

# Handling Defaults and Terminations Effectively

To paraphrase an old saying, there is nothing to concentrate the mind of a franchise lawyer like the prospect of a franchise termination in the morning. Both franchisors and franchisees, and their attorneys, need a clear understanding of their respective rights, and opportunities, in the default-termination process.

*By Carmen D. Caruso and David A. Harpest*



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## **The Gathering Storm**

Franchise terminations are not usually surprise attacks, but are instead the unfortunate culmination of a steadily deteriorating relationship, often with missed salvaging opportunities on both sides. Typically, the franchisor has (or should have) warned the franchisee that existing defaults must promptly be cured. Preliminary, informal warnings serve the interests of good franchise relations, and also place the franchisor on the high ground in the event that the warnings are ignored and the decision is made to proceed toward termination. Furthermore, a strongly-worded "shape up or ship out" letter (ideally from senior management) is an excellent way to identify a good franchisee, who is likely to cure or at least engage in constructive dialogue. Furthermore, the written warning will help to deflect any subsequent accusation that the alleged default is contrived or pre-textual. This is especially important where the default is subjective, such as for alleged non-compliance with system standards; or where the default is ambiguous, such as an underpayment of royalties resulting from disagreement or confusion on how the royalty formula applies to certain sales or refunds. For example, in a recent termination case in which the franchisee attempted to claim that he had been "defrauded" and that "no one cared" about the financial plight of his store, the fact that the

franchisor's president had written two letters urging this franchisee to pay more personal attention to his business, and to seek remedial training, was very influential with the court that issued a preliminary injunction against the franchisee.

For the franchisee who receives a default warning, the best advice is always to take the threat very seriously and to make every reasonable effort to cure the alleged deficiency, and to document in writing the efforts at compliance, in the hope of avoiding the issuance of a formal default notice. Even in situations where the notice of default would be curable, the franchisee has strong incentive to avoid the issuance of a formal notice, in order to avoid the possibility of a subsequent incurable default based on the "repeated violations" or "repeated default" provisions of the "grounds for termination" section of the franchise agreement.

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Sometimes, however, the franchisee simply lacks the funds to immediately become current. The best course of action is to try and negotiate a payment schedule, document any agreement in writing, and

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then, to stick to the agreed schedule. Unless there is a more serious underlying problem, most franchisors would rather get paid over-time than to terminate the franchisee outright.

Other times, the franchisee believes that the threatened default is without merit, or that the threat is retaliatory, for example, it allegedly comes as a surprise after the franchisee expressed disagreement with a system policy. Even then, the franchisee ignores a threatened default at its peril, and should instead become compliant while seeking redress of its actual or perceived grievances. This advice holds true even when the franchisee believes, rightly or wrongly, that the franchisor's misbehavior is beyond resolution through reasoned negotiation, or that the franchisee believes that it has serious damages claims against the franchisor. Such a franchisee is often tempted to exercise self-help through a royalty strike, but that extreme measure is almost always a bad idea if there is the slightest desire to maintain the franchise.

In more extreme cases, the franchisee cannot afford, or simply refuses, to continue paying royalties. That franchisee cannot realistically expect to remain in the franchise system during the course of any resulting litigation. Far better for that franchisee to consider a voluntary exit from the system while reserving all of his or her actual or potential claims than to be dragged into litigation as a defendant in a termination suit.

### **The Default Notice**

Having exhausted informal attempts at securing compliance, the franchisor and its counsel must get their default notice exactly right, recognizing that it could be sharply contested in litigation. The notice must comply with both the franchise agreement and applicable state franchising statutes.

When preparing a notice, the franchisor must first determine if the default is curable or non-curable. If the default is curable, the notice must provide the appropriate cure period, whether dictated by the franchise agreement or by state statute. In addition, the notice should specify the sections of the franchise agreement that have been violated and the facts establishing the

violation. It should also specify exactly what is required for a cure and should be clear as to whether termination will follow automatically in the absence of a complete cure (preferred practice), or whether the termination will only be effective upon the issuance of a subsequent notice of termination (not preferred). Where the notice of default will stand as the notice of termination if the default is not cured, the notice should also spell out the franchisee's exact post-termination obligations under the franchise agreement, including such important areas as de-identification, non-competition and continuing financial obligations. It is sufficient to cite the applicable sections of the agreement. As an additional preferred practice, the notice should indicate the consequences under the Lanham Act (prohibiting trademark infringement) if the franchisee were to remain open beyond termination.

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If the default is non-curable, the notice should explicitly state that fact. In either event, the default notice should refer to the specific section of the franchise agreement that provides for the default, give the factual details that led to the default, warn of Lanham Act infringement if franchisor trademarks are used after termination, provide notice that all post-termination obligations in the franchise agreement must be followed, state that none of the franchisor's rights or remedies regarding any other obligations under the franchise agreement have been waived and be sent pursuant to the notice provision in the franchise agreement.

When a default is curable, a franchisee should cure as soon as possible, regardless of whether an underlying franchisee grievance exists. Some state laws require that a franchisor treat franchisees equally regarding enforcement of default provisions, although franchisors can still issue default notices, and in special situations can cite specific reasons for tendering a default notice that would otherwise be viewed as discriminatory. If the

franchisee is in a perilous financial situation, he can still try to arrange a payment plan with the franchisor, as this still may be more attractive to the franchisor than a franchise termination. However, a franchisee that repeatedly accrues notices should not expect any coddling from its franchisor.

### **Enforcing the Termination**

After sending a termination notice, the franchisor should assure itself that the franchisee is following through with its post-termination duties. Most importantly, the franchisor must confirm that the terminated franchisee has stopped using all of the franchisor's trademarks, trade dress and other intellectual property. If this use continues, the franchisor should take immediate action to stop such use in order to protect its intellectual property rights. The franchisee should appropriately de-identify with the franchisor as provided for in the franchise agreement and the termination notice. Franchisors will also want to take possession of any equipment or materials that are leased or loaned to the franchisor, including operating manuals, proprietary software, telephone numbers and any other materials enumerated in the franchise agreement. The franchisor should also attempt to recover any monies owed by the franchisee and set forth in the termination notice.

When judicial action is necessary to enforce a termination, the franchisor usually faces the "choice of forum" issue. A franchise agreement's choice of law provision will govern unless the franchisee's state franchise law either partially or completely does away with the choice of law provision. Some franchise agreements also have a clause providing for jurisdiction of a particular court for any actions based on the franchise agreement. Additionally, many franchise agreements contain alternative dispute resolution provisions that may require mediation or arbitration before a default or termination notice can be issued. These provisions should be taken into account so the termination action is filed in the appropriate venue at the appropriate time.

The franchisor must also decide what relief it is seeking. The range of available relief may include: store or

business closure, de-identification, telephone number transfer, return of proprietary information, monetary remedies and possibly non-compete enforcement. In cases where federal jurisdiction is premised on a trademark infringement count, the franchisor must be prepared to address jurisdictional concerns that might arise if the franchisee is able to moot the trademark issue by demonstrating that is not infringing.

### **Franchisee Strategy**

Franchise termination provides the occasion for franchisees to retain counsel and to review every possible defense to termination, and possible counterclaims. Of course, franchisee counsel often laments that the client would have been better served by legal review much earlier in the process, but the reality is that many franchisees wait until the crisis stage before seeking advice.

Counsel for the franchisee must review carefully the default and termination notice(s) and evaluate them under the franchise agreement and state law; and must make a very quick determination whether the facts giving rise to the termination are contestable. For leverage purpose, franchisee counsel must also consider potential counterclaims based on possible disclosure violations, fraud and misrepresentation claims, contract claims (based on both express and implied legal duties), and possible antitrust or other tort claims.

The biggest dilemma faced by franchisees or their attorneys is how to get their claims and defenses presented before the termination is effective, and before potential trademark infringement liability begins. Franchisee counsel must consider whether to bring an action to enjoin the termination; however, the burden of proof may now be shifted to the franchisee who pursues this remedy. The franchisee may be required to show that it is likely to prevail on the merits in the event of trial on the merits of the termination decision. The franchisee must also convince the court that it will be irreparably harmed by store closure and that an award of subsequent damages will not be sufficient.

Very often, the best strategy for a franchisee facing termination is to negotiate a period of time in which the

franchise can be sold to preserve equity. To the extent that the franchisee can allege colorable defenses or counterclaims, the franchisee has obviously increased its leverage for this negotiation. The franchisee might also consider the prospect of surrendering the location, but reserving damages claims (or counterclaims). The most dangerous outcome, to be avoided at all costs, is to remain open post-termination without the protection of an injunction, thus risking trademark liability. Such an outcome virtually guarantees litigation and its resulting expenses. ■

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