



**GOING OUT OF
BUSINESS**

CONTRASTING PERSPECTIVES ON FRANCHISE TERMINATIONS

From the Franchisee's Perspective

By Howard Yale Lederman and David L. Steinberg

This article examines franchise terminations from the franchisee's perspective. But it also examines franchise termination law and realities as they are. Further, it reviews the contrasting broad and narrow good cause for franchise terminations standard and suggests that courts and state legislatures interpret the standard to promote a more level playing field for franchisees and franchisors.

The "Good Cause" Termination Standard

As outlined in the following article by David Janis, "Contrasting Perspectives on Franchise Terminations: From the Franchisor's Perspective—Terminating the Troubled Franchisee in Michigan," in granting a franchise, a franchisor licenses a franchisee the right to conduct a business under the franchisor's trade name or trademark for a defined period. To attempt to protect franchisees from arbitrary terminations, many state franchise laws have good-cause termination provisions.¹ So do many industry-specific franchise laws.² For example, the Michigan Franchise Investment Law (MFIL) defines "good cause" as:

[T]he failure of the franchisee to comply *with any lawful provision of the franchise agreement* and to cure such failure[,] after being

given written notice thereof and a reasonable opportunity, which in no event need be more than 30 days, to cure such failure.³

While in Michigan, any breach of the franchise agreement is good cause for termination, other states define good cause more broadly. For example, in *Petereit v S B Thomas, Inc.*,⁴ the United States Court of Appeals for the Second Circuit interpreted the Connecticut Franchise Act's⁵ good-cause provision broadly. The court held that "good cause is not limited to proving contractual breaches of the franchise agreement, *but may be based on a franchisor's legitimate business reasons.*"⁶ The court found that "the meaning of good cause is broader than franchisee breach... If the Connecticut legislature intended good cause to result only from franchisee breach," it failed to state so.⁷

The original Connecticut Act contained a good-cause provision without defining good cause. "The uncertainty over good cause gave great concern to franchisors...."⁸ This concern led to amendments, "including adding the current language showing that good cause encompasses more than franchisee breach."⁹ Through these amendments, the legislature recognized "that franchisors' economic interests must be accounted for in striking a balance between franchisee protection and attracting and retaining franchisors to do business in the state."¹⁰ Therefore, the court construed the good-cause provision expansively.

The Second Circuit's good-cause standard almost strikes a fair balance. *The court rightly recognized that as franchise systems mature, system-wide changes may be necessary* and that failure to allow them can be a reasonable basis for establishing good cause. But the court failed to recognize that some system changes during severe economic recessions materially impact on franchisees' ability to shoulder additional costs and burdens not bargained for in the franchise agreement. While franchisors need freedom and flexibility to enforce contract provisions essential for the brand's success and respond to changing market conditions, *Petereit* and similar decisions fail to recognize that franchisees need similar consideration for conditions beyond their control. Nearly every franchisee invests substantial time, money, and effort to make his or her franchise succeed. *Since termination destroys the franchisee's substantial investment, the good-cause standard must be balanced and reasonable.*

What is a Legitimate Business Reason?

The phrase "legitimate business reasons" implies that some franchisor business reasons will be legitimate, while others will not. The phrase also implies that arbitrary and discriminatory reasons will be illegitimate. Thus, if a franchisor terminates a franchisee for providing poor customer service, not keeping its property clean, reporting sales fraudulently, or failing to meet sales requirements, the terminations are, as a general rule, for good cause. If a franchisor terminates a franchisee because of area franchisee overcrowding, the termination is likely also for good

FAST FACTS

- Many state franchise laws have good-cause termination provisions.
- While some states' provisions define good cause as permitting franchisors to terminate a franchise for any franchise agreement breach, some courts have interpreted other states' provisions as defining good cause to mean legitimate business reasons.
- If a franchisee does not timely cure a default but then challenges the termination, federal and state courts will almost always uphold the termination.

cause. Finally, if a franchisor terminates a franchisee because of a franchise system change from nonexclusive to exclusive territory franchisee to enhance product or service reputation, quality, or customer service, the termination, as a general rule, is for good cause.

However, if after franchisees have built the franchisor's good reputation, a franchisor terminates its franchisees to change to company stores or in-house provision of goods or services without good reason, that termination is likely not for good cause. When the franchisor terminates franchisees for refusing to give up their exclusive territories so the franchisor can create and sell more franchises, as a general rule, that termination is not for good cause. For instance, in *Carlos v Philips Business Systems, Inc.*,¹¹ the franchisor and franchisee signed an exclusive territory franchise agreement. During the agreement period, the franchisor offered the franchisee a new agreement providing for nonexclusive territories. The franchisee rejected the offer. When the franchisee sued to enjoin the franchisor from terminating the franchise, the court granted the injunction and concluded that the franchisor lacked good cause to terminate.¹²

Thus, the Second Circuit's standard approaches a balanced and reasonable national standard.

Evaluating Terminations When a Franchise Distribution System is Restructured

More difficult cases arise when franchisors terminate franchisees to change their franchising systems. For example, in *American Mart Corp v Joseph E Seagram & Sons, Inc.*,¹³ Seagram reorganized its franchise system from a nonexclusive territorial system to an exclusive territorial system. To implement its reorganization, Seagram terminated some franchisees. When one franchisee sued to block its termination, the district court found good cause for termination. Affirming, the United States Court of Appeals for the Ninth Circuit likewise found good cause. The court

explained that Seagram had “compelling business considerations” and its “valid business judgment” provided good cause.¹⁴

As another example, in *Aurigemma v Arco Petroleum Products Co.*,¹⁵ Arco withdrew from marketing petroleum in Connecticut and terminated all its Connecticut franchises. These franchises included petroleum service station and convenience store franchises. When several service station operators sued for Connecticut franchise law violations, a district court held that while Arco had good cause to terminate the petroleum franchises because of its petroleum market withdrawal, good cause did not extend to terminating convenience store franchises.¹⁶

Other Considerations in the Termination Decision

Many franchisees do not understand that if they default and fail to cure a material franchise agreement breach, the franchisor has the right to terminate their franchises.¹⁷ Franchisors exercising this right have almost always successfully sued to enjoin the franchisee from continuing to use the franchisor’s trade name, trademark, phone number, and other intellectual property.¹⁸ These franchisors can also seek injunctive relief to enforce the franchise agreement’s noncompetition provisions.

The question arises: Do franchisors, as a rule, want to terminate their franchisees? The authors’ experiences differ. Mr. Lederman has seen many terminations. For instance, a semi-franchisor built a vast semi-franchisee network from nothing to thousands in four years. When a recession hit, many semi-franchisees could not buy mandatory inventory or pay required advertising fees or other required amounts. Over the next four years, the semi-franchisor terminated 50 percent of its semi-franchisees. The ostensible reason was failure to pay required amounts. The semi-franchisor had over-expanded.

Mr. Steinberg’s experience has been different: Over the past 30 years, he has observed that most franchisors will rarely terminate franchisees. Generally, termination occurs only as a last resort after several attempts to resolve the alleged franchise agreement breach have failed. For the franchisor, franchise termination not only results in a closed location generating no royalties, advertising fees, or other payments, but also results in a mandatory franchise disclosure document listing. Such “negative” disclosures can have a chilling effect on marketing to prospective franchisees or at least lead to questions regarding why the franchisor terminated the franchise. A prospective franchisee might react to the disclosure as, “In the future, that could be me.”

Both authors agree, however, that if a franchisee does not timely cure a default but then challenges the termination, federal and state courts will almost always uphold the termination.¹⁹ Nevertheless, a terminated franchisee’s counsel should review the facts, the franchisor’s conduct, and the franchise agreement carefully for opportunities to defeat good cause. For example, in *Husain v McDonald’s Corp.*,²⁰ the franchisees sued to enjoin the

franchisor from terminating their franchise. In affirming the lower court’s preliminary injunction, a California appeals court held that the Husains were likely to succeed on the merits of their claims that McDonald’s had established a policy of providing new 20-year terms to existing franchise buyers like the Husains and had made enforceable promises to them to rewrite the franchise agreements to so provide.

Given this environment, the franchisee’s counsel may have to assert creative arguments to have a chance to win. For instance, in *Dunkin’ Donuts Franchised Restaurants, LLC v Shrijee Investment, Inc.*,²¹ the defendants were two corporate franchisees operating eight metro Detroit Dunkin’ Donut/Baskin Robbins franchises. Dunkin’ Donuts terminated the franchisees for failure to pay royalties and advertising fees. In response, the franchisees asserted that Dunkin’ Donuts had created the events leading to the breach by (1) locating new stores so close to the franchisees and diminishing the franchisees’ revenues so substantially they could no longer afford to pay royalties and advertising fees, and (2) denying the franchisees the right to sell their franchises earlier when their debts to Dunkin’ Donuts were small and they could afford to pay them. Though concluding that Dunkin’ Donuts had good cause to terminate, the court considered the franchisees’ assertions colorable enough for serious examination. In *Petereit*,²² the court considered similar arguments and concluded that “when a franchisor’s actions result in a *substantial decline* in franchisee net



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income,"²³ the franchisor terminates the franchise constructively, thus triggering the good-cause requirement.

In *Dunkin' Donuts*,²⁴ another significant issue arose: whether the franchisor has good cause to terminate when the franchisee's failure to pay royalties or other required payments results from inability to pay because of a serious recession substantially impacting franchisee revenues. True, the franchisee's failure to make these payments breaches the franchise agreement. But does good cause exist when the failure to pay is the result of local or national economic factors beyond the franchisee's control? Should the court exercise its equitable powers to prevent termination if the franchisee might repay the money when economic conditions improve? This argument is creative and important for courts deciding good-cause termination cases to consider because the alternative is large-scale destruction of franchises and franchisees' investments.

Conclusion

Accordingly, whether good cause is broad or narrow depends on the governing good-cause standard. If any franchise agreement breach constitutes good cause, the franchisor can terminate on a breach's occurrence, limited only by any state law notice requirements. But if the legitimate business reasons standard governs, the franchisor must show a legitimate justification. Under this standard, the playing field is a little more balanced. To even the playing field, state legislatures need to adopt the legitimate business reasons standard. The fact that statutory good-cause termination provisions arose from franchisors' arbitrary franchise terminations strongly supports this standard.²⁵ The "any franchise agreement breach" standard is too close to the old arbitrary termination approach. Finally, courts need to interpret the legitimate business reasons standard in such a way as to recognize franchisees' need for protection from termination for reasons beyond their control. ■



Howard Yale Lederman has been an officer in the SBM Antitrust, Franchising & Trade Regulation Section since 2006. He practices mainly appellate, commercial, and employment litigation with Norman Yatooma & Associates. He has published appellate, commercial, and employment law articles in several Michigan publications. He also teaches a franchise law course.



David L. Steinberg has represented franchisors and franchisees for 30 years. He regularly counsels both startup and mature franchise companies in transactional and litigation matters. He has served as a franchise arbitrator with the American Arbitration Association since 1993. He has published several articles in the Franchise Law Journal and been a speaker at International Franchise Association and local seminars.

FOOTNOTES

1. See, e.g., Cal Bus & Prof Code § 20020-20021; MCL 445.1527; Conn Gen Stat § 42-133; 815 Ill Comp Stat Ann 705/19; Ind Code Ann § 23-2-2-7-1; Minn Stat Ann § 80C.14; Wash Rev Code § 19.100.180; Wis Stat Ann § 135.03.
2. See, e.g., 63 Pa Stat Ann § 818.13; Iowa Code Ann § 322F.2; MCL 445.1457a(1); MCL 445.1567(1); Mo Ann Stat § 407.840; Nev Rev Stat § 598.330(2).
3. MCL 445.1527 (emphasis added).
4. *Petereit v S B Thomas, Inc*, 63 F3d 1169 (CA 2, 1995).
5. Conn Gen Stat § 42-133e *et seq.*
6. *Petereit*, n 4 *supra* at 1184 (emphasis added).
7. *Id.*
8. *Id.*
9. *Id.*
10. *Id.*
11. *Carlos v Philips Business Systems, Inc*, 556 F Supp 769 (ED NY, 1983).
12. *Id.* at 776-777.
13. *American Mart Corp v Joseph E Seagram & Sons, Inc*, 824 F2d 733 (CA 9, 1987).
14. *Id.* at 734.
15. *Aurigma v Arco Petroleum Products Co*, 698 F Supp 1035 (D Conn, 1988).
16. *Id.* at 1042.
17. Even to franchisees recognizing the above, termination is shocking. They assume that because they have spent their life savings or obtained a huge personally secured bank loan to build a business promoting the franchisor's products or services, they are the franchisor's "partners." But they are not. Rather, franchisors and franchisees are independent contractors.
18. See, e.g., *PDV Midwest Refining, LLC v Armada Oil and Gas Co*, 305 F3d 498, 516-517 (CA 6, 2002) (enjoining the terminated franchisee from continuing to use the franchisor's trademark); *The Original Great American Chocolate Chip Cookie Co, Inc v River Valley Cookies, Ltd*, 970 F2d 273, 282 (CA 7, 1992).
19. See, e.g., *Dandy Oil Co v Knight Enterprises, Inc*, 654 F Supp 1265 (ED Mich, 1987) (upholding termination for franchisee misbranding of goods); *General Motors Corp v The New AC Chevrolet, Inc*, 263 F3d 296 (CA 3, 2001) (upholding termination for selling unauthorized products); *Fleetwood v Stanley Steamer International, Inc*, 725 F Supp 2d 1258 (ED Wash, 2010) (upholding termination for failure to pay royalties and other required amounts).
20. *Husain v McDonald's Corp*, 205 Cal App 4th 860; 140 Cal Rptr 3d 370 (2012).
21. *Dunkin' Donuts Franchised Restaurants, LLC v Shrijee Investment, Inc*, unpublished opinion of the US District Court for the Eastern District of Michigan, issued December 23, 2008 (Nos. 08-12836 and 08-14213), 2008 WL 5384077. Mr. Steinberg—co-author of this article—represented the franchisees.
22. *Petereit*, n 4 *supra*.
23. *Id.* at 1183 (court's emphasis).
24. *Dunkin' Donuts*, n 21 *supra*.
25. See, e.g., Chisum, *State regulation of franchising: The Washington experience*, 48 Wash L R 291, 314-315 (1973); Kirschner, *Franchise regulation: An appraisal of recent state regulation*, 13 Boston College L R 529, 532 (1972).