THE FRANCHISE DEBATE:

FRANCHISING IN THE HOSPITALITY INDUSTRY IN A DIFFICULT ECONOMY

The Eighth Annual Hospitality Law Conference
February 3-5, 2010
Houston, Texas

Kathie S. Lee, Esq.
Starwood Hotels & Resorts Worldwide,Inc.
600 Galleria Parkway, Suite 1700
Atlanta, GA 30339
(770) 857-2032
kathie.lee@starwoodhotels.com

Andrew P. Loewinger, Esq.
Nixon Peabody LLP
401 9th Street NW, Suite 900
Washington, DC 20004-2128
(202) 585-8855
aloewinger@nixonpeabody.com

Robert F. Salkowski, Esq.
Zarco, Einhorn, Salkowski & Brito, P.A.
100 S.E. 2nd Street, Suite 2700
Miami, FL 33131
(305) 374-5418
rsalkowski@zarcolaw.com

Kathie S. Lee is currently Vice President and Associate General Counsel for Starwood Hotels & Resorts Worldwide, Inc. Kathie is responsible for transactional, regulatory and operational-compliance work for Starwood related to franchising. She provides advice and counsel to the development, operations, finance, architecture and construction and other teams within Starwood on franchise issues.

Prior to joining Starwood, Kathie was Vice President, Corporate Counsel for Prudential Financial, Inc. Prior to Prudential, Kathie was with Cendant Corporation's real estate division lastly as Vice President, Legal. Kathie clerked for two federal bankruptcy judges, the last in the Southern District of New York.

Kathie is a member of the ABA Forum on Franchising and serves on the Governing Committee as the Director of the Corporate Counsel Division, a member of the Task Force for the International Franchise Association's Legal Symposium, the Association of Corporate Counsel and the National Asian Pacific American Bar Association. Kathie mentors recently transitioned in-house counsel and has spoken on a number of panels on a variety of legal issues.

ANDREW P. LOEWINGER
aloewinger@nixonpeabody.com

Andrew Loewinger is a partner in the Washington, D.C. office of Nixon Peabody LLP (an international law firm of 700 attorneys with national offices throughout the United States, and in London, Paris, and Shanghai) where he is co-chair of the firm's Franchise and Distribution Practice Group. Andrew is an internationally recognized franchise lawyer, and has represented numerous U.S. and non-U.S. companies in franchising and distribution matters in the United States and internationally on international franchising, licensing and distribution matters; franchise mergers and acquisitions; structuring and development of franchise programs; joint ventures; intellectual property licensing and protection; franchise sales law compliance; franchise relationship matters; franchisee association matters; and counseling on franchise disputes. He has devoted his practice full-time to franchising since 1985.

Andrew is a frequent speaker before American Bar Association Forum on Franchising, International Bar Association, and the International Franchise Association on franchise-related matters, and is the author of numerous articles for those organizations and others on franchise matters.

He is the co-editor and co-author of *International Franchise Sales Laws* published by the American Bar Association in 2006. Andrew was appointed in 2004 as the first Director of the International Franchise and Distribution Division of the American Bar Association's Forum on Franchising.

He has been recognized for several years as one of the top franchise lawyers in the United States and internationally in *Who's Who Legal, The International Who's Who of Business Franchise Lawyers;* as one of the top franchise lawyers in the United States in *Chambers USA: America's Leading Lawyers for Business* and internationally in *Chambers Global;* as one of the best lawyers in America in *Best Lawyers in America* in franchise law; and in *Franchise Times'* "Legal Eagles" as one of the top franchise lawyers in the United States and Canada.

Andrew has a B.A. from The Colorado College (Phi Beta Kappa, magna cum laude), a Masters in International Affairs from Columbia University; and a J.D. from Georgetown University Law Center.

ROBERT F. SALKOWSKI

Robert F. Salkowski is a partner with the law firm of Zarco, Einhorn, Salkowski & Brito, P.A. located in Miami, Florida. For the past fifteen years, Robert's practice has focused primarily on the representation of franchisees, dealers, and distributors throughout the country. Robert has represented the interests of his clients on a broad range of issues, including wrongful termination, trademark infringement, implied covenant of good faith and fair dealing, and in-term and post-term restrictive covenants. In addition, Robert has represented a limited number of franchisors in the development of their franchise systems.

Robert received his undergraduate degree from George Washington University and his Juris Doctorate degree from the University of Miami School of Law.

I. INTRODUCTION[1]

The hospitality industry battled a tough 2009. Therefore, it is no surprise that many in the industry are wary about the prospects for 2010. This year's forecast, however, appears bright as a number of economists have declared the recession over and new surveys indicate an uptick in travel and lodging for 2010.[2] Although the statistics are promising, it is important not to forget that the industry has weathered the effects of the most difficult economic climate most can remember. Last year, food, fuel and commodity prices were up while hotel occupancy, restaurant sales, and overall profitability were down. Given these circumstances, hotel and restaurant franchisors that were vigilant by implementing plans and procedures to help deal with troubled franchisees should not immediately abandon those plans, because it remains to be seen whether 2010 will be a true rebound year.

II. BANKRUPTCY

A. General Bankruptcy Issues

a. 11 U.S.C. §365-Executory Contracts

The commencement of a case under the Bankruptcy Code creates an estate which is comprised of "all legal or equitable interests in the property of the debtors as of the commencement of the case."[3] Executory contracts are considered to be an integral part of the estate. Section 365 of the United States Bankruptcy Code addresses executory contracts.[4] Because executory contracts are not defined by the Bankruptcy Code, courts have typically made the determination as to the existence of an executory contract on a case-by-case basis. That being said, for the most part, courts have agreed that executory contracts may be defined as either those contracts upon which performance remains due to some extent on both sides prior to the bankruptcy filing, or those contracts under which the debtor has unperformed duties that the bankruptcy trustee (or debtor in possession) may elect to perform or breach, depending upon which option would most benefit the bankruptcy estate.[5] Both hotel license agreements and restaurant franchise agreements typically fall within the definition of an executory contract.

b. 11 U.S.C. §362- The Automatic Stay

The filing of a bankruptcy petition acts as a temporary injunction in favor of the debtor against any creditor from either continuing or initiating an action against the debtor.[6] The

[1] The authors wish to thank Melissa Bernheim, Esq. of Zarco, Einhorn, Salkowski & Brito, P.A. and Christopher Wallace, Esq. and Diana Vilmenay, Esq. of Nixon Peabody LLP for their assistance in preparation of portions of this paper.

[2] *See* Victoria Burt, *Prepare For An Upswing in 2010*, Hotel & Motel Management, December 11, 2009 (http://www.hotelworldnetwork.com/overall-design/prepare-upswing-2010).

[3] 11 U.S.C. §541(a)(1).

[4] 11 U.S.C. §365.

[5] *See* 1-365 COLLIER BANKRUPTCY MANUAL P 365.02 (3d ed. rev. 2009).

[6] *See generally*, 11 U.S.C. §362.

automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It temporarily gives the debtor a break from its creditors, stopping all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drove it into bankruptcy.[7] It further prevents a creditor from interfering with a debtor's executory contract rights without court approval. The automatic stay however, does not protect a debtor from the continuation of all actions. Indeed, there are exceptions to the automatic stay which include: criminal prosecution, paternity proceedings, child support or alimony collection actions, repayment of pension loans and IRS audits.[8]

In the context of a hotel or restaurant franchise or license agreement, the automatic stay provides the Chapter 7 trustee with the ability to assume and assign a contract and to distribute the proceeds of such sale to creditors prior to the franchisor or licensor obtaining relief from the automatic stay. The automatic stay provides the Chapter 11 debtor in possession with a breathing period to reorganize the franchise business or assume and assign the franchise agreement to a third party.[9] The automatic stay further prevents, albeit temporarily, the franchisor from taking any action to terminate a hotel or restaurant franchise or license agreement, or to obtain any property of the estate from the franchisee or licensee. It is critical to note however, that the automatic stay will not prevent the termination of a franchise agreement that expires pursuant to its own terms during the course of the bankruptcy proceeding.[10] Accordingly, if a hotel or restaurant franchise or license agreement is set to expire following the filing of the bankruptcy petition, the automatic stay will not prevent the expiration and termination. Moreover, despite the bankruptcy, once the subject agreement expires, the franchisee or licensee will still remain required to perform all post-expiration/termination obligations of the agreement. Further, a franchisee or a licensee is required to remain current on payments due to franchisor or licensor post-petition. The failure to remain current on fees by franchisee or licensee would allow the franchisor or licensor to seek a motion for relief from the automatic stay provision of the Bankruptcy Code and thus allow the franchisor or licensor to terminate the franchise or license agreement.

c. 11 U.S.C. §108-Defaults and the Statute of Limitations Period

The statute of limitations constitutes the period of time that a party has to bring an action. Section 108 of the Bankruptcy Code operates to toll the statute of limitations period for bringing actions, and extends the period of time for debtors or trustees to effect cures of defaults in certain situations. Specifically, Section 108(a) provides the trustee (or debtor-in-possession) two years from the date of the order of relief in the bankruptcy to commence an action that the debtor could have brought on the date it filed for bankruptcy. Section 108(b) extends for sixty days from the order for relief, the time to take actions that the debtor could have taken on the date the petition was filed, including the time to cure certain defaults or take other curative actions. As explained more fully below, in a hotel or restaurant franchise or license agreement, Section 108 may

---

[7] Notes of Committee on the Judiciary, Senate Report No. 95-989.
[8] 11 U.S.C. §362(b).
[9] *See* MATTHEW BENDER & CO., INC., 2-13A FRANCHISING §13A.03 (2009).
[10] *Id*.

operate to toll or extend the period of time for the franchisee or licensee to cure any defaults of its franchise or license agreement that it may have committed. In relation to a franchise relationship, Section 108(b) may also operate to extend the time under which a franchisee may seek to cure a default in a franchise relationship it intends to assume.[11]

d. 11 U.S.C. §105-Equitable Powers of the Bankruptcy Court

Section 105 of the Bankruptcy Code codifies the equitable powers of the Bankruptcy Court.[12] While not unlimited, Section 105 provides bankruptcy courts with broad authority to take whatever action is appropriate or necessary in the exercise of their jurisdiction. Specifically, Section 105 of the Bankruptcy Code provides in relevant part:

> The Court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.[13]

The equitable powers afforded to the bankruptcy courts through Section 105 include the authority to extend the automatic stay provided by Section 362 of the Bankruptcy Code to other judicial or administrative proceedings that threaten to interfere with the debtor or its bankruptcy proceeding.[14] Moreover, in certain instances, bankruptcy courts have been able to use the equitable powers provision of Section 105 to enjoin judicial or administrative proceedings related to non-debtor third parties, where the continuation of the judicial or administrative proceeding involving the third party may interfere with the debtor or its bankruptcy proceeding.[15]

For example, in *W.R. Grace & Co.*,[16] the debtor, W.R. Grace, had contractual indemnification obligations to a non-debtor third party Burlington Northern railroad. Shortly after W.R. Grace filed for bankruptcy protection, 113 asbestos-related personal injury suits were filed against Burlington Northern relating to its transport of materials from W.R. Grace's mining operations.. Under certain of the agreements between W.R. Grace and Burlington Northern, W.R. Grace agreed to hold Burlington Northern harmless for liability with respect to the transportation of materials from W.R. Grace's mine. As such, Burlington Northern asserted its contractual indemnification rights against W.R. Grace. W.R. Grace then petitioned the court to utilize its Section 105 powers to enjoin all suits against Burlington Northern pending the outcome of the bankruptcy under the premise that the suits against Burlington Northern would interfere with W.R. Grace's bankruptcy. The bankruptcy court, in reliance upon Section 105 of the Bankruptcy Code, found that a sufficient "identity of interest" existed between W.R. Grace and Burlington Northern to expand the relief afforded by Section 105 to enjoin the suits against Burlington Northern.

---

[11] *See e.g.*, Michael W. Garner, *Franchise and Dealer Agreements Under Chapter 11 of the Bankruptcy Code*, 59 AM. BANKR. L.J. 99, 132 (1985).
[12] 11 U.S.C. §105.
[13] *Id*.
[14] *See W.R. Grace & Co. v. Chakarian*, 386 B.R. 17 (Bankr. Del. 2008).
[15] 386 B.R. 17 (Bankr. Del. 2008).
[16] *Id.*

In relation to the hospitality industry, Section 105 has been utilized by franchisees and licensees to prevent expiration or termination of a franchise agreement[17] as well as to support a motion for extension of time to cure a default under Section 108(b) of the Bankruptcy Code.

B. Franchise Bankruptcy

a. In General

Among the numerous types of bankruptcies filed on a daily basis, a franchise bankruptcy tends to be one of the more complicated due to the nature of the franchisor-franchisee relationship. Indeed, by its very nature, a franchise bankruptcy differs from a traditional debtor/creditor bankruptcy given the plethora of contractual cross-obligations that exist between a franchisee and a franchisor. The basic premise of a franchise is that the franchisor and franchisee enter into a contractual relationship through which the franchisor grants the franchisee the right to utilize the franchisor's system, trademarks and trade dress, in return for the payment of a fee, usually in the form of a royalty. In the hospitality or restaurant context, the franchisee or licensee enters into an agreement with the franchisor or licensor to utilize its hotel flag or restaurant name, concept and branding. As a result of this relationship, aside from a franchisor's continued interest in receiving royalty payments, the franchisor has a vested interest in the franchisee's success, given the negative effect the franchisee's failure could have on the franchisor's goodwill and image.

Accordingly, when a franchisee or licensee files for bankruptcy, the franchisor or licensor possesses an especially high interest in protecting the goodwill and trademark of the franchisor or licensor. This interest is usually accounted for in the contractual obligations placed upon the franchisee through the execution of the franchise agreement. Specifically, franchisors typically include cross-default provisions (i.e. in a situation where the franchisee has multiple agreements, a breach of one results in a breach of all of the agreements), right of first refusal provisions and contractual limitations on the disposition of real estate interests (assuming the franchisor either owns or subleases the franchise real estate location) in franchise agreements in order to assert a certain level of control over the franchisee. All of these provisions can cause a franchisee substantial grief when, and if, it finds itself needing to seek relief through bankruptcy.

b. Rights of Franchisor and Franchisee in Property Held by Franchisee

The most important asset of a franchisee's bankruptcy estate is the franchise agreement and all of the corresponding rights it entitles the franchisee to possess. This is of course only the case if the franchise agreement has not been terminated at the time a bankruptcy petition is filed. If a franchisor has not effectively and properly terminated a franchise agreement prior to the franchisee filing for bankruptcy, then the franchise agreement becomes an asset of the bankruptcy estate and is deemed an executory contract. Given the importance of the franchise agreement to a franchisee, struggling franchisees that have not yet been terminated by the franchisor may choose to file for bankruptcy, to both protect their franchise agreement and, assuming they no longer intend to remain a franchisee, secure the franchise agreement for

[17] *See In re Pinellas Motel Partnership*, 2 B.R. 113, 118 (Bankr. M.D. Fla. 1979).

potential purchase and assignment to a third-party.[18] As explained more fully below however, the filing of a bankruptcy petition does not automatically secure the franchise agreement for the franchisee. If the franchisee is in default of the franchise agreement at the time it files for bankruptcy but the franchise agreement has not yet been terminated by the franchisor, the franchisor, in certain instances, may still prevent the franchise agreement from becoming an asset of the estate by barring the franchisee's attempts to assume the agreement.

c. Effect of Filing for Relief Upon Termination of Agreement

If prior to the franchisee's filing of the bankruptcy petition, the franchisor is able to effectively terminate the franchise agreement, the filing of the bankruptcy petition will not revive the franchise agreement. In fact, once the franchisor lawfully terminates the franchise agreement prior to the bankruptcy filing, the franchise agreement will not be considered property of the estate.[19] In the context of the hospitality and restaurant industry, the hotel franchisee or licensee will lose the right to carry the flag of the franchisor and the restaurant franchisee will lose the name and branding of the restaurant. Moreover, both the hotel and restaurant franchisee or licensee will be forced to immediately de-identify, thereby removing all trademarked images, designs or other identifying marks linking them to the franchisor or licensor. This is often a time-consuming and expensive process.

d. Franchisee's Assumption of the Franchise Agreement

Upon the filing of a bankruptcy, the trustee (or debtor in possession) is faced with the possibility of assuming or rejecting the debtor's outstanding executory contracts. Specifically, Section 365 of the Bankruptcy Code provides that the trustee (or the debtor-in-possession in a Chapter 11 bankruptcy), subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor, including any franchise or license agreements.[20] Specifically, if the franchisee is in compliance with the agreement, the trustee or debtor may assume the agreement in its entirety with court approval. In a Chapter 7 bankruptcy filing, the trustee has sixty (60) days in which to assume the executory contract or it will be deemed automatically rejected.[21] In a Chapter 11 bankruptcy proceeding, the debtor or trustee may assume the executory contract up until confirmation of the plan.[22] Given that the sometimes extensive period of time between the filing of the petition and the assumption of the executory contract in a Chapter 11 case may leave both the franchisor and franchisee in a precarious situation because neither one possesses assurances that the other will perform, the non-debtor

[18] Given its value, in most instances the ability to assume and assign a franchise agreement to a third party provides the debtor with the best chance of realizing capital to either pay off creditors or reorganize the bankruptcy estate.

[19] *In re Gainesville P-H Properties, Inc.*, 77 B.R. 285, 295 (Bankr. M.D. Fla. 1987).

[20] 11 U.S.C. §365. It is also important to note that while assumption of an executory contract requires court approval, rejection of an executory contract does not require approval and in fact, an executory contract not assumed by a debtor is deemed rejected in a Chapter 11 bankruptcy if it is not assumed prior to confirmation of a plan of reorganization. *See* 11 U.S.C. §365(d)(4)(A)(ii).

[21] 11 U.S.C. §365(d).

[22] *Id*.

party to the franchise agreement may file a motion with the court to compel the debtor to assume or reject the franchise agreement prior to the usual deadlines.[23]

While assumption is an option, it is not an automatic right where the franchisee is currently in breach of the franchise agreement. In a case where the debtor has defaulted on the franchise agreement, in order for the debtor or trustee to assume the agreement, they must cure the default, compensate the franchisor for any loss it has suffered and provide adequate assurance of future performance under the contract.[24]

Applying Section 365(b)(1) of the Bankruptcy Code to a franchise situation, the first step in assuming the franchise agreement requires the debtor or trustee to cure any outstanding defaults of the franchise agreement. In other words, the franchise agreement must be brought back into compliance with its terms.[25] Once a debtor has cured the defaults in the franchise agreement, it must next compensate the non-breaching party for any economic loss it has suffered as a result of the debtor's breach and further provide adequate assurance of future performance under the contract.

The Bankruptcy Code does not define the term "adequate assurance." However "Black's Law Dictionary defines 'adequate assurance' as 'evidence that a debtor will probably be able to perform its obligations under a contract, such as the posting of a bond or a showing that the debtor will generate sufficient income to pay any arrearages and future obligations.'"[26] In the hospitality or restaurant industry, adequate assurance of future performance of monetary defaults would likely include proof that the franchisee or licensee can afford to pay royalties and advertising fund contributions on a go-forward basis. Adequate assurance of future performance however, is not just monetary. This is especially true in a franchise situation given the franchisee's right to utilize the franchisor's trademark. Indeed, given the special nature of the franchise relationship, there is an increasing dichotomy between monetary and non-monetary defaults of franchise agreements with respect to adequate assurance. As highlighted above, adequate assurance that a monetary default will not occur in the future may easily be provided with proof of a debtor's future ability to pay. Providing the non-debtor party with adequate assurance that no future non-monetary defaults of the franchise agreement will occur is another story.

As noted herein, one of the biggest advantages to a hospitality or restaurant franchisee in entering into a franchise relationship is its ability to utilize the trademarks and trade dress of the franchisor. Once a franchisee engages in a non-monetary default of the franchise agreement, such as the unlawful use of the franchisor's trademark, the franchisor suffers harm, that in many cases, has far-reaching effects. Providing a franchisor with adequate assurance that such unlawful activity will not be repeated by the franchisee in the future will be very difficult, if not impossible. In situations such as these, courts have made it very clear that the franchisee will be held to a higher standard, for both curing nonmonetary defaults, as well as providing adequate

---

[23] 11 U.S.C. §365(d)(2).

[24] 11 U.S.C. §365(b)(1)

[25] 1-365 COLLIER BANKRUPTCY MANUAL P 365.09 (3d. ed. rev. 2009).

[26] *See* Lesley A Truitt, Note and Comment, *From the Conflicting Treatment of Nonmonetary Defaults in §365(b), AnException for Franchises Emerges*, 17 BANK. DEV. J. 257, 276 (2000) (*quoting* Black's Law Dictionary 40 (70th ed. 1999)).

assurance that the default will not be repeated in the future, especially where the nonmonetary default involves a material breach.[27]

Despite the foregoing, not all contracts are assumable. As noted herein, franchise agreements "are far more personal arrangements than other executory contracts because at the heart of every franchise agreement is a license of the franchise's most valuable asset--its trademark."[28] When an executory contract is based on the provision of personal skills or upon personal trust or confidence, the trustee, and in certain instances, the debtor in possession, has been prohibited from assuming the executory contract. Specifically, Section 365(c)(1) of the Bankruptcy Code precludes the assumption or assignment of an executory contract "if applicable law excuses a party . . . from accepting performance from or rendering performance to an entity other than the debtor. . . whether or not such contract . . . restricts assignment of rights . . . . ."[29]

The exception found in Section 365(c)(1) of the Bankruptcy Code has traditionally been referred to as the "personal services contract" exception as a result of the fact that courts had originally limited the exception to contracts deemed to qualify as personal services contracts under applicable state law.[30] Courts are no longer limiting this exception to traditional personal service contracts, and given the personal nature of franchise agreements, courts have included franchise agreements as executory contracts that have been excluded from a debtor's general assumption and assignment in certain instances.[31] This is especially true where a franchisor deems the franchisee to no longer be qualified to serve as a franchisee. As a result, if a franchise agreement is determined to be within the parameters of the Section 365(c)(1) exception, a bankruptcy filing may automatically terminate the franchise agreement. In the hotel or restaurant franchise context, termination would necessarily result in the automatic shut-down of the hotel or restaurant and the requirement that the franchisee immediately de-identify, thereby removing all trademarked images, designs or other identifying marks linking them to the franchisor or licensor.

Termination, however, can obviously be avoided if the franchisee obtains the franchisor's consent to assume the franchise agreement.[32] Given the magnitude of the potential effect a franchisee's inability to assume the franchise agreement may have on its bankruptcy estate. However, it would be wise for a potential debtor to evaluate its risks with respect to its franchise agreement prior to filing for bankruptcy and wherever possible, it is further advisable for the franchisee to attempt to negotiate with the franchisor prior to taking the bankruptcy plunge.

e. Franchisee's Assignment of the Franchise Agreement

Section 365(f) of the Bankruptcy Code permits a trustee (or debtor in possession), regardless of any restriction imposed by the contract or applicable non-bankruptcy state law, to

---

[27] *Id*. at 278-9.
[28] *Id*. at 260 (*citing* William J. Keating, Franchising Advisor 1.01, 3.01, 7 (1987)).
[29] 11 U.S.C. §365(c).
[30] *See* Michelle Morgan Harner, Carl E. Black & Eric R. Goodman, *Debtors Beware: The Expanding Universe of Non-Assumable/Non-Assignable Contracts in Bankruptcy*, 13 AM. BANKR. L. REV. 187, 188 (2005).
[31] *Id*. at n.196.
[32] *See generally, id*.

assign an executory contract, provided that the trustee first assume the contract, and that adequate assurance of future performance of the contract be provided by the assignee.[33] If the executory contract is in default, it must first be cured by the trustee (or debtor in possession) before assumption and assignment can occur.[34] Given that Section 365(k) of the Bankruptcy Code makes clear that once assignment is complete, the trustee (or debtor in possession) is relieved of its liabilities under the contract, adequate assurance of future performance by the assignee is critical as to all material and monetary terms of the contract. In the hotel and restaurant franchise context, Section 365(f) of the Bankruptcy Code would permit the franchisee to assume and assign its hotel or restaurant franchise or licensee agreement to a new franchisee or licensee that in most cases, would need to receive prior approval from the franchisor. By assuming and assigning the agreement however, the franchisee would be able to recover some or most of its investment in the franchise to pay the creditors of its bankruptcy estate.

Given that in order to assign an executory contract the trustee (or debtor in possession) must first assume the contract, the same restrictions on a debtor's ability to assume its franchise agreements in bankruptcy apply with respect to the debtor's ability to assign its franchise agreements. Indeed, despite Section 365(f)'s limitations on applicable non-bankruptcy law prohibiting assignment, some courts have found that Section 365(c)(1) of the Bankruptcy Code, which precludes the assumption or assignment of an executory contract if applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, works as a bar to restrict the assignment of franchise agreements in bankruptcy.

For example, in *Pioneer Ford Sales*,[35] a bankrupt Ford dealership sought to assume and assign its franchise agreement with Ford to another car dealership. Ford objected to the assignment on the basis that the franchise agreement contained language prohibiting the assignment and that assignment was barred pursuant to Section 365(c)(1) of the Bankruptcy Code.[36] The bankruptcy court and the district court both found that the franchise agreement was not a personal services contract and therefore was assignable.[37] Ford appealed to the First Circuit Court of Appeal which reversed the decisions of the bankruptcy and district court and found that the franchise agreement specifically restricted the assignment of the franchise agreement.[38] The First Circuit further found that state law further supported the lack of assignability of the franchise agreement irrespective of any anti-assignment language within the franchise agreement and therefore, pursuant to the Court's expansive reading of Section 365(c)(1), the franchise agreement was not assignable.[39]

---

[33] 11 U.S.C. §365(f).
[34] 11 U.S.C. §365(b).
[35] *See In re Pioneer Ford Sales*, 26 B.R. 116 (Bankr. D. R.I. 1983).
[36] *Id.* at 116.
[37] *Id*. at 119.
[38] *See In re Pioneer Ford Sales*, 729 F.2d 27 (1st Cir. 1984); *see also In re Van Ness Auto Plaza*, 120 B.R. 545, 547 (Bankr. N.D. Cal. 1990) (refusing to permit assignment of Porsche franchise agreement to another automobile dealer as a result of applicable nonbankruptcy California state law pursuant to Section 365(c)(1) of the Bankruptcy Code).
[39] *Id*. at 31.

It is critical to note that not all courts have agreed with the courts in *Pioneer Ford Sales and Van Ness Auto Plaza*. However, given the more expansive approach to Section 365(c)(1) being taken by courts overall, it remains wise for a potential debtor to evaluate its risks with respect to the assignment of its executory contracts prior to filing for bankruptcy.

f. Franchisee's Rejection of the Franchise Agreement

In addition to having the right to assume and assign a franchise agreement, the debtor may also choose to reject its franchise agreement. Rejection of the franchise agreement does not constitute a termination of the contract.[40] While the obligations of both parties are generally excused, rejection of the franchise agreement does not affect the parties' substantive rights under the franchise agreement. For example, if the franchisee owes the franchisor royalty fees, those fees are still considered part of the franchisor's claim against the franchisee. Moreover, covenants not to compete (usually consisting of a period of time by which the franchisee agrees not to engage in the same business within a certain territorial radius of its franchise) by the franchisee will generally be enforceable even following rejection.[41]

Rejection of a franchise agreement is addressed by Section 365(g) of the Bankruptcy Code. Pursuant to Section 365(g), when a contract or lease has not previously been assumed, rejection constitutes a breach immediately before the date of the filing of the petition.[42] As a result of the rejection being treated as a prepetition breach, the nonbreaching party to the franchise agreement then becomes a creditor of the bankruptcy estate that possesses a prepetition claim for damages arising from the rejection of the franchise agreement.[43]

III. <u>RECEIVERSHIPS</u>

A. Introduction

In today's challenging economic times, with a growing number of hotel and restaurant owners simply unable to meet their continuing financial obligations, secured lenders and other creditors are turning more and more to the use of receivers to protect the asset that secures the debt, whether that asset is real property or an existing business. As discussed below, the appointment of a receiver, even the mere threat, gives a secured lender significant leverage in negotiations between it and the borrower, and could serve as a powerful weapon in the quest for an early resolution of the dispute.

---

[40] *See* ENFORCING COVENANTS NOT TO COMPETE AFTER REJECTION (Bruce H. White & William L. Medford eds., ABIJ 2001); *see also In re Annabel*, 263 B.R. 19, 25 (Bankr. N.D.N.Y. 2001).

[41] *See* ENFORCING COVENANTS NOT TO COMPETE AFTER REJECTION (Bruce H. White & William L. Medford eds., ABIJ 2001) (*citing In re Annabel*, 263 B.R. 19, 25 (Bankr. N.D.N.Y. 2001)); *see also In re Klein*, 218 B.R. 787, 790-961 (Bankr. W.D. Pa. 1998); *In re Steaks to Go, Inc*., 226 B.R. 35 (Bankr. E.D. Mo. 1998).

[42] 11 U.S.C. §365(g).

[43] *See* MATTHEW BENDER & CO., INC., 2-13A FRANCHISING §13A.02 (2009).

B. What is a Receiver

A receiver is defined as one who "take[s] possession of and preserves [during the pendency of litigation] and for the benefit of the party ultimately entitled to it, the fund or property in litigation."[44] Stated differently, a receiver's role is to secure the rights of both parties to the property at issue in the underlying action. If allowed by the order of appointment, a receiver can apply rents and profits to the satisfaction of a mortgage debt, prevent the waste of the particular property, and in certain circumstances, can remove the threat of foreclosure and prevent additional interest from accruing when the parties agree that the action can cure the default and forestall foreclosure.[45] Importantly, receivers act as fiduciaries, and represent the court and all parties in interest.[46]

There a two generally recognized types of receivers. Equity receivers generally include custodial receivers and statutory receivers. A custodial receivers' role is to maintain the *status quo* of an asset or property for a definite period of time, usually only during the pendency of the litigation.[47] The role of a statutory receiver is to liquidate and wind-down the affairs of the corporation, and include those situations where misappropriation of corporate assets by insiders is asserted, at the request of a stockholder suing individually or on behalf of the company, or where dissent among a corporation's managers prevent the conduct of the business without serious losses.[48]

On the other hand, and perhaps more common in the hospitality industry, rent receivers are often sought by secured lenders for the protection of a secured lender itself. The right of a secured lender to impose a rent receiver routinely arises from the provisions of the mortgage or other loan document, and is intended to protect the mortgagee's interests by imposing a court-supervised, disinterested person to collect the rents and pay expenses pending the ultimate disposition of the mortgaged premises.[49]

1. Considerations by a Court in the Appointment of a Receiver

The appointment of a receiver is considered a harsh, drastic, and extraordinary remedy.[50] The appointment of a receiver typically rests within the sound discretion of the court, and is to be exercised with restraint and with great circumspection.[51]

There is no set formula that a court follows when asked to consider the appointment of a receiver, although statutes in several states may set forth certain requirements. However, a

---

[44] *F.T.C. v. World Wide Factors, Ltd.*, 882 F.2d 344, 348 (9th Cir.1989).
[45] *NationsBank of Georgia v. Conifer Asset Management Ltd.*, 928 P.2d 760, 764 (Colo. Ct. App. 1996).
[46] *Equity Trust Co. Custodian ex rel. Eisenmenger IRA v. Cole*, 766 N.W.2d 334, 341 (Minn. Ct. App. 2009).
[47] *State v. E. Shores, Inc.*, 329 A.2d 585 (Ch. Div. 1974).
[48] *Kaufman v. 53 Duncan Investors, L.P.*, 847 A.2d 35, 39 (App. Div. 2004); *Chen v. Stewart*, 100 P.3d 1177, 1190 (Utah 2004); *Shaw v. Robison*, 537 P.2d 487, 490 (Utah 1975).
[49] *Kaufman v. 53 Duncan Investors, L.P.*, 847 A.2d at 38 – 40; *Fidelity Union Trust Co. v. Pasternack*, 196 A. 469 (E. & A. 1938).
[50] *Benefield v. State ex rel. Alvin Cmty. Health Endeavor, Inc.*, 266 S.W.3d 25, 31 (Tex. App. 2008).
[51] *Dunaway v. Garland County Fair and Livestock Show Ass'n, Inc.*, 245 S.W.3d 678, 686 (Ark. App. 2006)

contractual covenant calling for the appointment of a rent receiver is normally accorded great weight.[52] Generally, factors that a court considers in determining whether a receiver should be appointed include: (i) whether the party seeking the appointment of a receiver has a valid claim; (ii) whether there is fraudulent conduct or the probability of fraudulent conduct by the party opposing the receiver; (iii) whether the property at issue is in imminent danger of being lost, concealed, injured, diminished in value, or squandered (iv) whether legal remedies are inadequate; (v) whether the harm to the plaintiff by denial of the appointment would outweigh injury to the party opposing appointment; (vi) the plaintiff's probable success in the action and the possibility of irreparable injury to plaintiff's interest in the property; and (vii) whether the plaintiff's interests sought to be protected will in fact be well-served by receivership.[53] In determining whether the appointment of a receiver should be allowed, courts also consider alternative remedies that are available to the creditor that are less harsh and drastic, but serve to protect the property at issue.[54]

2. Who may be appointed as a Receiver

Statutes of several states contain particular requirements for a person to be appointed as a receiver. Absent such a statute in a specific jurisdiction, any person could be considered for a receiver, including a personal relative of one of the parties or a shareholder of a party corporation, regardless of their qualifications.[55] However, unless otherwise waived,[56] in order for a person to be considered for the appointment of a receiver, that person must not have an interest in the action, and must otherwise be impartial and disinterested.[57]

3. Tactical Reasons for a Party Seeking the Appointment of a Receiver

The purpose of a receiver is not to determine the rights of any party in a legal dispute. Nor is a receiver entitled to change any existing contractual relations, determine rights between the parties by reason of an existing contract, or to excuse performance of an existing contract.[58] With such "limitations" on its powers, the question to be asked is simple---why appoint a receiver?

There are many reasons a party to a lawsuit may seek the appointment of a receiver, despite the associated ancillary costs and increased expenses. First and foremost, a secured lender may want to avoid the possible liability that accompanies its control of a property during the pendency of litigation. Or, a secured lender may want to ensure that the property is properly being maintained through the revenues generated by the property itself, such as rent or room revenues. Also, a secured lender naturally has a vested interest in ensuring that the monetary

---

[52] *Barclays Bank, P.L.C. v. Davidson Ave. Associates, Ltd.*, 644 *A*.2d 685 (App. Div. 1994)

[53] *Sterling Sav. Bank v. Citadel Development Co., Inc.*, 2009 WL 2952041 * 9 (D. Or. 2009).

[54] . *Hotel 71 Mezz Lender LLC v. Falor,* 58 A.D.3d 270, 275-276 (N.Y. App. Div. 1st Dep't 2008); *Ypsilanti Fire Marshal v. Kircher*, 730 N.W.2d 481, 500 (Mich. Ct. App. 2007).

[55] *Norwest Bank Nebraska, N.A. v. Bellevue Bridge Com'n,* 607 N.W.2d 207, 211 (Neb. App. 2000).

[56] *Davis v. Bayless*, 70 F.3d 367, 374 (5th Cir. Tex. 1995)("Texas law apparently disfavors, but does not prohibit, such reliance by a receiver on counsel for one of the parties to the receivership proceeding.").

[57] *Norwest Bank Nebraska, N.A. v. Bellevue Bridge Com'n,* 607 N.W.2d 207 at 210.

[58] AMJUR RECEIVERS §§90- 91.

obligations due it by the borrower are paid during the pendency of the underlying action, which may include a foreclosure. A receiver would ensure that any revenues generated by the property that exceed the costs to properly maintain the property and support its operations are paid to the secured lender, as opposed to any other unsecured creditors, or the borrower itself.

Serious consideration must also be given to the obvious tactical advantage achieved by a lender over a borrower who is faced with the possible appointment of a receiver. Despite a receiver's inability to excuse the performance of a party under a contract, a receiver maintains the right in certain circumstances to replace existing management, notwithstanding the existence of a management or employment agreement. This is especially so where existing management is incapable of safeguarding and maintaining the property at issue.[59] By removing existing management, a receiver would be more likely to determine the actual problems impacting the property or business, and perhaps by correcting those problems, enhance and increase the value of the asset. Further, some franchisor or licensor, under the terms of a "comfort letter" entered into by the franchisor or licensor with franchisee or licensee and lender may require that a management company approved by franchisor or licensor be retained in the event a receiver is appointed. Moreover, the "comfort letter" may dictate other terms and conditions in the event the lender elects to retain a receiver and/or initiate a foreclosure proceeding. If a "comfort letter" has been entered into by the parties, early discussions between the lender and the franchisor or licensor may assist in obtaining the necessary consent or approval (or determining early in the process that consent or approval may be a challenge) from the franchisor or licensor.

Moreover, emotional borrowers and those who are using income from the property or business to support their lifestyles are often unrealistic, in either their view toward the precarious financial condition they find themselves in, or in their ability to negotiate with the lender. Expeditious workout agreements and alternatives other than protracted litigation often result from those situations where a borrower is faced with the prospect of a receiver being appointed to oversee the property or business at issue. And thus, receiverships represent a strong weapon for the lender.

IV. FRANCHISEE'S NON-PAYMENT OF ROYALTIES IN A CHALLENGING ECONOMY

This section discusses specifically the problem of franchisee non-payment -- an issue that may arise or persist with troubled franchisees -- and provides some practical strategies to address the issue.

A. Franchisee Non-payment

As predicted by many, a greater proportion of franchisees experienced difficulties running their businesses in 2009 and consequently defaulted under the terms of their franchise agreements. Franchisors must remain diligent in handling issues involving franchisee defaults because ultimately those issues and prolonged problems can negatively affect the franchisor's brand. These problems do not tend to be surprises; there is usually a downward trend in the

[59] *See e.g., Republic of the Philippines v. Marcos*, 653 F.Supp. 494, 498 (S.D.N.Y. 1987).

franchisees' financial conditions and operations which franchisors should monitor closely and recognize from the outset. It is important for franchisors to pay attention to these trends and any other warning signs. Early detection may help a franchisor and franchisee handle the issue more effectively and it may also obviate the need for more drastic (and expensive measures).

A franchisee's systemic delay in paying or total failure to pay revenue that a franchisor relies on such as royalties, advertising fees, reservation system fees and other fees is one of the most common problems and the most obvious red flag that the franchisee is likely in trouble. It goes almost without saying that franchisors must deal with payment problems early on before late payment or insufficient payments turn into no payment at all. By observing franchisee payment trends and enforcing applicable franchise agreement provisions governing financial reporting, a franchisor is more likely to detect issues early and to prevent a bad situation from snowballing. Diligent franchisors will save more time and resources working out arrangements with underperforming franchisees sooner rather than later.

Discussed below are a number of different suggested strategies for dealing with franchisee non-payment and factors franchisors should consider when determining which strategy to implement.

B. Franchisor Remedies for Non-payment

(1) Interim Remedies

In certain cases, including where the franchisee's royalty payment default is not severe or where the franchisor believes that it is dealing with a capable franchisee, more severe measures such as termination of the franchise agreement may not be the best option for handling a troubled franchisee. Instead, the following interim remedies may be advisable:

i. Promissory notes, forbearance agreements & personal guarantees

A forbearance agreement and/or a promissory note may be appropriate interim remedies where the franchisee has experienced temporary financial difficulties and needs additional time to get up to date on payments. These options are also preferable to termination where both the franchisor and franchisee desire that the franchisee remain in the system.

Under a forbearance agreement the franchisor would agree to suspend termination of a franchisee in default so long as terms agreed upon by the parties are met. The franchisor would agree to postpone, reduce, or suspend payment of royalty fees owed by the franchisee during a limited time period. In turn, the franchisee agrees to take certain actions to bring itself in compliance with the franchise agreement. Forbearance agreements are usually accompanied by promissory notes. In the promissory note, the franchisee would agree to pay past due royalty fees or some other agreed upon amount, with interest, over a specified period. It is prudent to ask the franchisee's principals for a personal guaranty where it is unclear whether the franchisee entity will be able to make payments under the note. Franchisors have additional rights for monetary recovery under the promissory note where a personal guaranty has also been signed.

ii. **Royalty abatement/ reduction in royalty percentage**

A limited royalty abatement or reduction in the royalty percentage paid to the franchisor for a period of time may be another appropriate option to offer either a struggling franchisee or group of franchisees. Obviously a royalty abatement to a group of franchisees may have very significant implications and ripple effects in a franchise system, and must be carefully considered. Since a franchisor's decisions to decrease one or more franchisees' required royalties will have an adverse impact on the franchisor's revenue intake, this is a decision the franchisor must make very carefully. This option may be appropriate for a capable franchisee who has consistently performed well, paid royalty payments in the past on time and who, based on the franchisor's analysis, is experiencing a temporary difficulty. A royalty abatement may be done by itself or in conjunction with a forbearance agreement described above.

iii. **Redirecting portion of royalties to increased local advertising efforts or ad fund**

Increasing brand awareness and recognition through more advertising may provide the boost a franchisee needs to drive revenue and increase performance. In this instance, the franchisor may provide the franchisee the option to direct a portion of the royalty fees it pays to local advertising efforts or the system's advertising fund contributions. Here, as with the option to pay decreased royalties, the franchisor must determine whether offering these limited forms of relief will help to improve the overall likelihood of success for the franchisee within the system.

iv. **Leverage supply arrangements**

Certain vendors and suppliers may be amenable, in this challenging economy, to negotiating price deals or to renegotiating existing supply arrangements for their products and services. Franchisors must look for opportunities to capitalize on breaks and savings for themselves and their franchisees.

(2) Removal of Benefits/Cutting off Reservation System

Where a franchisee has inexplicably failed or refuses to make royalty payments, denying the franchisee certain benefits intrinsic to the smooth running of the franchise system may be an effective way, in certain circumstances, to force the franchisee to start making royalty payments again. Some examples of these benefits are training programs, other support, advertising opportunities, and customer promotions, participation in supplier programs, or use of software. One benefit that a franchisor could cut off would be the franchisee's use of the reservation system. The franchisee's ability to regain use of the reservation system should be, pursuant to the franchise agreement, contingent on payment of royalty fees in arrears.

Denial of benefits to a franchisee raises a variety of issues for a franchisor. First, the franchisor should confirm that it has a clear contractual right to withhold, deny, or suspend the relevant benefit or assistance under its franchise agreement. Second, there is the business issue as to whether such a denial or suspension is advisable. For example, is the benefit so essential to the franchisee's operation that its denial will harm the franchisee's operation and thus accelerate the franchisee's downward spiral? In such instances, a third issue that arises is whether the denial of benefits may constitute a constructive termination, requiring compliance with both the terms of the franchise agreement and any applicable state franchise termination requirements. These issues are particularly acute for any contemplated cut-off of a reservation system, which is typically considered essential to a lodging franchisee's operation.

(3) Termination

i. **Unilateral Termination**

If all other remedies fail, the franchisor may decide it has no choice but to terminate the agreement. Prior to terminating the franchise relationship, the franchisor must adhere to any required notice and cure periods that exist under both the franchise agreement and applicable state law. A number of the states have laws governing franchise relationships which generally require that franchisors adhere to certain substantive and procedural requirements when terminating franchises.[60] The California Franchise Relations Act, for example, states that a franchisor must have "good cause" to terminate a franchise agreement and that the franchisee must be given written notice and a reasonable opportunity to cure most defaults before termination. [61] Perhaps even more importantly, the franchisor must understand what the franchise agreement says about termination before ending the relationship because of the potential for wrongful termination or breach of contract claims. [62] The franchisor should also document each instance of the franchisee's default in order to create a clear record and thus, clear basis, for the termination. Accordingly, warning notices, default notices and any other communication between franchisor and franchisor regarding late or insufficient royalty fee payments must be well documented in writing.

ii. **Mutual Termination**

Although there is some peace of mind associated with terminating the franchise agreement of a non-paying franchisee, terminations are hard on both parties. Where a franchisor has the opportunity to do so and chooses to do so, it may be more desirable to agree to a mutual termination with the franchisee. Mutual terminations have a few advantages. First, the typical notice and cure periods that would be required under the parties' franchise agreement and state laws requiring good cause and/or notice requirements will not apply to a mutual termination

---

60 The following states have laws applicable to certain aspects of franchise relationships including terminations, nonrenewal, and transfers: Alaska, Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Rhode Island, South Dakota, Virginia, Washington and Wisconsin.

61 Cal. Bus. & Prof. § 20020.

62 *See, e.g., LaGuardia Associates and Field Hotel Associates v. Holiday Hospitality Franchising, Inc.*, 92 F.Supp.2d 119 (E.D.N.Y. 2000) (Where franchisor had waived past payment defaults, it could not terminate the franchise agreement for franchisee's failure to comply immediately with terms of agreement without first providing sufficient notice and a reasonable time for franchisees to cure the conduct).

agreement. Second, the franchisor may ask for and obtain a general release from liability from the franchisee as consideration for agreeing to terminate the agreement before its maturation. Third, the termination agreement can be drafted such that the franchisee will be obligated to pay the franchisor any amounts owed, termination fees, or agreed damages over a certain period of time.

C. Practical Issues

Not every struggling franchisee will be a good or suitable candidate for the interim remedies suggested above. Franchisors must assess each individual franchisee on a case-by-case basis to determination what will be in the best interest of the brand or system vis-à-vis the struggling franchisee. The franchisor must also consider the precedential impact of granting any particular relief to a franchisee. While agreements to abate or forebear are generally confidential, the requests by other franchisees for same or similar relief granted to a particular franchisee suggest otherwise. Franchisors working with troubled franchisees should carefully document in writing any alternative arrangement including any of the accommodations discussed above. This is also important considering the following practical points regarding waivers, issue work-outs and confidentiality.

(1) Waiver

Case law has illustrated (*see, e.g., LaGuardia*, supra fn.4) the problems franchisors face where they attempt to enforce royalty fee payment terms in the franchise agreement or terminate the franchise agreements after failing to collect royalties for an extended period of time. A court may find that the franchisor waived its right to collect those fees. The common remedy to avoid the waiver issue is for the franchisor to make sure that the franchise agreement contains an anti-waiver provision. In working out an alternative arrangement (e.g., a forbearance agreement), the franchisor may also want to execute an agreement with the franchisee wherein the agreement specifically states that the franchisor has not agreed to waive past due royalty fees payments if applicable. Further, the franchisor should ensure that, with any alternative arrangement entered into between the parties, specific language is incorporated into the alternative arrangement documentation specifying that such arrangement is without waiving any of franchisor's rights under the terms of the franchise or license agreement and that franchisor or licensor reserves all its rights and remedies.

(2) Work-out Issues

Negotiating forbearance agreements, promissory notes, and releases among others will take some work and effort on behalf of both parties. Franchisors must make sure to have airtight agreements in place in the event the franchisees breach these subsequent contracts.

(3) System Confidentiality Issues

The importance of confidentiality cannot be stressed enough. Franchisors entering into alternative arrangements with struggling franchisees should incorporate provisions in the agreements which require that the terms of the parties' agreement be kept confidential. A franchisee that has been working its hardest to pay royalties on time may be resentful of accommodations made for struggling peers. If it is possible, franchisors should try to be consistent in the manner in which they handle the same or similar defaults among different franchisees. Inconsistent treatment may be deemed unfair by the franchisees and may create discord within the franchisee community. Further, a franchisor or licensee may risk a claim of discrimination by a franchisee. By asking for a franchisee's confidentiality, franchisors may be able to avoid issues within the franchise system.

*   *   *

In sum, there is no set formula for determining what strategy will be the most effective in each individual situation. Franchisors must remember, however, to consider the effect of any plan for addressing defaults with any particular franchisee on the system as a whole.

V. ENFORCING SYSTEM-WIDE STANDARDS IN DIFFICULT ECONOMIC TIMES

System-wide standards are crucial for helping to establish quality control and uniformity throughout the franchise system, protecting brand equity, and shaping customer perceptions and expectations. The success or failure of every franchise system is, in great part, a function of the inherent strength of the franchisor's intellectual property and its standards and specifications for operation of the franchised businesses ("System Standards") and the extent to which the franchisor will protect them throughout its franchise system.

In difficult economic times, it is easy for franchisors and franchisees to lose their focus on the importance of System Standards, as franchisees struggle to survive and face declining revenues. But these are the times that System Standards become even more crucial to the survivability of franchisees and the franchise system as a whole.

Below, we address the importance of System Standards, some practical considerations that arise in a down economy, and general methods for enforcing System Standards.

A. The Need For System Standards and Practical Considerations in a Down Economy

Consumers expect a consistent level of product quality and service from unit to unit. Inconsistency in consumer "experience" at different units (or at the same unit on different visits) will, most likely, be perceived as a decline in quality generally and result in lowered expectations, fewer visits to system units, and reduced goodwill. A bad (or even diminished) experience at a unit in one place will certainly increase the likelihood that the customer will not frequent system units in other places.

When the economy is down, franchisees can lose sight of quality and service as they try to save costs and focus on marketing and increasing revenues, but it is particularly important during difficult economic times to uphold System Standards so that customers keep coming back. A bad economy is often responsible for "weeding out" weaker brands, so maintaining a strong brand and customer loyalty is crucial.

The current economic environment makes it necessary for franchisors and franchisees to work together in a collaborative effort to maintain the quality standards of the entire franchise system. Franchisors may need to adopt new practices, such as more formal quality assurance programs, and focus on rewarding good behavior rather than penalizing franchisees for poor behavior.

There is a greater likelihood in a down economy that more franchisees will experience financial difficulties and violate the terms of their franchise agreement. To protect the integrity of the system and the brand, Franchisors must stay ahead of these defaults and deal with them proactively. The sooner that problems with a franchisee's operations can be identified, the easier it is to help that franchisee turn things around. The importance of developing and implementing quality assurance programs and other enforcement mechanisms (as discussed further below) cannot be overstated. Franchisors must not lose sight of quality and service during hard economic times if they hope to survive into the future.

Franchisors can take advantage of the difficult economy by implementing or reinventing their quality assurance programs, retraining franchisees on operational standards, retraining quality assurance representatives who conduct on-site inspections, and identifying problem franchisees before they harm the franchisor's goodwill. When enforcing System Standards, franchisors must be cognizant of the franchisee's economic condition and avoid penalizing a franchisee too harshly, ultimately making it more difficult for that franchisee to comply with System Standards and survive the economic downturn. It is also important to remember that System Standards are not all created equal. Some are core standards or material to the system – *e.g.*, cooking a hamburger at the proper safe temperature or installing hard wired smoke detectors – and some are not – *e.g.*, failure to provide name tags to employees. A franchisor must remain flexible and be innovative in addressing the operational problems of its franchisees.

B. Methods for Enforcing System Standards

The following are common methods used by franchisors to maintain System Standards and to compel franchisees who have strayed from the franchisor's standards to correct their deficiencies.

1. Announced Site Visits

One of the best ways to assess whether or not a franchisee is complying with System Standards is to conduct periodic site visits to the franchisee's operating units. Regularly scheduled visits give the franchisor the opportunity to conduct detailed site inspections and review the written inspection report (and/or previous reports) with the franchisee. It also gives the franchisee the opportunity to ask for clarification of the applicable System Standards and review the proposed remediation plan with the franchisor's representative. Regularly scheduled site visits present the added opportunity of permitting the franchisor's representative to introduce new and/or improved products or services to the franchisee and to provide first hand instruction of any operating procedures applicable to such new products and/or services. It is good policy to precede scheduled site visits with a written agenda of issues and to follow such visits with a detailed written report or assessment of the level of compliance and/or non-compliance with the System Standards as well as a proposed plan to remedy any non-compliance within a reasonable period of time.

2. Unannounced Site Visits; "Secret Shopper" Programs

Often, a franchisor will choose to make unannounced site visits to the franchisee's locations to assess system compliance in a "real world" setting. This is usually done to mitigate the possibility that the franchisee has "cleaned up its act" in anticipation of a scheduled site visit. Unannounced or "surprise" visits are a good way to address this concern, but they may also result in a heightened level of skepticism, mistrust or even hostility on the part of the franchisee. An alternative to unannounced site visits which may very well achieve the same results (without the unintended hostility) is the employment of a third-party "secret shopper" or "mystery shopper" to actually shop the franchisee's locations surreptitiously and report details of the experience back to the franchisor. The results of the secret shopper may also provide valuable information to the franchisee about how its employees are acting when the franchisee is not looking. Related to the secret shopper approach is to actively solicit feedback from actual customers. Customer comments can help franchisors oversee the franchisee's operations and allow the franchisor to be proactive in solving System Standards problems before they get out of control.

3. Report Cards

Written reports assessing a franchisee's compliance and/or non-compliance with System Standards are essential in any attempt to achieve consistent operations. In addition to being a communications and learning tool, these reports often become the basis for implementing default and/or termination remedies in the franchise agreement and may be pivotal evidence in any post termination legal proceedings. Special care must be taken in writing these reports to both clearly communicate the operating deficiencies to the franchisee and illustrate the reasonable concerns of the franchisor to the ultimate trier of fact who may rely on them in any litigation regarding the issue of System Standards enforcement.

4. Warning Letters

A warning letter to a defaulting franchisee may be enough where the franchisee has no history of non-compliance and the defaults are relatively minor. A simple letter from the franchisor, or, more effectively, its counsel, will often scare a franchisee into compliance. The letter should specify the nature of the defaults and warn the franchisee that its failure to remedy the defaults will result in a formal notice to cure and its accompanying notice fees or legal fees. Warning letters are generally more bark than bite, but that might be all that is required under the circumstances.

5. Negotiated Departure or Downsizing

When a franchisee's non-compliance with System Standards is serious or chronic, the franchisor may wish to meet with the franchisee in person to discuss an "exit strategy." In other words, the franchisor communicates to the franchisee that the franchisee can be terminated based on its defaults and that the only way to avoid termination is to sell some or all of the franchisee's units back to the franchisor or to a third party. Other options in the hospitality context include allowing a franchisee a certain period of time to find another brand to re-brand the hotel as an example or time to unwind from the brand so that the franchisee can operate as an independent. A complete departure from the system will obviously solve all non-compliance issues with that particular franchisee, and it allows the franchisee to recover some or all of its investment. Downsizing allows the franchisee to focus its efforts on a smaller number of units and, at least in theory, be in a better position to comply with System Standards at those units. It is also more cost effective for the franchisor than going through a termination action.

Typically, a franchisor will approach a franchisee about selling its units after a notice of default has been issued and the franchisee has failed to cure (see subsection 8 below). The franchisor will send a pre-termination "last chance" letter requiring a meeting with the franchisor. The letter should communicate to the franchisee that its current operations are unacceptable, detail the operational deficiencies, and demand a personal meeting by a set date. The franchisee should understand that it must come to the table or face termination.

6. Withholding Special Benefits and/or Services

A potentially attractive alternative to termination is to withhold from the franchisee certain benefits or services. For example, the franchisor could eliminate or limit the franchisee's expansion opportunities, take away performance rewards, reduce territorial rights, eliminate the right to participate in new product launches, or, in the case of hotel franchises, remove access to hotel reservation systems and directories. The purpose of withholding these types of benefits or services is to motivate the franchisee to "clean up its act" through economic incentive. The benefits and services are taken away with the understanding that they will be reinstated once the franchisee comes into full compliance with System Standards.

Franchisors must be cautious when invoking this strategy. The franchisee may have a contractual right to these benefits and services, and the franchisor does not want to be at risk of breaching the franchise agreement itself. The best way to avoid this is to have a provision in the franchise agreement that sets out exactly which benefits and services the franchisor can withhold when the franchisee is found to be in default of the agreement. The franchise agreement and any notices to the franchisee should contain anti-waiver language so that the franchisor is not giving up its right to terminate if things do not work out. The franchisor must also be careful not to harm the business of the franchisee to such extent that it gives rise to a constructive termination claim. The franchise agreement and notices should contain express language disclaiming constructive termination.

7. Non-Renewal

One relatively simple, if delayed, solution franchisors often employ for dealing with a franchisee that does not comply with System Standards is to simply wait for the franchise agreement to expire. Depending on the severity of the defaults and the length of term remaining in the franchise agreement, non-renewal is often the easiest and cheapest method of eliminating a non-conforming franchisee from the system. The franchisor will have to look at all of the circumstances and should consider the length of time it would take to obtain a court order upholding termination or providing injunctive relief. The franchisor will also have to consider the applicable franchise laws to determine whether good cause, or some other standard, is required for non-renewal of a franchise agreement. For example, several states treat non-renewal in the same manner as termination and require good cause, although uncured violations of System Standards are almost always considered a good cause basis for termination (see subsection 9 below).

8. Notice of Default With Opportunity to Cure

Typically, if a franchisor goes through the time and expense of writing the franchisee, it will be in the form of a formal notice of default that provides a certain number of days within which the franchisee must cure its defaults. This is by far the most common first step for dealing with standards problems. Such notices have several advantages: (1) they allow the franchisor to comply with franchise agreement provisions and laws that require notice prior to termination; (2) they minimize business disruption by allowing the franchise to remain operating pending a cure; (3) they demonstrate a willingness on the part of the franchisor to work with the franchisee; and (4) they set up termination in the event the franchisee fails to cure the defaults.

However, there are also disadvantages to notices of default. If a franchisee fails to timely effect a cure, the franchisor may be forced to terminate to avoid claims of waiver or trademark abandonment. This may depend on the language in the franchise agreement, which may state that the franchise agreement "shall terminate" if the franchisee fails to cure the default. Another disadvantage is that a franchisee may see the notice as more of a legal threat than a good faith attempt to work issues out in a businesslike manner, especially if the notice comes from the franchisor's legal counsel. This often marks the beginning of what becomes a strained and acrimonious relationship between the franchisor and franchisee, which can be accelerated during a down economy.

A notice of default should always be followed up with at least one inspection. An inspection immediately after the expiration of the cure period is necessary to ensure compliance. An interim inspection may also be helpful under certain circumstances to track the franchisee's progress in curing the defaults and to provide the franchisee with additional assistance and advice for effecting a cure. These follow-up inspections should be carefully documented with complete written evaluations signed by the franchisee and photographs and/or video surveillance to establish a record.

9. Enforcement by Termination

Termination is the ultimate System Standards enforcement mechanism: a franchisee that is no longer in the system cannot violate the franchisor's standards. The advantages of termination are apparent. It permanently enforces the franchisor's System Standards as to that franchisee, which is especially useful for repeat offenders who have consistently failed to maintain standards. It also sends a clear message to other franchisees in the system that the franchisor takes its System Standards seriously and violators will not be treated lightly. The disadvantages are also clear. Termination is usually not taken by franchisees sitting down. They risk losing their investment and their livelihood, and they usually will not go down without a fight. This may result in counterclaims and delay tactics to put off termination as long as possible. That means high costs to the franchisor and a long time during which the franchisee may continue to violate System Standards (absent a preliminary injunction). Termination also creates turnover in the system. The franchisor will have to find and train a new franchisee who may lack experience.

The first question a franchisor must consider is when is it appropriate to terminate. Under most franchise agreements, a franchisee can be terminated with or without an opportunity to cure depending on the nature of the default. A failure to comply with System Standards is typically deemed curable. Depending on the nature of the default, a cure period might be anywhere from 30, 60 or 90 days to 24 hours and may depend on local law. Franchisors will usually seek termination only against repeat offenders or franchisees whose standards violations are egregious or pose a public health or safety risk.

Courts have consistently held that a franchisee's failure to maintain System Standards constitutes good cause for termination. *See McDonald's Corp. v. Robertson*, 147 F.3d 1301, 1309 (11th Cir. 1998); *Dunkin' Donuts Inc. v. J.P. Donuts, Inc.*, Bus. Franchise Guide (CCH) ¶ 11,989 (N.D. Ill. 2000); *In re Gainesville P-H Properties, Inc.*, Bus. Franchise Guide (CCH) ¶ 8,925 (Bankr. M.D. Fla. 1987); *Dayan v. McDonald's Corp.*, Bus. Franchise Guide (CCH) ¶ 8,223 (Ill. App. Ct. 1984). Courts have upheld termination of repeat violators even where there is no health or safety threat. *See Original Great Am. Chocolate Chip Cookie Co., Inc. v. River Valley Cookies, Ltd.*, 970 F.2d 273, 279 (7th Cir. 1992); *KFC Corp. v. Goldey*, 714 F. Supp. 264, 266 (W.D. Ky. 1989).

When a franchisor has chosen to terminate its franchisee, and litigation has commenced or draws near, there are two alternatives that franchisors often consider to try to avoid a costly termination battle. The first is to convince the franchisee to sell its franchised business. Although a franchisee loses its right to transfer its business once the franchise agreement is terminated, a franchisor can reinstate the franchise agreement for the sole purpose of allowing the franchisee to sell the business to a third party. The parties can enter into a settlement agreement that would (1) reinstate the franchise agreement, (2) permit the franchisee to sell the franchised business to a third party approved by the franchisor within a certain time frame, such as 90 days, (3) provide that the franchisee surrender the franchised business to the franchisor if the business is not sold within the required time period (or, in the alternative, set a price at which the franchisor will purchase the business); and (4) allow the franchisor to bring a claim against the franchisee for breaching either the settlement agreement or the franchise agreement. Once a settlement agreement is executed, the underlying termination litigation can be dismissed.

The second alternative to litigating termination is re-licensing, whereby the franchisee's franchise rights are restored after termination based on certain conditions and pursuant to a new franchise agreement. The conditions could include, among other things, bringing the franchise into full compliance with all System Standards (including, if necessary, a remodel or refurbishment), paying all fees owed to the franchisor, including the costs of the termination action, and attending additional training. The new franchise agreement could also contain additional provisions, such as stricter penalties for non-compliance with System Standards, higher royalty fees, and additional remodeling requirements. Franchisors should keep in mind, however, that if the re-licensing agreement has different terms than the form franchise agreement, those terms may have to be disclosed pursuant to applicable franchise disclosure laws. To take advantage of re-licensing, the franchisee should be required to de-identify until all re-licensing conditions are met.