

FRANCHISOR/FRANCHISEE DISPUTE RESOLUTION



What does a “franchise” mean? In the most basic sense, a franchise is a business model in which a franchisor licenses the use of its trademark(s) and other, related intellectual property, along with its method of business operation, to a licensee for a fee (the “franchisee”). The relationship between the two is almost always memorialized in a contract commonly known as a franchise agreement, though some franchise systems refer to them as “licensing agreements,” for example. It is important to keep in mind that not all trademark licensing agreements will establish a franchisor/franchisee relationship, but those that do must comply with both federal and state law, as applicable.

VIOLATION OF THE FRANCHISE AGREEMENT

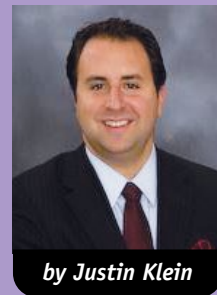
What happens when a franchise agreement is breached? Naturally, it will depend on which party (the franchisee or franchisor) has committed the violation(s) leading to that breach. Regardless of who committed the breach or even if there are multiple allegations of breach, the first place to look to determine your rights is, of course, the franchise agreement itself. A well-drafted franchise agreement will contain the appropriate dispute resolution procedures, of which both franchisor and franchisee should be aware and will be required to follow.

For example, the franchise agreement will provide direction as to how a notice of a default must be given and how much time either party may have to cure that default, if any. Short of involving a formal process, however, it is almost always a good idea for the parties to attempt to privately resolve their disagreements regarding the perceived default, why it occurred and how the parties can move forward together productively.

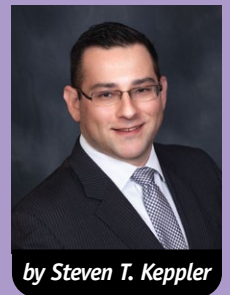
In practice, it is often the best option for all involved if the franchisor and franchisee can work together to resolve any disagreements that may arise. Generally, cooperation and communication can be the path of least resistance. Moreover, determining how to deal with the default can be a crucial consideration because not only will the relationship between the franchisor and franchisee be affected, but also, communication can help avoid undue business disruptions – or worse, damage to the brand. Keep in mind, franchisees have invested significant time and equity into their

businesses that they want to protect, while franchisors generally prefer to maintain their systems and franchisee counts where possible.

If informal resolution can be achieved through open and productive communication, both sides can keep costs down, a win for everyone. In addition, productive dialogue with a franchisee in default can include counsel and advice on how to better follow the franchisor’s system. If necessary, additional training or support to ensure compliance with the system can be a topic for discussion, as well. Furthermore, franchisors can use the opportunity to learn where franchisees are struggling and potentially identify a larger systemic problem that if approached correctly, can benefit not only the struggling franchisee but the system as a whole.



by Justin Klein



by Steven T. Keppler

THE NOTICE OF DEFAULT

If communication does not resolve the problem, the parties must follow the procedure outlined in the franchise agreement. Typically, the first step a franchisor will take is to issue a Notice of Default, which will set forth the conduct the franchisor claims is in breach of the franchise agreement and the time in which the franchisee may cure the defect.

Often, the transmission of the Notice of Default acts to “formalize” the dispute process for the franchisee, and in many cases, is sufficient to obtain compliance. However, if the franchisee does not cure in the time provided, the franchisor may issue a Notice of Termination. Several states have franchise relationship laws that will dictate the timing of any proposed termination of the franchise relationship. If your franchise is in a state with such laws, you should speak with knowledgeable franchise counsel about your rights.

Once the Notice of Termination is issued, the franchise agreement will typically set forth post-termination obligations on the franchisee, such as ceasing operations, returning operations

manuals and other branded materials, and removing all signage (“debranding”), noncompete provisions, final accountings and other measures designed to protect the franchise system. The reality of this is enough to encourage, if not force, compliance in many cases.

In practice, the decision to terminate a franchisee before the franchise agreement expires or failure to renew may well lead to a dispute. Therefore, it is necessary to understand the limitations imposed by the franchise agreement on the parties’ respective remedies, as well as any protections the franchisee may enjoy under local law. Typically, a well-drafted franchise agreement will include choice of law provisions and a forum selection clause intended to benefit the franchisor. The franchise agreement may also include a covenant to use a chosen, alternative dispute method to litigation, like mediation or arbitration, and set forth a roadmap the parties mutually agree to follow.

ALTERNATIVE DISPUTE RESOLUTION

1. Mediation: Mediation/arbitration provisions should be carefully crafted to maximize the parties’ understanding of the dispute resolution process. Mediation is, increasingly, becoming more utilized in franchise disputes. It is quicker and often more cost effective than pursuing full arbitration and/or litigation. Mediation is a relatively informal meeting between the parties and a neutral, third party retained to help the parties work through a dispute to resolution. Mediation can help limit costs, time and the public embarrassment litigation may invite. Mediation is confidential, permitting the parties to speak more openly and freely than they might if they are trying to work through a dispute on their own.

2. Arbitration: Arbitration is also often used in franchise agreements to limit the party’s access to the courts to resolve a dispute. Often, arbitration is touted as a more efficient, streamlined approach to dispute resolution. In general, the parties can often control their own schedule with far greater precision than may be available in state and federal courts. While arbitration is typically completed more quickly than trial and motion practice is typically kept at a minimum, the efficiency does come with a price tag. Literally. Indeed, arbitration hearings can be virtually identical (in terms of preparation and execution) to litigation in a courtroom; therefore, it is critical to understand the scope of any arbitration provision and the economic impact if arbitration is required.

The best practice is, of course, to have a well-drafted, thorough franchise agreement, which properly identifies how defaults will be handled – and to have strong operations and oversight to ensure that defaults do not occur. This will help protect the franchisor but also the system at large, considering that each franchisee is dependent on the other franchisees in the system to maintain the brand standards and ensure the best customer experience.


HOW TO NAVIGATE FRANCHISOR/FRANCHISEE DISPUTES

- Know your franchise agreement. A thorough understanding of your rights/obligations under the franchise agreement is crucial to both maintaining a positive relationship between franchisor and franchisee, but also so both parties know what they should expect from the others performance.
- Keep lines of communication open. When the franchisor and franchisee are able to openly discuss issues, in many cases a problem can be quickly and inexpensively resolved.
- When talking does not work, follow the franchise agreement’s notice requirements. Your franchise agreement will dictate

how notices are sent and when, and what the parties must do to cure. A formal letter can often resolve a situation where regular communication cannot.

- Follow the dispute resolution process. Your franchise agreement may require the parties privately mediate disputes before moving forward with litigation/arbitration. You should use this mechanism because it may narrow the scope of dispute and keep costs in check.

- When all else fails ... Some disputes cannot be resolved amicably or through mediation. Be sure to know whether your franchise agreement requires arbitration, whether there is a forum selection clause or choice of law provision, and whether and under what circumstances a party may be obligated to bear the other’s costs.

- Hire competent counsel. If you are not sure of your rights, do not know how to get your position across in a constructive manner or if you are facing termination of your franchise, hire a competent franchise attorney in your area who will be able to guide you through the process, answer your questions and give you actionable advice. 

Justin M. Klein is a franchise and business attorney and a partner with the nationally recognized franchise law firm of Marks & Klein LLP, which represents Planet Fitness® franchise operators throughout the United States. **Steven Keppler** is a commercial litigator for Marks & Klein. You can contact Klein at justin@marksklein.com or Keppler at steven@marksklein.com.



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