Interim Relief: Preserving Franchise Goodwill During Termination Proceedings

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For a variety of reasons, a franchisor may find itself in arbitration seeking to vindicate its right to terminate a franchise agreement. For example, arbitration may be necessary if the franchisee challenges the termination or refuses to comply with its requirements. In addition, some franchisors seek a declaratory ruling before a termination is considered final in order to insulate themselves from future claims for wrongful termination. In an ideal world, a termination arbitration would be much quicker than a court proceeding for a franchisor to rid itself of a franchisee who is damaging the image of the franchise—and the value of the trade or service mark—by violating material provisions of the franchise agreement. The promise of a streamlined procedure for termination, when necessary, was likely one of the factors that led the franchisor to include an arbitration clause in its standard franchise agreement in the first place. However, as experienced franchisors have discovered, arbitrations can drag on for many months, even years, while the parties deal with assorted legal, procedural, scheduling, and discovery issues, which become even more complex and time-consuming when the franchisee asserts counterclaims in the termination proceeding. In short, there are times when an arbitration takes longer than it should. In the meantime, what can the franchisor do with a recalcitrant franchisee who is refusing to accept termination or failing to comply with system standards while the arbitration is pending?

Violations serious enough to cause a franchisor to seek to terminate a franchise agreement, at least in the quick-service restaurant business, frequently involve food quality and safety issues that can threaten customers' health and expose the franchisor to substantial liability while the termination arbitration is pending. A surprising number of practitioners believe that court intervention is necessary to address this problem and, as a result, have criticized arbitration. However, the current versions of widely applicable arbitration rules establish that ancillary court proceedings generally are not required. When a franchisee fails to cooperate with store inspections, audits, food temperature, or cleanliness requirements, or other important provisions of the franchise agreement, the franchisor may be able to secure relief in the form of an interim order from the arbitral panel to compel compliance pending arbitration.

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One beneficial byproduct of moving for interim relief is the helpful introduction to the case (from the franchisor's point of view) that it provides to the arbitral panel. Generally, a termination arbitration demand is a terse and bare-bones document that does not shed much light on the nature of the franchise violations for which termination is sought. Unlike a more narrative court complaint, the arbitration demand gives the arbitrator little, if any, of the flavor of the case. Particularly in termination proceedings based on health and safety violations, the typical arbitrator is likely to have a visceral reaction to the franchisor's depictions of violations that involve, for example, pest infestation, foods kept at an unsafe temperature, and employees' failure to wash hands or wear gloves. Ideally, these allegations should be supported by affidavits, evaluation reports, photographs, or videotapes submitted with the motion, or all of these. Because of the generally elastic nature of arbitration and its goal of achieving equity, providing a more detailed version of the ultimate facts at the outset of the proceedings may be beneficial in the appropriate case as it proceeds toward final resolution.

An essential step to securing interim relief is establishing that the franchisee is in violation of a clear and material provision of the parties' franchise agreement. This can often be done by submitting to the arbitrator a copy of the parties' franchise agreement, recent store evaluation reports, and accompanying affidavits from the individuals performing those evaluations. If the arbitrator is convinced that noncompliance would adversely affect the franchisor's goodwill and the value of the mark (most easily done for health and safety violations), and that he or she has the authority to enter an interim order under the parties' agreement to arbitrate, there is a good chance that the requested order will be entered.

For simplicity's sake, this article assumes that the subject franchise agreement is for a fast-food restaurant franchise and is governed by either the American Arbitration Association (AAA) Commercial Rules or the JAMS Rules.

Authority to Award Interim Relief

AAA Commercial Rules

Unless otherwise provided in the parties' agreement to arbitrate, the rules applicable to an arbitration under the AAA Rules are those in force at the time that the arbitration was filed (rather than when the franchise agreement was executed).[1] The AAA Rules have evolved over the years to clarify and broaden the arbitrator's authority to enter interim relief. Under the 1993 and 1996 rules, Rule 34 provided that "[t]he arbitrator may issue such orders for interim relief as may be deemed necessary to safeguard the property that is the subject matter of the arbitration, without prejudice to the rights of the parties or to the final determination of the dispute."

The subject matter of a fast-food restaurant franchise termination arbitration generally includes, among other things, recipes, formulas, food preparation procedures, business methods and policies, as well as the franchisor's service marks and trademarks. It was therefore not difficult under the 1993 rules, under most circumstances, to establish that the arbitrator had the requisite authority.

In 1999, the rules concerning interim relief were amended. New Rule 36, unchanged in the current rules, provides that:

> (a) The arbitrator may take whatever interim measures he or she deems necessary, including injunctive relief and measures for the protection or conservation of property and disposition of perishable goods.
>
> (b) Such interim measures may take the form of an interim award, and the arbitrator may require security for the costs of such measures.
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> (c) A request for interim measures addressed by a party to a judicial authority shall not be deemed incompatible with the agreement to arbitrate or a waiver of the right to arbitrate.

Accordingly, establishing the necessary arbitral authority became even easier.[2]

JAMS Rules

Under JAMS Rule 24(d) (2002), "[i]n addition to the final Award, the Arbitrator may make other decisions, including interim or partial rulings, orders and awards." Similar to the AAA Rules, JAMS Rule 24(e) provides that:

> [T]he Arbitrator may take whatever interim measures are deemed necessary, including injunctive relief and measures for the protection or conservation of property and disposition of disposable goods. Such interim measures may take the form of an interim Award, and the Arbitrator may require security for the costs of such measures. Any recourse by a Party to a court for interim or provisional relief shall not be deemed incompatible with the agreement to arbitrate or a waiver of the right to arbitrate.

Standards for a Preliminary Injunction or Interim Relief

Once the franchisor has persuaded the arbitral panel that it has the requisite authority, the arguments for awarding relief are essentially identical to those that the franchisor would make in court.[3] The judicial standards for granting a preliminary injunction or interim relief are well recognized. A party seeking relief must demonstrate that, absent injunctive relief, it will suffer irreparable harm and that it is likely to succeed on the merits.[4] There is no reason that the same considerations should not control resolution of a motion filed in an arbitration proceeding, and the arbitrator will likely accept these established standards as applicable to the arbitration.

Importance of the Availability of Interim Relief

Under the Lanham Act,[5] a trademark exists only as a symbol of goodwill and has no independent significance without it.[6] A franchisor therefore has a legal duty to take quality control measures or risk "abandonment" of its trademark.[7] These measures typically include inspections to enforce system standards. The failure to establish and enforce system standards may result in public deception and operate as a fraud on consumers, who expect a certain amount of uniformity when relying on a franchisee's use of a recognized trademark.[8] Accordingly, most franchisors retain the contractual right of inspection and quality control to enforce systemwide standards. In its request for interim relief, the franchisor should simply request an order compelling the franchisee to live up to his or her bargain to ensure that the chain's customers are not disappointed—or sickened or injured.

Courts have routinely granted franchisors' requested injunctions when a franchisee has refused to adhere to system standards. For example, in *Dunkin' Donuts, Inc. v. Albireh Donuts, Inc.*,[9] Dunkin' Donuts sued one of its franchisees, seeking an injunction and attorneys' fees for breach of contract and violation of the Lanham Act after uncovering numerous health, safety, and sanitation violations during its contractual inspections. At the start of the case, Dunkin' Donuts moved to enjoin the franchisees from continuing to violate the standards set forth in its franchise agreement and operations manual. The district court granted the preliminary injunction. On irreparable harm, the court held:

> In light of the significant quality control standards with which [Dunkin' Donuts] requires its franchisees to comply and the evidence of non-compliance with these standards, the Court agrees . . . that the above factors demonstrate that [Dunkin' Donuts] is likely to suffer irreparable harm. This is because . . . the serving of inferior, non-conforming products under [Dunkin' Donuts'] name could have a detrimental impact on [Dunkin' Donuts'] name and goodwill, devalue [its] trademark, and subject [it] to a loss of business and exposure to substantial tort liability. The courts have repeatedly held that such damage is not readily quantifiable and, thus, constitutes irreparable harm.[10]

After finding that Dunkin' Donuts would suffer irreparable harm without an injunction, Judge McAvoy also concluded that the franchisor was likely to succeed on the merits because "[t]he plain terms of the franchise agreement require Defendants to comply with [Dunkin' Donuts'] quality, health, and safety standards and permit [it] to inspect Defendants' store for compliance therewith."[11] He also recognized that "one of the most valuable and important protections afforded by the Lanham Act is the right to control the quality of the goods manufactured and sold under the holder's trademark" and that "the dangers posed to the public and [Dunkin' Donuts'] name and goodwill and the insubstantial burden that would be imposed" by requiring the franchisee to comply with the franchise agreement further justified the injunction.[12]

In addition, the court refused to require Dunkin' Donuts to post a bond "because there is no evidence, or likelihood, that [the franchisees] will suffer any costs or damages if it is later found that they have been wrongfully enjoined or restrained" and that the franchisees were simply being asked to comply with the terms of the franchise agreement and operating manuals, which "should not cause them any unnecessary expense or loss and certainly not subject them to any costs beyond that which they seemingly should now be spending to safely operate their shop."[13]

In a case concerning a franchisor's right to inspect, Shred-It America, Inc., a franchisor involved in the document shredding business, sued to terminate its franchise agreement with a franchisee for, among other things, failing to cooperate with inspections.[14] Like most franchise agreements, the Shred-It agreement permitted the franchisor's agents to enter the franchisee's premises to conduct inspections, take photographs, and interview employees.[15] When Shred-It agents arrived for a scheduled inspection, however, the franchisee "refused entry, which resulted in such agents involving local law enforcement to enforce Shred-It's right to inspect under the franchise agreement."[16] After entry, Shred-It determined that the franchisee was not operating within Shred-It's standards.[17] The court held that "given the recent history which had transpired between the parties and given the fact that there is no explicit provision in the franchise agreement which limited Shred-It's right to conduct such inspections, the record indicates that it was clearly within Shred-It's right to terminate the franchise agreement after [the franchisee's] refusal to permit" the inspection.[18] The court therefore held that Shred-It had made a substantial showing of the likelihood of success on the merits and enjoined the franchisee from continuing to operate the Shred-It franchise.[19] An interim order seeking compliance pending arbitration would be far less drastic than the one sanctioned by the court in *Shred-It America*.

Often, a franchisee's primary defense to a failure to cooperate is the apparent belief that violations discovered during inspections have been pretextual. However, courts have repeatedly rejected these arguments in similar cases when granting a franchisor's requested injunction.[20]

Conclusion

In the appropriate case, an order for interim relief can be a powerful tool to force a stubborn and uncooperative franchisee to behave while a termination arbitration is pending. While the order cannot repair the parties' continuing relationship, it may make dealing with the franchisee (and the delay in arbitration) more tolerable and help alleviate the inevitable erosion of goodwill caused by a poorly operating franchise.

Endnotes

1. AAA Commercial Rule 1 (2000).
2. The interim relief process can be further expedited if the parties have agreed to the AAA Optional Rules for Emergency Measures of Protection. *See* Michael E. Chionopoulos, *Preliminary Injunction Through Arbitration: The Franchisor's Weapon of Choice in Trademark Disputes*, 20 FRANCHISE L.J. 15 (2000).
3. For a discussion of court injunction actions, *see* Harold R. Bruno III, *Is Proper Termination Necessary to Obtain a Trademark Injunction?*, 21 FRANCHISE L.J. 207 (2002).
4. The specific standards for obtaining a preliminary injunction vary by circuit. *See* MOORE'S FEDERAL PRACTICE 3d § 65.22[5].
5. 15 U.S.C. §§ 1051 *et seq.*
6. J. THOMAS MCCARTHY, MCCARTHY ON TRADEMARKS AND UNFAIR COMPETITION § 18:2 (4th ed.) (citing United Drug Co. v. Theodore Rectanus Co., 248 U.S. 90 (1918); Am. Steel Foundries v. Robertson, 269 U.S. 372 (1926)).
7. *Id.* § 18:48.
8. *Id.* § 18:3; Société Comptoir de L'Industrie Cotonnière Etablissements Boussac v. Alexander's Dep't Stores, Inc., 299 F.2d 33, 35 (2d Cir. 1962); Dawn Donut Co. v. Hart's Food Stores, Inc., 267 F.2d 358, 367 (2d Cir. 1959). *See also* Noah D. Genel, *Keep It Real: A Call for a Broader Quality Control Requirement in Trademark Law*, 8 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 269, 270–71, 294–95 (1997).
9. 96 F. Supp. 2d 146 (N.D.N.Y. 2000).
10. *Id.* at 149. *See also* McDonald's Corp. v. Robertson, 147 F.3d 1301 (11th Cir. 1998) (affirming injunction preventing franchisees from continuing to operate restaurant because of violation of franchisor's operational standards); Dunkin' Donuts, Inc. v. Kashi Enter., Inc., 106 F. Supp. 2d 1325 (N.D. Ga. 2000) (granting preliminary injunction requiring franchisee to remedy violations of franchise agreement's health, sanitation, and safety requirements); Baskin-Robbins, Inc. v. A. Ender, Ltd., No. CV-N-99-206-ECR (PHA), 1999 WL 1318498 (D. Nev. Sept. 10, 1999) (enjoining franchisees from violating franchisor's health and sanitation standards in its manual of standards for operations); Burger King Corp. v. Stephens, CIV. A. No. 89-7691, 1989 WL 147557 (E.D. Pa. Dec. 6, 1989) (enjoining franchisees from using franchisor's trademarks and service marks and ordering restaurants closed pending compliance with operational standards).
11. *Albireh Donuts, Inc.*, 96 F. Supp. 2d at 150.
12. *Id.* at 150–51 (citation omitted).
13. *Id.* at 151.
14. Shred-It America, Inc. v. Haley Sales, Inc., No. 01-CV-0041E(SR), 2001 WL 209906 (W.D.N.Y. Feb. 26, 2001).
15. *Id.* at *2.
16. *Id.*
17. *Id.*
18. *Id.* at *3.
19. *Id.*
20. *See, e.g.*, McDonald's Corp. v. Robertson, 147 F.3d 1301, 1309 (11th Cir. 1998); Burger King Corp. v. Stephens, CIV. A. No. 89-7691, 1989 WL 147557, at *11 (E.D. Pa. Dec. 6, 1989); Baskin-Robbins, Inc. v. A. Ender, Ltd., No. CV-N-99-206-ECR (PHA), 1999 WL 1318498, at *1 (D. Nev. Sept. 10, 1999); *Shred-It*, 2001 WL 209906, at *3 n.3. *See also* Original Great Am. Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273, 279, 280–81 (7th Cir. 1992) (reversing district court's granting of a franchisee's request for a preliminary injunction restoring terminated franchise).