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FRANCHISE LAW

Sometimes, breaking up is hard to do

By Joseph Schumacher and Kimberly S. Toomey

Like the end of any relationship, the termination of a franchise can be an ordeal.

In some instances, franchisors may unwittingly complicate the process by failing to safeguard their own rights or by violating statutory protections afforded to the franchisee. In franchising, the best-laid plans for termination are laid early and consider issues related to franchise law and litigation. These issues include the franchisor's right to terminate, evidence supporting this right, franchisee defenses and affirmative claims and any applicable franchise-relationship statutes.

In addition, franchisors need to consider their own rights and determine how to proceed against the terminated franchisee-whether to sue, exercise leasehold rights or allow the franchisee to slip quietly into bankruptcy. Setting the franchisor's goals and outlining the legal framework for achieving those goals are important steps in creating a successful termination strategy.

The biggest mistakes made by franchisors in the termination process occur before the termination ever happens. There are, however, a few measures that a franchisor can take to avoid franchisee lawsuits. First, franchisors should know the franchisee's law. If the franchisee's state invalidates forum selection clauses, the franchisor should consider filing its action at the time of termination to have the first-filed action in its home state and dramatically reduce the possibility of an out-of-state lawsuit. Second, the franchisor (or its counsel) should carefully review the franchisee's operations file and interview people involved in the termination decision. The franchisor needs to identify the franchisee's potential defenses and claims and prepare its case early. Third, before termination, a franchisor should review any course of dealing or past practices that may affect the enforceability of the termination. In some cases, this review may allow the franchisor to correct any course-of-dealing problem and create a new understanding between the parties.

Franchisee can't keep using the mark.

For example, if the franchisor has not previously enforced certain franchise agreement provisions, it should consider issuing a "new day" notice to advise franchisees of its intent to enforce its contractual rights and, in doing so, defeat a franchisee's reliance on any prior course of dealing.

There are also franchise-relationship statutes to consider. Franchisors need to be keenly aware of any state statutory protections afforded to franchisees. Nineteen states have enacted laws that affect a franchisor's relationship with its franchisees. Most of these statutes require good cause for termination or nonrenewal (see, e.g., Conn. Gen. Stat. § 42-133f), and some require the franchisor to afford the franchisee an opportunity to cure any defaults before it terminates or fails to renew a franchise. See, e.g., Wis. Stat. § 135.04. To properly terminate franchisees covered by these statutes, therefore, a franchisor must confirm that its grounds for termination constitute "good cause" under the statute and that it provided the required notice and opportunity to cure. Failure to comply with either the good-cause or notice requirements of state relationship statutes may subject a franchisor to sanctions, damages, injunctive relief, attorney fees and statutory damages.

Trademarks are another important issue. Whether a franchise agreement is terminated or expires, the franchisor's first order of post-termination business is to ensure that the franchisee is no longer using the franchisor's trademarks. Because a franchisor's system is based on the public's recognition of its marks and the association of those marks with quality, a renegade franchisee's use of the trademarks must be stopped immediately to protect consumer good will and the investment of existing franchisees.

When termination is based on standards violations, a franchisor's swift action to shut down the franchisee's operation-or to de-identify the location-accomplishes three important goals. First, the franchisor protects its good will by dispelling any customer confusion that the franchisee's inferior products are connected with the system. Second, the franchisor sends an important message to existing franchisees that the franchisor will expedite the closing of any substandard location and that no continued operation under the franchisor's marks will be tolerated. And third, the franchisor cuts off the potential liability arising from any continued operation under its marks: dissatisfied customers, warranty work, personal injury or other vicarious liability claims.

A franchisor's trademarks are protected by the Lanham Act, 15 U.S.C. 1051 et seq. Lanham Act remedies include injunctive relief and statutory damages, including treble damages and attorney fees. With very few exceptions, franchisors are successful in obtaining preliminary injunctions against terminated franchisees who continue to use their system marks.

Even in the face of claims of wrongful or improper termination, courts have consistently held that a trademark owner enjoys unassailable rights in determining who may use its marks. In *S&R Corp. v. Jiffy Lube Int'l Inc.,* 968 F.2d 371 (3d Cir. 1992), the 3d U.S. Circuit Court of Appeals held that a franchisee's pretermination complaints are irrelevant to the franchisor's post-termination infringement claims under the Lanham Act. After Jiffy Lube terminated its franchisee for failure to pay royalties, the franchisee argued that its use of Jiffy Lube's trademarks should be permitted because the franchisor wrongfully terminated the franchise agreement.

Rejecting this claim, the 3d Circuit stated that a franchisee's remedy for breach is either to terminate the franchise agreement or to continue operating and sue for breach. Under no condition is a franchisee entitled to continue using the franchisor's trademarks after the franchisor has revoked its permission.

Similarly, in *Jake Flowers Inc. v. Kaiser,* 2002 WL 31906688 (N.D. Ill. Dec. 31, 2002), Jake Flowers Inc. (JFI), a pizza franchisor, terminated a franchise agreement because the franchisees refused to execute a new agreement in the middle of the franchise term. The facts of the case seemed to support the franchisees' theory of improper termination. After termination, the franchisees de-identified their restaurant, but they continued using the telephone number advertised under JFI's trademark.

JFI sued for trademark infringement. The court rejected the franchisees' argument that JFI's wrongful termination of the franchise prevented JFI from prevailing on its trademark claims. While the franchisees may seek damages for wrongful termination, the court held that nothing in JFI's conduct would permit the franchisees' continued use of JFI's trademark without a license.

Covenants not to compete

In most industries, franchise agreements contain provisions that restrict a franchisee's right to operate a competing business during the franchise term and for a defined period after the termination or expiration of the agreement. The covenant not to compete is designed to allow the franchisor to refranchise or otherwise develop the former franchisee's trading area without competition from the former franchisee. Restrictive covenants are creatures of contract and public policy, so the enforceability of these provisions varies from state to state.

In California, covenants not to compete are not generally enforceable, unless the franchisor can show that the franchisee is using the franchisor's trade secrets in the operation of the competing business. Calif. Bus. & Prof. Code § 16600; but see *Big O Tires Inc. v. Granada Enterprises Corp.,* Bus. Franchise Guide (CCH) ¶ 11,607 (C.D. Calif. Feb. 22, 1999). In Georgia, covenants not to compete are enforceable. However, if the court finds that any part of the covenant is overly broad-as to time, geographic region or scope-the court will reject it entirely. See *Allen v. Hub Cap Heaven Inc.,* 484 S.E.2d 259 (Ga. Ct. App. 1997).

Franchisors need to be careful when drafting covenants not to compete. Broad drafting of the covenant may render it unenforceable in some jurisdictions. A more conservative approach is to draft it narrowly. First determine precisely what is required to protect the franchisor's interests-what distance customers are drawn from, how long it will take the franchisor to establish a new franchisee in the territory and what range of services franchisees provide. These factors provide the basis for the covenant itself and the evidence of reasonableness needed to enforce it.

Back to the future

Lost future royalties should be taken into consideration. In addition to the injunctive relief available under the Lanham Act and common law, franchisors considering termination should review the monetary losses caused by termination. Termination prevents future losses from a delinquent franchisee, but it will also likely end any negotiations regarding past due amounts and will certainly eliminate the franchisor's future royalty revenue.

Under certain circumstances, franchisors may recover this royalty revenue as an element of damages. Although the case law is mixed (and sometimes turns on which party terminated the franchise relationship), some courts have awarded franchisors lost future royalties reduced to net present value and reduced by any amounts reasonably attributable to servicing the franchise.

Lost future royalties are more often awarded when the franchisee terminates the relationship, especially when the franchisee continues to operate a business. See *McAlpine v. AAMCO Automatic Transmissions Inc.,* 461 F. Supp. 1232 (E.D. Mich. 1978). Under these circumstances, courts view the franchise relationship as an agreement for a term of years and the franchisee's nonperformance renders it liable for making the franchisor whole. Put simply, when a franchisee terminates, courts are less likely to be sympathetic and may require the franchisee to pay the franchisor its anticipated royalties for the entire term.

Failed franchises

When a franchisor terminates, the analysis of lost future royalties becomes trickier. In cases in which a franchisor terminates because a franchisee fails to pay-and especially when the franchisee is struggling financially-courts are reluctant to award lost future royalties based on a failed franchise. See *I Can't Believe It's Yogurt v. Gunn,* 1997 U.S. Dist. Lexis 14480 (D. Colo. April 15, 1997). The reasoning is simple: Because royalties are based on a percentage of sales, a franchisee whose operation has been terminated by the franchisor cannot generate sales or the related royalties.

Additionally, in the case of a failed or failing franchise, courts have held that the likelihood of collecting royalties is too speculative to award damages for lost profits. Moreover, under a contract analysis, courts have held that a franchisor's termination of a struggling franchisee is the direct cause of the franchisor's lost-future-royalty damages. In such cases, courts hold that a franchisor cannot recover damages from its franchisees for a loss it caused by its own conduct.

Although the law is continuing to develop in this area and the future of lost future royalties remains uncertain, it is generally advisable to bring these claims even when the franchisor terminates the agreement.

To avoid the uncertainty of a lost-future-royalties claim, some franchisors include liquidated-damages provisions in their franchise agreements. The clauses enjoy more predictable enforcement by courts and are regularly used in the hotel industry instead of covenants not to compete or claims for lost future royalties. Courts generally enforce the clauses as contractual terms, so long as they are not considered punitive and reasonably compensate the franchisor for its lost opportunity. If franchisors are concerned about the award of lost future royalties, and especially in states where a covenant not to compete may not be enforceable, liquidated-damages provisions give franchisors a reasonable option to recover their damages and to ensure franchisees' commitment to the system.

No matter what the franchisor's contractual rights are, the best way to approach termination is to devise a business and legal strategy in advance. If a franchisor is well informed and coordinates its efforts with counsel, it can create a termination strategy that both accomplishes its goals for the terminated franchisee and speaks to existing franchisees to encourage compliance and assure them that the system is well protected. NLJ

Joseph Schumacher chairs the distribution practice and franchise group at the Philadelphia office of Wiggin & Dana. **Kimberly S. Toomey** is an associate in that group.