Alternatives to Termination: Effective Means of Facilitating Compliance or Merely Delaying the Inevitable?

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When a franchisee is in material default under its franchise agreement and fails to timely and adequately cure that default, a franchisor is faced with a decision regarding whether to terminate the franchise agreement or to pursue some other course of action. Sometimes the decision is simple: the franchisee's breach is so egregious or its performance so poor that the only rational decision is to end the franchise relationship as soon as possible. But things are not always that simple. If the franchisor prefers not to terminate the franchisee based upon its assessment of various business, relational, economic, and legal factors, the franchisor will often consider what other options are available, both from the perspective of mutual agreements with the franchisee as well as from the perspective of its unilateral rights. This article focuses on the actions that a franchisor may take unilaterally, as an alternative to termination, that may assist the franchisor in achieving its business objectives without the necessity of terminating the franchise agreement.[1]

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1. The options available in connection with a mutual agreement are virtually limitless, bounded only by the creativity of the franchisor and the franchisee and their mutual willingness to agree to a different arrangement than what was anticipated by the parties when they entered the franchise agreement, often crafting a solution that may not even be contemplated in the franchise agreement. Such options include but are not limited to forbearance agreements, payment plans, loans, workouts, facilitating a sale, or the franchisor stepping in to operate the franchised business. Several articles discuss such options in the context of financially distressed franchisees, but which may also apply to defaulting franchisees. *See*, *e.g.*, Jason B. Binford, Robert F. Salkowski & Andra Terrell, *Structured Workouts: Franchisor Strategies for Dealing with the Financially-Challenged Franchisee*, Am. Bar Ass'n 38th Ann. Forum on Franchising W–20 (2015); Van Elmore & Daniel Eliades, *The Financially Distressed Franchisee: Advanced Strategies for Franchisors and Franchisees*, Am. Bar Ass'n 30th Ann. Forum on Franchising W–11 (2007).

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Section I of this article summarizes a variety of potential alternatives to termination and the types of contractual provisions that franchisors may include in their agreements to ensure that they have such options available to them. Section II of this article considers the special case of a franchisor exercising step-in rights to take over operations of the franchised business. Section III surveys the limited case law evaluating the exercise of contractual termination alternatives. Section IV addresses the application of statutory considerations to the exercise of contractual termination alternatives. Section V explores the key considerations that a franchisor should weigh when considering whether an alternative to termination will aid the franchisor in achieving its objectives.

I. Contractual Alternatives to Termination

While pre-termination provisions receive less attention than termination provisions, particularly in the case law, most franchise agreements provide franchisors with a number of tools short of termination that can be used to facilitate compliance when a franchisee is in default. These provisions range from remedial training provided by the franchisor, to restrictions on access to certain aspects of the franchised system, to financial measures. Franchise agreements that contain a variety of such provisions provide the franchisor with tools that may facilitate a cure of defaults and facilitate compliance, depending upon the nature of the default.

Remedial tools are particularly helpful when a franchisee intends to comply with its obligations, but lacks the ability or access to information to comply with the franchisor's system. Reflecting the utility of such a tool, most franchise agreements contain a provision whereby the franchisor can require a franchisee to attend additional training sessions (at the franchisee's expense), whether or not the franchisee is in default. A sample version of such a provision is as follows:

> Franchisor may require that Franchisee, its owners and/or managers attend and successfully complete supplemental training, to be conducted at times and locations designated by Franchisor. Franchisor may charge a tuition fee for any such training, and Franchisee will be responsible for all expenses incurred by Franchisee's owners and/or managers in attending such training.

A franchisor can invoke such a provision to provide refresher training or to ensure that a franchisee's management is well-versed in the requirements of the franchisor's system, particularly after a turnover in key personnel at the franchisee. When supplemental or remedial training is available to address the particular defaults at issue, such a tool is an ideal first step because it may target the root cause of the franchisee's defaults, leading to ongoing future compliance and ensuring a consistent application of the franchise system, as expected by the consuming public.[2]

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2. "The quality and consistency of a customer's experience is crucial to enhancing the strength of the brand and, therefore, to enhancing sales and long-term prospects for the system. In the franchise context, establishing and maintaining system standards are key components in

Another tool included in some franchise agreements is a provision that allows the franchisor to reduce or eliminate a franchisee's exclusive territory.[3] A sample of language that may be included in such a provision is as follows:

> Franchisee agrees that if it has received a notice of default issued pursuant to Section [x] of this Franchise Agreement and has not cured the default within the time period permitted in the notice of default, then Franchisor has the right to reduce the geographic size of, or eliminate, the Exclusive Area under this Franchise Agreement in Franchisor's sole discretion. Following any reduction to the geographic size of, or elimination of, the Exclusive Area, Franchisor shall have the right to open and operate a new location, or to grant a franchise to another party to open and operate a new franchised location, at any site that is outside any remaining Exclusive Area.

While implementation of such a provision is not limited to performance standards defaults, this type of provision can be particularly helpful in addressing situations where a franchisee is in default of reasonable performance standards, leading to an under-utilization of the franchisee's territory. When a franchisee fails to comply with agreed performance standards included in the franchise agreement, the franchisee is adversely impacting not only its own revenues, but also the franchisor's anticipated revenues relating to that territory, and the franchisee is potentially opening the door to competitors in that territory. Accordingly, when a franchisee is in default of performance standards, and fails to cure its default, a reduction in the exclusive territory can better align the territory with the franchisee's demonstrated capabilities in operating the franchised business, while creating opportunities to bring one or more operators into the area to maximize the territory's potential and to best retain customers in that area for the franchised system, rather than creating opportunities for competitors in the territory.[4] The changes to the exclusive territory may be permanent. Or, the changes may be temporary, providing the franchisee an incentive to cure their defaults and to regain access to the original protected territory, assuming that the franchisor has not yet granted a new franchise in the relinquished territory.

Yet another alternative to termination that is included in some franchise agreements is the ability to restrict access to certain systems or components of the franchise system while a franchisee is in default.[5] Such provisions are more common in franchise agreements for hotel franchises or other systems where a franchisee derives a material part of its business from an online reservation system. A form of this type of provision follows:

this process." Ronald T. Coleman, Jr., *Franchisors' Use of Customer Satisfaction Survey Results in Disputes with Franchisees*, 36 Franchise L. J. 1, 25–26 (2016).

3. Michael Einbinder, Benjamin B. Reed & Stephanie Russ, *It Ain't Over 'Til It's Over: Creating, Enforcing, and Defending Franchisor Remedies Short of Termination*, Am. Bar Ass'n 30th Ann. Forum on Franchising W–7, at 14–16 (2023).

4. *Id.* at 15 ("By reducing the territory and, consequently, corresponding management pressures, the franchisor can give the franchisee a better chance of success without further risk of termination.").

5. *Id.* at 16.

> Franchisee agrees that if it has received a notice of default issued pursuant to Section [x] of this Franchise Agreement and has not cured the default within the time period permitted in the notice of default, then Franchisor has the right to suspend Franchisee from the reservation system while such default remains uncured. Once the default is cured, Franchisor will promptly reconnect Franchisee to the reservation system. Franchisor's exercise of its remedies in this Section will not constitute actual or constructive termination of this Franchise Agreement or preclude Franchisor from terminating this Franchise Agreement or exercising any other rights under this Franchise Agreement.[6]

The rationale for this type of provision is three-fold. First, it maximizes opportunities for franchisees who comply with their agreements and who are contributing to the growth and performance of the franchise system. If a defaulting franchisee is excluded from online listings or reservation systems, customers are more likely to find and patronize locations that are in compliance. Second, exercising such a provision enhances the likelihood of a good customer experience and improves prospects for repeat business. For example, if a hotel franchisee is in default for failure to refresh the décor and furnishings in accordance with system requirements, the system will be better off, and the customer is likely to have a better experience, if a customer patronizes a location that is in full compliance with the system, including any required décor and furnishing updates. Third, the exercise of this provision (and even the existence of this type of provision in the franchise agreement) provides an incentive for the franchisee to comply with the system and to promptly cure any defaults.[7]

Financial mechanisms are another type of provision contained in franchise agreements that can incentivize compliance.[8] Franchisees that are in default, particularly those that repeatedly default under their agreements, often command a disproportionate amount of the franchisor's time, effort, and resources as the franchisor takes steps to preserve and enhance the system's goodwill. Accordingly, these types of provisions may provide that the franchisee will pay a certain fee and/or will reimburse the franchisor for any attorneys' fees or other costs that it incurs in connection with securing the franchisee's compliance. Financial mechanisms can incentivize compliance by adding an additional factor that a franchisee must consider when assessing the risks and cost of non-compliance.[9] They also can help offset some

6. *See also* Hyatt Franchise Agreement 31–32, *available at* https://www.sec.gov/Archives/edgar/data/1468174/000119312509165558/dex1046.htm (last visited on June 17, 2024) (containing Hyatt's right to suspend franchisee from reservation system in the event of default).

7. Lack of access to a hotel reservation system may have a significant impact on a franchisee's business, providing a strong incentive to cure outstanding defaults. For example, during 2021, the median contribution to room night revenue for franchised Westin hotels in the United States and Canada that operated as Westin hotels for at least two years as of December 31, 2021, was 77.8%. *See* Westin Franchise Disclosure Document issued on Mar. 31, 2022, at 112, *available at* https://www.hotel-development.marriott.com/resourcefiles/fdd-document/2022-westin-fdd.pdf (last visited Mar. 29, 2024).

8. Einbinder, Reed & Russ, *supra* note 3, at 9–14.

9. Establishing the terms of appropriate financial mechanisms will depend upon the system at issue. While a franchisor should not establish unreasonable financial terms in such

of the additional resources and costs that the franchisor needs to allocate to address the defaults by that franchisee.

The foregoing types of provisions generally either provide additional resources or incentives to the franchisee, but still rely upon the franchisee to take the necessary actions to cure their defaults and comply with the system's requirements. When such provisions have been implemented but fail to yield compliance—or when the franchisor believes that such provisions will not result in timely compliance, particularly in circumstances where health, safety, or potential severe harm to the brand are at issue—the franchisor may need to consider a more active role if the franchisor wants to pursue a path other than termination. One such approach, the exercise of step-in rights, is discussed in the next section of this article.

II. Step-In Rights—A More Active Contractual Alternative to Termination

A. *General Overview*

Step-in rights, sometimes referred to as takeover provisions, are terms contained within a franchise agreement that "grant[] the franchisor the right to assume operation and/or management of a franchisee's business" during a certain period of time and under certain circumstances.[10] One of the franchisor's purposes in exercising its step-in or takeover rights is to protect its brand either from the reputational harm associated with outright termination and closure of the business or from a franchisee's destructive actions once it finds out termination is impending.[11] In certain circumstances, it might be in the franchisor's best interest to step in and manage the business itself to bring the franchisee back into compliance and avoid outright termination. Step-in rights also may be exercised in the interim while the franchise is being sold or transferred to a buyer. Step-in rights are typically coupled with financial mechanisms, allowing the franchisor to retain some or all revenues generated from the business during the takeover period and/or to be reimbursed its out-of-pocket expenses incurred in the takeover.

Common events triggering a franchisor to exercise its step-in rights include the following: death or disability of the franchisee or franchisee's owner; situations where there is no one to operate the business; when the franchisee abandons the business or is absent; when a franchisee's actions

provisions, nominal provisions are likely to be ineffectual and may lead a franchisee to decide that it would prefer to pay the specified amount, rather than comply with the system.

10. *See generally* Patrick Maslyn & Morgan Ben-David, *Enforcement and Risks of Post-Termination Buybacks and In-Term Step-In Rights*, 52nd Ann. Int'l Franchise Ass'n Legal Symposium, at 4 (2019).

11. Interim Healthcare, Inc. v. Durbin, No. 21-CV-62561, 2022 WL 874092, at *2 (S.D. Fla. Mar. 24, 2022) ("As Plaintiff rightly notes, 'step-in' rights are the 'tool' that allows Plaintiff to protect its trademarks, trade secrets, and goodwill that will allegedly be irreparably harmed. . . . The ability to exercise 'step-in' rights therefore, is inextricably intertwined with whatever irreparable harm Plaintiff will allegedly suffer.").

threaten the goodwill or reputation of the franchisor, its marks, or the system; and where the franchisee fails to comply with, or is in default of, the franchise agreement.

Ultimately, while step-in rights are rarely exercised, providing optional step-in rights for the franchisor in the franchise agreement may be a good option to help the franchisor protect its brand and prevent harm to its reputation. This is a relatively low-risk option because the franchisor is not required to exercise the step-in rights, but has the option to do so if it is in the franchisor's best interest. However, such provisions may cause issues for the franchisee when it comes to obtaining a loan because the lender will have concerns that a third party (the franchisor) can disrupt the revenue stream, which is presumably being used to pay the loan, at its option. Further, the franchisor must be careful to draft a provision that allows it to manage and operate the business while minimizing its risk if things continue to go awry based upon the course set by the franchisee. The franchisor also must ensure that ancillary contracts, such as lease agreements, do not interfere with its ability to exercise these rights, rendering the provision meaningless.

B. *Examples of Step-In Provisions*

A franchise agreement may contain basic step-in rights that are optional for the franchisor to exercise in the event of default. Including these rights in the original agreement is a fairly low-risk practice as it merely provides an option to the franchisor should it be in its best interest under the circumstances. For example, a franchisor could consider the following language:

> 15.6 Step-In Rights. In the event we have provided you with a notice of default hereunder which is either incurable or uncured, we will have the right, but not the obligation, to step in and operate the [franchise] for such period of time as we deem necessary, in our reasonable business judgment, under the circumstances. In the event we exercise such right, you must indemnify and hold us harmless under the terms of Section 20.3 hereof for our operation of the [franchise], except in the case of our gross negligence or reckless misconduct and you must immediately reimburse us for any and all out-of-pocket expenses that we incur in operating the [franchise] during such time-period. You consent to our using monies from the [franchise]'s Gross Sales for such reimbursement. All rights under this Section 15.6 are in addition to all other rights and remedies available to us under this Agreement, including without limitation our right to terminate this Agreement under this Section 15.[12]

Or, a franchisor could include the following more in-depth provision:

> Our Step-In Rights. The parties want to prevent any interruption of the Franchise that would cause harm to the Franchise and to [our franchise system] and lessen their value. Therefore, you authorize us to step in to operate the Franchise for as long as we reasonably believe necessary and practical. We may do so without waiving any other rights or remedies that we may have. Cause for stepping-in

12. School of Rock Franchise Disclosure Document, effective Sept. 22, 2023, *available at* https://www.cards.commerce.state.mn.us/documents/%7B70C4148B-0000-CB18-9A12-2678BAA46AC6%7D/download?documentClass=FRANCHISE_REGISTRATIONS&contentSequence=0 (last visited Apr. 11, 2024).

may include our reasonable determination that: you are incapable of operating the franchise; you are absent or incapacitated because of illness or death; you have failed to pay when due any taxes or assessments against the franchise or property used in the franchise; you have failed to pay when due any liens or encumbrances placed upon or against your business property; or we decide that significant operational problems require us to operate the Franchise for a time. We may exercise our step-in rights if you are ill or disabled, you, your lender, or the Small Business Administration (SBA) requests our assistance or agrees to our proffered support and supervision, directly or indirectly or through contract agents. If you have a loan for the franchise that is guaranteed by the SBA, our right to step-in will be limited to a sixty-day period unless otherwise requested or agreed with the lending bank at that time.

We will pay you a Commission on revenue we receive from our operation of the Franchise. We will first pay from that Commission all expenses, debts and liabilities that we incur during our operation of the Franchise. This will include our personnel and administrative costs, plus 15% of that Commission to cover our overhead expenses. In addition, we will have the option, but not the obligation, to pay for you any claims owed by you to any creditor or employee of the franchise. You will reimburse us upon demand, or we may withhold from Franchise Commission payments, including interest at applicable legal rates.

We will have no obligation to retain any employee of the Franchise or to honor any contractual employment commitments that you previously made. If we elect to retain any employee, employment will be pursuant to a new employment agreement between us and the employee. Employment will commence on the first business day on which we carry on business through the franchise. You agree to defend, indemnify, and hold us harmless from or against any claim by an employee of yours for unpaid salary, vacation pay, or other benefits.

Upon our exercise of these Step-In Rights, you agree to hold us harmless for all acts, omissions damages, or liabilities arising during operation.

Our operation of the franchise will not operate as an assignment to us of any lease or sublease of franchise property. We will have no responsibility for payment of any rent or other charges owing on any lease for franchise property, except as the charges relate to the period of our operation of the Franchise.

You agree to pay our reasonable legal and accounting fees and costs we incur because of our exercise of these Step-In Rights.[13]

III. Cases That Have Evaluated Alternatives to Termination

While cases that address the right of the franchisor to terminate a franchise agreement are legion, there is a relative dearth of case law regarding the exercise of the contractual alternatives to termination discussed in this article. This section discusses the key cases and themes from the cases that have evaluated the exercise of step-in rights and other contractual alternatives to termination.

A. *Cases Evaluating Contractual Alternatives to Termination*

The primary alternative to termination that has been the subject of litigation relates to restricting access to reservation systems. The courts that have

13. ITEX Corporation Franchise Disclosure Document, effective Oct. 23, 2020, *available at* https://www.franchimp.com/?page=pdf&f=104620_2021.pdf (last visited Apr. 11, 2024).

considered claims relating to denial of access to reservations systems where the franchisee is in breach have dismissed such claims as being barred by the terms of the contract. For example, in *Baymont Franchise Systems, Inc. v. The Bernstein Company, LLC*,[14] the franchisee asserted a counterclaim that the franchisor wrongfully suspended access to the reservation system. The court held that the franchise agreement only provided that the franchisee would be provided access if it is up to date on its payment of fees and that the agreement "further provides that [the franchisor] may suspend [the franchisee's] access to the reservation system and in fact may also discontinue and divert reservations activity, in the event of default or failure to pay or perform as required by the Franchise Agreement."[15] Accordingly, the court dismissed the counterclaim based upon denial of access to the reservation system, and the court denied leave to amend in light of the contract terms.[16]

In *Red Roof Franchising, LLC v. Riverside Macon Group, LLC*,[17] the Sixth Circuit affirmed a jury's ruling in favor of the franchisor as to the franchisee's claim that the franchisor improperly denied it access to the online reservation system without providing the franchisee adequate time to cure its defaults on the grounds that the franchisee failed to move for judgment as a matter of law at trial and thus allowed the matter to go to the jury.[18] Before trial, the trial court had denied the franchisor's motion for summary judgment regarding the franchisee's claim for breach of contract when its access to the reservation system was cut off immediately upon its defaults despite the franchise agreement providing a cure period with respect to such defaults.[19]

In *Sandonato v. Days Inn Worldwide, Inc.*,[20] a magistrate judge in the District of Rhode Island issued a report and recommendation recommending denial of the franchisor's motion for summary judgment as to the franchisee's claim that the franchisor improperly denied it access to the computerized reservation system.[21] The magistrate's recommendation was based upon its finding of disputed material facts: the franchisor maintained that the franchisee had inadvertently turned off the access, which the franchisee denied.[22] The court noted that the franchisor could have argued that "it was its prerogative to restrict Plaintiff's access to the [computerized reservation system] based on Plaintiff's defaults," but did not, implying that the court may have granted

14. Baymont Franchise Sys., Inc. v. Bernstein Co., LLC, Civ. No. 18-620-JMV-AME, 2021 WL 2935426, at *8 (D. N.J. July 13, 2021).

15. *Id.*

16. *Id.* at *10.

17. Red Roof Franchising, LLC v. Riverside Macon Group, LLC, No. 21-3648, 2022 WL 620174, at *3–4 (6th Cir. 2022).

18. *Id.*

19. Red Roof Franchising, LLC v. Riverside Macon Group, LLC, Case No. 2:18-cv-16, 2020 WL 2494462, at *5 (S.D. Ohio May 14, 2020).

20. Sandonato v. Days Inn Worldwide, Inc., C.A. No. 07-451S, 2010 WL 8461122 (D. R.I. July 21, 2010).

21. *Id.* at *7.

22. *Id.*

summary judgment to the franchisor had it simply asserted that it had the right to restrict access to the reservation system.[23]

Cases that have addressed the use of financial mechanisms in the event of financial defaults have regularly enforced such mechanisms.[24] Accordingly, from this limited body of caselaw, the courts appear to be inclined to affirm contractual alternatives to termination, so long as the franchisor implements such alternatives in accordance with their terms, including providing contractual notice and cure periods.

B. *Cases Evaluating Step-In Provisions*

Very few cases evaluate step-in provisions in franchise agreements. However, a handful of cases have discussed step-in rights in the context of motions for injunctive relief. In *Sunni, LLC v. Edible Arrangements, LLC*,[25] a franchisor did not renew a franchisee's three franchise agreements because the franchisee pled guilty to tax fraud.[26] The franchisor also refused to allow the franchisee to transfer the franchises to another buyer.[27] The franchisee initiated arbitration, but before the arbitrator could enter a decision, the franchisor sent the franchisee notice that it was going to cut off the franchisee's access to the franchisor's online ordering system.[28] In response, the franchisee sought injunctive relief in federal court to enjoin the franchisor from cutting off its access before the arbitration was complete.[29] However, the franchisor intended to exercise its step-in rights and manage the stores itself during the transition, meaning that the franchisor would "assume control and operate the three franchises in a manner consistent with their current operation, including maintaining all leases, retaining staff and employees, and maintaining all appropriate records of the franchises."[30]

The court held that, because the franchisor intended to exercise its step-in rights and manage the stores, the franchisee could not show irreparable harm.[31] The court reasoned that there would be no harm to the stores by the franchisor managing them as the stores would not close or lose their leases, personnel changes would not be made, and the franchisor was keeping record of profits to pay the franchisee should it lose at arbitration.[32] Accordingly, the court denied the franchisee's petition for injunctive

23. *Id.*
24. *See*, *e.g.*, Kiddie Acad. Domestic Franchising, LLC v. Faith Enter. DC, LLC, Civ. No. WDQ-07-0705, 2010 WL 673112, at *4 (D. Md. Feb. 22, 2010) (applying ten percent late charge in franchise agreement to both unpaid royalties plus accrued interest on the unpaid royalties).
25. Sunni, LLC v. Edible Arrangements, LLC, No. 14 Civ. 461 (KPF), 2014 WL 1226210 (S.D.N.Y. Mar. 25, 2014).
26. *Id.*
27. *Id.*
28. *Id.*
29. *Id.* at *9.
30. *Id.* at *1.
31. *Id.* at *9.
32. *Id.*

relief.[33] In so doing, the court effectively validated the franchisor's exercise of its step-in rights. This validation is important, as the possibility of exercising step-in rights without interference from a court or arbitrator before a final decision on the merits gives franchisors considerable leverage in negotiating with recalcitrant franchisees.

In *Interim Healthcare, Inc. v. Interim Healthcare of S.E. Louisiana, Inc.*,[34] the franchisee interfered with the franchisor's step-in rights by continuing to operate under the franchisor's proprietary marks and by refusing to comply with the step-in rights set forth in the franchise agreement. The franchisor sought and was granted an injunction allowing it to exercise step-in rights and operate the franchise to prevent customer confusion and harm to the franchisor's goodwill and reputation.[35]

There is also limited case law regarding whether a franchisor exercising step-in rights would expose itself to liabilities for breaches of duties, either of good faith and fair dealing or potential fiduciary duties owed to its franchisee or the franchisee's employees and customers. For example, in *Charter Practices International, LLC v. Robb*,[36] a franchisee counterclaimed against a franchisor's termination, claiming breach of the covenant of good faith and fair dealing due to a franchisor exercising step-in rights during the period of time between termination and sale of the franchise to a third party.[37] Ultimately, the federal district court dismissed the franchisee's counterclaim, reasoning that the franchise agreement permitted the franchisor to exercise its step-in rights during this period of time and made clear that the franchisee owned the franchise and was entitled to revenue credit until the official date of termination.[38]

Accordingly, the existing case law, though minimal, indicates that courts are likely to enforce step-in rights and that a franchisor may even obtain injunctive relief to implement such rights when the franchisee refuses to comply with its obligation to permit a franchisor to takeover operations under a step-in provision.

IV. Statutory Provisions That May Impact the Exercise of Contractual Alternatives to Termination

Because this article addresses contractual alternatives to termination, it is assumed that the franchisor evaluating alternatives to termination has already determined that it has a right to terminate the particular franchise agreement under the terms of the agreement and applicable law. However,

33. *Id.*

34. Interim Healthcare, Inc. v. Interim Healthcare of S.E. Louisiana, Inc., No. 19-CV-62412, 2020 WL 3078531 (S.D. Fla. June 10, 2020).

35. *Id.* at *21–22.

36. Charter Practices Int'l, LLC v. Robb, No. 3:12-CV-1768 (RNC), 2017 WL 4366717 (D. Conn. Sept. 30, 2017).

37. *Id.* at *4.

38. *Id.*

that analysis does not mean that the franchisor is free to completely ignore applicable franchise relationship laws when considering alternatives to termination. Various provisions contained in such laws may impact the decision regarding whether to implement a contractual alternative to termination, as well as the manner in which the franchisor implements the alternative to termination.

A. *Statutory Provisions Governing Notice, Cure, and Good Cause*

Most franchise relationship laws have specific notice, cure, and/or good cause provisions that apply to franchise terminations. While a franchisor might assume that such provisions have no application when it is considering a contractual alternative to termination, as opposed to an actual termination, such an assumption would be folly. For example, the Wisconsin Fair Dealership Law (WFDL) expressly sets forth the same notice requirements for any of the following: "termination, cancellation, nonrenewal or *substantial change in competitive circumstances*."[39] Many of the alternatives to termination would arguably result in a change in competitive circumstances, rendering the WFDL's notice requirements directly applicable. Similarly, the Virginia Retail Franchising Act states that it is unlawful for a franchisor to "cancel a franchise without reasonable cause or *to use undue influence to induce a franchisee to surrender any right given to him* by any provision contained in the franchise."[40] A franchisor engaging in alternatives to termination would have to consider whether it is comfortable that its actions would not amount to "undue influence" under Virginia law.

Additionally, the more severely a contractual alternative to termination impacts the franchisee's business, the greater are the prospects that the franchisee would argue that the action taken constituted a constructive termination and therefore implicates any notice, cure, and good cause requirements that apply to a termination under applicable franchise relationship laws.[41] While the trend in cases evaluating constructive termination claims by franchisees after the Supreme Court's decision in *Mac's Shell Service, Inc. v. Shell Oil Products Co.*[42] has been to require that the franchisee actually cease operations,[43] a franchisor should consider that the greater the impact on a

39. Wis. Stat. § 135.04 (emphasis added).

40. Va. Code Ann. § 13.1-564 (emphasis added).

41. *See* Girl Scouts of Manitou Council, Inc. v. Girl Scouts of United States of America, Inc., 646 F.3d 983, 990 (7th Cir. 2011) ("The district judge correctly described the transfer [of all of Manitou's territories to other councils] as amounting to 'constructive termination' of Manitou's dealership.").

42. Mac's Shell Service, Inc. v. Shell Oil Prods. Co., 559 U.S. 175, 182 (2010).

43. *See, e.g.*, Pai v. DRX Urgent Care, LLC, No. CIV.A 13-3558 JAP, 2014 WL 837158, at *7 (D.N.J. Mar. 4, 2014) ("The Supreme Court recently has made clear that a claim for constructive termination by a franchisee requires that a franchisee no longer be in operation."); Bell v. Bimbo Foods Bakeries Distrib., Inc., No. 11 C 03343, 2012 WL 2565849, at *4 (N.D. Ill. July 2, 2012) ("[T]he Supreme Court noted in *Mac's Shell* [that] a plaintiff must actually sever a particular relationship to maintain a claim for constructive termination.").

franchisee's business, the more likely the action could be found to constitute a constructive termination.

As noted earlier, because this article assumes that the franchisor has determined that it has a right to terminate the franchise agreement under the terms of the agreement and applicable law, the franchisor will already have determined that it has satisfied any "good cause" requirement under applicable law. Implementing minor financial mechanisms, such as a required fee of $100 in the event of a late payment, is highly unlikely to be viewed as effecting a substantial change in competitive circumstances or resulting in a constructive termination. Accordingly, following any statutory notice or cure requirements would not be necessary in those circumstances. Nevertheless, the franchisor would be well-advised to follow all applicable notice and cure requirements when implementing significant contractual alternatives to termination in the same manner as it would when effecting an actual termination.[44]

B. *Statutory Provisions Restricting Encroachment*

A franchisor might assume that if it has the right to terminate a franchise agreement, then it should logically have the right to exercise any lesser rights in those circumstances, including any contractual alternatives to termination. However, before exercising a contractual right to reduce or eliminate a franchisee's exclusive territory and grant a franchise or open a new company-owned location in the franchisee's former territory, a franchisor would be well-advised to consider any applicable relationship law restrictions on encroachment.[45]

Several of the franchise relationship laws contain restrictions on encroachment. For example, the Hawaii Franchise Investment Law (HFIL) provides that "it shall be an unfair or deceptive act or practice or an unfair method of competition for a franchisor to . . . [e]stablish a similar business or to grant a franchise for the establishment of a similar business at a location within the geographical area specifically designated as the exclusive territory in a franchise previously granted to another franchisee in a currently effective agreement, *except under the circumstances or conditions prescribed in the agreement.*"[46] A contractual alternative to termination that permits the franchisor to reduce or eliminate the franchisee's exclusive area in the event of a material default would likely satisfy the exception set forth in the emphasized language. Accordingly, under the HFIL, there is minimal risk from exercising such a contractual right where the franchisor would have the right to terminate the franchise agreement.

44. Einbinder, Reed & Russ, *supra* note 3, at 29 ("In other words, the franchisor is well-served to comply with the notice and cure requirements for taking alternative actions as it would if it were pursuing termination.").

45. If the franchisor reduces or eliminates the franchisee's exclusive territory, then it would not be triggering any encroachment restrictions. However, such changes would likely constitute a substantial change in competitive circumstances as discussed above.

46. Haw. Rev. Stat. § 482e-6(2)(E) (emphasis added).

However, not all franchise relationship laws are created equal. For example, the Washington Franchise Investment Law (WFIL) provides that it "shall be an unfair or deceptive act or practice . . . [i]f the franchise provides that the franchisee has an exclusive territory, which exclusive territory shall be specified in the franchise agreement, for the franchisor or subfranchisor to compete with the franchisee in an exclusive territory or to grant competitive franchises in the exclusive territory area previously granted to another franchisee."[47] Similarly, the Minnesota regulations provide that it "shall be unfair and inequitable" for a franchisor to "compete with the franchisee in an exclusive territory or grant competitive franchises in the exclusive territory previously granted to another franchisee if the terms of the franchise agreement provide that an exclusive territory has been specifically granted to a franchisee."[48] Notably, neither the WFIL nor the Minnesota regulations contain the type of exception included in the HFIL.

To date, the case law provides no clear guidance as to whether the WFIL and the Minnesota regulation would be interpreted to apply an exception similar to the express exception in the HFIL. The only case interpreting the anti-encroachment provision in the WFIL did not answer this question: it found there was no violation of the WFIL because the franchisor's performance was excused when both parties had already repudiated the franchise agreement before the alleged violation of the WFIL.[49] Similarly, the only case interpreting the encroachment provision under the Minnesota regulations provides no guidance for exercising a contractual right as an alternative to termination because that case held that the challenged conduct (primarily relating to online sales) was expressly excepted from the exclusive territory granted under the franchise agreement.[50]

The Indiana Deceptive Franchise Practices Act (IDFPA), which applies only to encroachment by company-owned outlets, prohibits "[e]stablishing a franchisor-owned outlet engaged in a substantially identical business to that of the franchisee within the exclusive territory granted the franchisee by the franchise agreement or, if no exclusive territory is designated, competing unfairly with the franchisee within a reasonable area."[51] However, similar to the WFIL and the Minnesota regulations, the IDFPA has no carve-out for franchisor actions in the franchisee's former territory. And the latter part of the prohibition would appear to create a "reasonable area" of protection for the franchisee, even if the franchisor exercised a contractual right to eliminate a franchisee's exclusive area based upon its material defaults. No cases have interpreted the IDFPA's encroachment provision.

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47. Wash. Rev. Code § 19.100.180(2)(f).

48. Minn. R. § 2860.4400(C).

49. Nelson v. Nat'l Fund Raising Consultants, Inc., 823 P.2d 1165, 1171 (Wash. Ct. App.), *aff'd in part, rev'd in part on other grounds*, 842 P.2d 473 (Wash. 1992).

50. Newpaper, LLC v. Party City Corp., No. CIV. 13-1735 ADM/LIB, 2014 WL 2986653, at *8 (D. Minn. July 1, 2014).

51. Ind. Code § 23-2-2.7-2(4).

The Iowa franchise relationship law is similar to the latter portion of the IDFPA, except that it applies to both company-owned and franchised locations.[52] Specifically, the Iowa franchise relationship law generally prohibits the franchisor from opening and operating a company-owned location, or granting a franchisee the right to open and operate a location, "in unreasonable proximity to the existing franchisee's outlet or location and [that] has an adverse effect on the gross sales of the existing franchisee's outlet or location."[53] The Iowa law has four express exceptions, three of which either would not apply to a reduction or elimination of exclusive territory as an alternative to termination or would involve a fact-intensive inquiry that could only be measured twelve months after the opening of the new location, thereby rendering it unhelpful to guiding a franchisor's decision-making process as to whether reducing an exclusive territory as an alternative to termination is an attractive option.[54] The fourth exception applies when "[t]he existing franchisee has been granted reasonable territorial rights and the new outlet or location does not violate those territorial rights."[55] There are no cases interpreting whether the "grant[of] reasonable territorial rights" could include circumstances where the franchisor is reducing an exclusive territory as an alternative to termination.

Thus, under the current array of franchise relationship laws and implementing regulations, a franchisor contemplating whether to exercise a contractual right to reduce or eliminate an exclusive territory would be acting in a manner that is potentially contrary to the language of laws and regulations in Washington, Minnesota, Indiana, and Iowa, with no existing case law to give it comfort that its conduct is permissible. Accordingly, a franchisor exercising such a provision in one of those states would need to be prepared to endure potentially costly litigation to establish the propriety of such action as a case of first impression, as well as potentially facing an adverse determination, and the damages that may accompany it, if the actions are found unlawful.

A franchisor undoubtedly would have several strong arguments supporting the exercise of a contractual right to reduce or eliminate an exclusive territory, as an alternative to exercising its right to terminate the franchise agreement. First, a franchisor could argue that because the franchise relationship laws are intended to protect franchisees, they should be interpreted to allow a franchisor to exercise a contractual alternative to termination when the franchisor has a right to terminate the franchise agreement. Any other interpretation would be disadvantageous to franchisees because the franchisor would be more incentivized to terminate a franchisee if the option of reducing or eliminating an exclusive territory is unavailable or unlawful. Second, a franchisor could argue that encroachment provisions in

52. Iowa Code § 537A.10(6)(a).
53. *Id.* § 537A.10(6)(a).
54. *Id.* § 537A.10(6)(a)(1)-(3).
55. *Id.* § 537A.10(6)(a)(4).

the relationship laws were intended to prevent encroachment that a franchisee reasonably could not have contemplated at the time it entered the franchise agreement, which is not a concern when a franchisor is modifying or eliminating an exclusive territory and adding a new location as specifically provided in the franchise agreement. While the specific context is different, the rationale would be similar to that adopted by the court in *Newpaper, LLC v. Party City Corp*.[56] There, the court determined that online sales that were carved out from the exclusive area protections did not violate the statute because they were covered by an agreed-to carve-out.[57] Here, the franchisor would similarly be exercising a specific contractual right that operates as an exception to an immutable protected exclusive area.

Thus, a franchisor electing to exercise a contractual right to reduce or eliminate an exclusive territory when it would have the right to terminate the franchise agreement for a material default likely would be able to set forth a strong argument supporting its actions. However, given the uncertainty arising from the language of the relationship statute provisions regarding encroachment, a franchisor should assess these risks carefully in connection with other key factors when deciding whether to terminate, exercise a contractual right to reduce or eliminate the exclusive territory, or implement another contractual alternative to termination.

V. To Terminate or Not to Terminate—Key Considerations

When a franchisee is in material breach of the franchise agreement, a franchisor considering whether to terminate the franchise agreement or to exercise one or more contractual alternatives to termination should weigh a variety of factors. As discussed in this article, most contractual alternatives to termination are enforceable under common law principles upholding the parties' freedom to contract. However, where franchise relationship laws apply to a particular franchise agreement, a franchisor assessing the option of reducing or eliminating a franchisee's exclusive territory and opening a new location or granting a franchise in the franchisee's former territory should consider the potential application of statutory prohibitions on encroachment. And the franchisor should consider the likely efficacy of the particular alternative to termination given that, as a best practice, the franchisor should comply with any notice and cure provisions under the franchise agreement and any applicable franchise relationship law in connection with any alternative that is likely to have a material impact on the franchisee's business.

However, legal considerations are only one aspect of the decision-making process. A franchisor must also consider that a termination of a franchised location may have some or all of the following business impacts, among others: (1) the franchisor will lose the revenue stream from the territory unless

56. Newpaper, LLC v. Party City Corp., No. CIV. 13-1735 ADM/LIB, 2014 WL 2986653, at *8 (D. Minn. July 1, 2014).

57. *Id.* at *8.

and until a new franchised or company-owned store is opened in the territory; (2) the franchisee may lack sufficient resources to satisfy a judgment for damages; (3) even when a new location is opened in a territory, it may take several years for the new location to attain the level of revenues that were being earned by the terminated franchisee; (4) the lack of presence in a particular market that has a demonstrated customer demand for the particular products or services offered by that franchise system may open the door to a competitor entering the market and capturing those customer relationships; and (5) prospective franchisees may view a significant number of terminations in a short window of time as reflecting negatively on the system.

And failing to terminate a franchisee who is in material breach or otherwise implementing alternatives to termination that bring that franchisee back into compliance with system standards may have some of the following consequences: (1) the franchisee who is in material breach may have a negative impact on customer's views of the franchisor's system and brand; (2) franchisees who are failing to follow the franchisor's system may be more likely to take actions that result in third parties bringing claims against the franchisee, as well as the franchisor as the "deep pocket;" and (3) failing to take action against a noncompliant franchisee may encourage other franchisees to follow that franchisee's lead, mistakenly believing that they may be able to increase their profitability, without recognizing that such compliance failures may negatively impact their enterprise value.

When weighing these various business and legal factors, the best solution likely will vary depending upon the specific circumstances. Sometimes, proceeding directly with termination will be the best option, particularly where health and safety issues are present or a franchisee is engaged in conduct that makes them an unreliable or untrustworthy future business partner. In other circumstances, deploying contractual alternatives to termination may be the best option. And when alternatives to termination are applied, but fail to achieve compliance, the franchisor may decide to then proceed with termination. Taking the two-step approach also blunts any future arguments in litigation that the franchisor was not acting in good faith or had ulterior motives when terminating. However, in making a determination about the best solution in a particular situation, the franchisor should take care to treat similarly situated franchisees in a similar manner, or else the franchisor may be faced with defending a claim for breach of an anti-discrimination provision under a state franchise relationship law[58] or for breach of the covenant of good faith and fair dealing.

When deciding whether to exercise its step-in rights a franchisor should assess several practical considerations. Specifically, the franchisor should consider several questions, such as:

58. *See, e.g.*, Ark. Code Ann. § 4-72-202(7); Haw. Rev. Stat. § 482e-6(2)(C); Ind. Code § 23-2-2.7-2(5); Minn. R. § 2860.4400(B); Wash. Rev. Code § 19.100.180(2)(c); Wisc. Stat. § 135.02(4).

1. The franchisor should consider their objective. Namely, what is the reason the franchisor wants to step in rather than terminate and potentially sell the territory to a new franchisee?
2. The franchisor should also consider the benefits of the transaction, such as avoiding reputational harm, cost, and whether there is an adequate justification for outright termination.
3. Further, the franchisor should consider the pitfalls associated with step-in rights, such as lack of adequate resources (personnel shortage); risk/legal liability; administrative and operational costs; lack of franchisee ability to maintain compliance once it is achieved, if operations are returned to the franchisee; and potential inability for the franchisor to step in under ancillary contracts, such as lease agreements and insurance contracts.
4. The franchisor should also consider the length of the time for which the franchisor is willing to step in.
5. The franchisor should also consider whether its franchisees often use third-party financing to purchase the franchise, as the inclusion of step-in rights may produce a joint-employer issue and lenders may object to such rights.[59] In fact, when the Franchise Registry was utilized in connection with the SBA loan approval process, approval on the Franchise Registry required compliance with time limitations on the duration of a franchisor's step-in rights.[60]

It is important for the franchisor to consider practically whether it can afford and has the resources to step in should it want to step in and manage the franchise. For example, a franchisor may want to create an internal team that is available to step in quickly and operate a franchised location to ensure that it has the personnel and resources to adequately take over an existing franchise. However, constructing such a team may prove quite expensive to the franchisor and may not be worth the cost if the franchisor rarely exercises this option. And while outsourcing this task to a third party would enhance flexibility, each franchise system has a proprietary system, and it is unlikely that a third party will know the system well enough to seamlessly takeover on a moment's notice. Moreover, there likely will be additional challenges in bringing the operations into compliance, given the circumstances leading to exercise of the step-in rights, that a third party may not be equipped to handle well. In addition, the costs of exercising step-in rights, or being prepared to do so, may be prohibitive, leading a franchisor to determine that termination is the better option.

Further, financial risk and legal liabilities are two main factors that the franchisor must consider. For example, the franchisor must assess whether

59. Binford, Salkowski & Terrell, *supra* note 1, at 7.

60. Dennis Wieczorek, *Franchise Agreement Provisions That Affect Eligibility for SBA Loans*, 15(2) Franchise Law., Spring 2012, at 1.

the insurance protecting the franchisee extends to it in the event of third-party claims while the franchisor is operating the business through the exercise of step-in rights. The franchisor also must consider whether taking over the franchisee's operations would expose it to legal liabilities for the franchisee's mistakes, such as poor recordkeeping; debt obligations to third parties such as suppliers; lack of insurance; and lack of compliance with state, local, and federal laws. Moreover, the franchisor may need to consider whether it needs to obtain any licenses or permits before it can operate the franchised business, especially in other jurisdictions than its own. And the lack of case law regarding the exercise of step-in rights creates additional uncertainty with respect to potential legal liabilities.

Ultimately, the franchisor must consider whether including the ability to exercise step-in rights makes sense for its franchise system. The authors of this article recommend including a permissive provision within the franchise agreement allowing the franchisor to exercise step-in rights upon the triggering events discussed above. Once a triggering event occurs, the franchisor should work closely with its counsel to determine whether it should exercise its option to step in and operate and manage the business, giving careful consideration to the pertinent business and legal considerations.

VI. Conclusion

Franchisors who do not have any contractual alternatives to termination, or who only have limited alternative options, may benefit from adding such provisions or increasing the variety of options included in their franchise agreements. After all, if the provision is not included in the franchise agreement, it will not be available as an option unless the franchisor and franchisee agree to such an option through mutual discussions at the time the material default arises. When such contractual alternatives are included in the franchise agreement, the franchisor should consider them as an additional arrow in the quiver. Choosing which arrow to loose will require a considered weighing of the various legal and business factors presented by the particular circumstances.