement and manual, and discloses in its FDD. By including a well-drafted general reservation of rights and other reservations in provisions specific to certain aspects of the system that are likely to change over time, the franchisor can position itself to make the changes necessary to keep the system viable. But, even if the franchisor has the legal authority to act, it should be sensitive to the business and relationship implications related to a proposed change. Conducting adequate market studies and consulting the franchisees are important practical aspects to maintaining harmony in the franchise system, obtaining franchisee support for the system change, and avoiding litigation. Finally, both franchisees and franchisors would be well-advised to review the legal disputes involving franchisee attempts to avoid compliance and franchisor attempts to enforce standards. Such a review can assist the parties in assessing their rights and responsibilities, and (hopefully) avoid future disruption of what should be the ultimate goal of both parties; to maximize the collective success of the franchise system.

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[140] 550 U.S. 554 (U.S. 2007).

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Himanshu is a partner at the law firm of Zarco Einhorn Salkowski & Brito, P.A., where he concentrates his practice in the areas of complex commercial litigation, franchise arbitration, litigation and mediation, general business and corporate law and appellate practice. The firm represents dealers, distributors and franchisees in arbitration and litigation proceedings throughout the United States as well as internationally.

Himanshu graduated from Vanderbilt University in December 1994 with a B.A. degree in Economics. He then earned his J.D. in 1998 from the Brandeis School of Law at the University of Louisville. Himanshu currently represents franchisees in state and federal courts and arbitration proceedings throughout the United States. Himanshu is admitted to practice before all state courts in Florida, the United States District Courts for the Middle and Southern Districts of Florida, Eastern District of Michigan and the Districts of Arizona and Colorado. In addition, Himanshu is admitted to practice in the United States Court of Appeals for the First Circuit, Eight Circuit, Eleventh Circuit and Federal Circuit.

Since joining Zarco Einhorn Salkowski & Brito, P.A., Himanshu has authored several articles discussing various issues in the franchise industry, including "Is Your Franchise Agreement Complete: Be Aware of the Merger and Integration Clause," "A Comparison of Franchise Disclosure Requirements Under United States Law and International Law," and "Is the Franchisee Responsible When the Guest is Injured on Hotel Property?" Himanshu also co-authored the article titled "Common Issues in Hospitality Franchising," which was presented at the 2004 Hospitality Law Conference in Houston, Texas, and "Common Discovery Issues in Franchising," which was presented in 2009 at the 32nd Annual Forum on Franchising in Toronto, Canada. Himanshu was also invited by the Asian American Hotel Owner's Association to be a guest speaker at its 2003 national convention in Long Beach, California during which time he gave a presentation on how to successfully negotiate a franchise agreement. Himanshu is currently a member of the Asian American Hotel Owner's Association and serves on its Industry Relations Committee.

Himanshu holds the maximum "AV" (pre-eminent) rating by the Martindale-Hubbell Directory. Himanshu has been named a Florida Rising Star by Florida Super Lawyers. He has also been listed in the Cambridge Who's Who Registry Among Executives and Professionals as a 2010/2011 representative for Miami, Florida, and also been listed in the Cambridge Worldwide Who's Registry in the 2012 edition. In 2012, Himanshu was recognized in the Wall Street Journal and Miami Magazine as a Top Young Attorney in Florida, and also recognized as one of Florida' outstanding young lawyers in franchise and dealership law.

Himanshu can be reached at the law firm of Zarco Einhorn Salkowski & Brito, P.A. via telephone at (305) 374-5418 or via e-mail at hpatel@zarcolaw.com.

JOHN DENT

John Dent is the Senior Vice President and Deputy General Counsel of Hilton Worldwide, Inc., based in McLean, Virginia. In that role, John leads a global team of lawyers and paraprofessionals supporting over 3800 hotel properties owned, managed, and franchised by Hilton Worldwide under its ten hotel brands in 91 countries. The team's services include negotiation, drafting, interpretation and enforcement of hotel management and franchise agreements; real estate acquisitions, dispositions, financing and asset management; and hotel operations. John's prior positions at Hilton have included responsibility for development and major dispute resolution. From November 2010 to June 2011, he was Acting General Counsel. Before joining Hilton, John was an associate and then a shareholder in the Los Angeles law firm of Tuttle & Taylor, where he specialized in resolving hotel management disputes. John earned his J.D. from the University of Chicago Law School and his B.A. in English from UCLA.