

Are Material Changes to Renewal Franchise Agreements Subject to the Implied Covenant of Good Faith and Fair Dealing?

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Despite the almost limitless variety of franchise agreements, the conditions to renew the franchise relationship at the end of the initial term usually include the following: “The Franchisee will sign the Franchisor’s then current form of Franchise Agreement, which agreement may contain terms materially different than the terms of this Agreement.”

If the franchise agreement merely states that the franchisee has a right to renew, a court may presume that the terms of the renewal franchise agreement are the same as the existing agreement except for the extended term.¹ If the franchise agreement does not contain an explicit right to renew, courts will not imply one.²

The conditions to the right to renew are included in a boilerplate franchise agreement that is offered by a franchisor on a take-it-or-leave-it basis. The parties rarely negotiate these conditions. Because many, if not most, franchisees



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1. See, e.g., *Carlos v. Philips Bus. Sys.*, 556 F. Supp. 769 (E.D.N.Y. 1983), *aff'd*, 742 F.2d 1432 (2d Cir. 1983) (holding that under New Jersey statute, a new agreement that changed the relationship of deal from exclusive to nonexclusive was effectively a refusal to renew or a termination); see also *Kaesar Compressors, Inc. v. Compressor & Pump Repair Servs., Inc.*, 832 F. Supp. 2d 984 (E.D. Wis. 2011) (holding that a dealer’s refusal to sign renewal contract was not good cause to terminate relationship under Wisconsin Fair Dealership Act).

2. See *Payne v. McDonald’s Corp.*, 957 F. Supp. 749 (D. Md. 1997); see also *Corp v. Atl.-Richfield Co.*, 860 P.2d 1015 (Wash. 1993).

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fail to retain franchise counsel at the time of purchase, the legal and business ramifications of these provisions are rarely fully explained to or understood by a prospective franchisee until five, ten, or even twenty years later, when a substantially different—and more onerous—franchise agreement that has been unilaterally changed by the franchisor is presented to the franchisee.

Many franchise agreements treat expiration and non-renewal in the same manner as termination due to the franchisee's default. The post-termination or post-expiration provisions may allow the franchisor to take over the franchisee's business by assuming franchisee's lease, telephone numbers, directory listings, and customer list; terminate the franchisee's web page and social media accounts; and give the franchisor the right to purchase the business assets for an often unreasonably low price, such as the business' book value. In contrast, franchisees intend to create and build a business that creates equity for the future to be sold or transferred to heirs, not one that is a temporary "rent-a-business" that must be returned to the franchisor.

This is the franchisee's dilemma. Accept the new onerous terms of the franchise agreement or walk away from the business the franchisee has spent years investing in and cultivating. So what is the franchisee to do?

I. What If the Franchisor Refuses to Negotiate?

After the franchisee tells the franchisor that he or she is not willing to agree to the terms of the proposed renewal franchise agreement, the franchisor may tell the franchisee to either sign it or close up shop and abide by the covenant not-to-compete. At this point, the franchisee's only options are to accept the new terms, or refer to the dispute resolution, governing law, and venue provisions of the franchise agreement.

The franchisee may be required to jump over the following hurdles created by the franchisor:

A. Informal Dispute Resolution

The franchise agreement may have an informal dispute resolution procedure. If such a provision exists, it must be followed. This usually requires an individual franchisee spending time and money traveling to the franchisor's home office and meeting to discuss the franchisee's concerns. The International Franchise Association has an Ombudsman Program for its members to assist with the resolution of disputes arising from business issues. The expectation is that the ombudsman will assist franchisors and franchisees to resolve their disputes to their mutual satisfaction and avoid costly and time-consuming litigation. In an informal and confidential manner, the ombudsman, who operates as a neutral, independent third party, assists franchisees and franchisors in identifying the issues that require resolution and making use of various alternatives for managing conflict effectively.³ Of the forty-two complaints handled

3. IFA RESOLVE, <http://franchise.org/ifa-resolve>.

through the Ombudsman Program, only three related to the renewal of a franchise. Because this is a confidential process, the exact nature of the complaints or their resolution is unknown.⁴ Assuming this process does not resolve the issue, the next hurdle is mediation.

B. Mediation

The franchisee may have to file a demand for mediation of the problem provisions of the renewal franchise agreement. The Center for Public Resources (CPR) Institute for Dispute Resolution has created the National Franchise Mediation Program (NFMP).⁵ Franchisors that join the program must agree for at least two years to attempt to resolve any dispute with any of its franchisees through mediation. Although either a franchisor or a franchisee can initiate a complaint, the most common use of the program is franchisee initiated as follows:

- (1) The franchisee completes a form letter briefly describing the complaint against the franchisor to the administrator of the program.
- (2) The franchisee agrees to meet within a specified time period with a senior representative of the franchisor at the franchisor's home office to discuss the issues informally with the franchisor. Many times, this step can resolve the dispute because the franchisor and the franchisee are communicating directly about the problem. Various educational tools are available to the franchisor to assist in this important part of the process. Even if a resolution cannot be reached, a mutual respect and understanding of the issues can set the stage for a successful resolution at a later stage of the process.
- (3) If the dispute cannot be resolved through the initial negotiations of the parties, the administrator of the program will recommend up to five experienced franchise mediators for the parties to choose a mediator. If the parties cannot agree on a mediator, the administrator will select the mediator based upon a ranking order priority from both parties.
- (4) The mediator's compensation rate is determined before appointment and each party pays one-half of the cost of the mediator along with an administrative fee of \$1,500 to the administrator.
- (5) Mediation is scheduled within a specified time frame.
- (6) Each party delivers to the mediator a summary of the background of the dispute and other information to familiarize the mediator with the dispute.
- (7) Mediation is held and normally can be accomplished in a one-day session.
- (8) If the mediation does not result in a negotiated resolution the mediator will give both parties a written evaluation of the issues.⁶

The NFMP claims a success rate of more than 90 percent in cases where the franchisee agreed to participate and in which a mediator was needed.

4. IFA Franchise Ombudsman Program, January 1, 2016 to December 31, 2016—Types of Complaints, <http://www.franchise.org/ifa-resolve>.

5. See National Franchise Mediation Program, <http://emarket.franchise.org/NationalFranchiseMediation.pdf> (last visited Mar. 6, 2016).

6. *Id.*

Many times the disputes are resolved before the need for a mediator's intervention. However, there are no specific statistics available about the success rate when the issues involve material changes to the terms of the renewal franchise agreement.⁷ Mediation works only if both parties are open-minded and willing to understand the other party's position as well as the costs and risks of arbitration or litigation.

Many of the larger franchisors that are members of the IFA have volunteered to participate in the NFMP. To find out if your franchisor has joined the NFMP, contact CPR at (212) 949-6490. Even if your franchisor has not joined, ask it to use the NFMP to mediate the terms of the renewal franchise agreement. If the franchise agreement is silent on mediation, ask the franchisor to mediate anyway. Mediation may avoid the cost of arbitration or litigation.

Unfortunately, the NFMP applies only to mediation between a single franchisee and the franchisor. Without the franchisor's consent, mediation on a group, class, or collective basis cannot take place. If the franchisor does not consent, NFMP is not available. In the authors' opinion, CPR should change its policy and allow collective mediation of similar disputes affecting more than one franchisee or systemic problems within the franchise network. This would ameliorate the "divide and conquer mentality" of many franchisors and be a more efficient and economical way to resolve such disputes.

If mediation is not successful, you are backed into a corner if your franchisor continues to stonewall you. You have three choices: (1) sign the renewal franchise agreement and related documents, including a general release, and worry about whether your business will continue to be successful; (2) do not sign the renewal franchise agreement and be subject to its post-expiration provisions, including de-identification and the covenant not to compete; or (3) arbitration or litigation.

C. Arbitration

If the franchise agreement contains an arbitration provision, do not waste your time and money challenging its enforceability. Numerous court decisions under the Federal Arbitration Act⁸ have stayed litigation (or dismissed the court action) and enforced an arbitration provision.⁹ The franchisee's demand for arbitration should seek a declaratory judgment that certain terms of the renewal franchise agreement are either unconscionable or breach

7. Telephone Interview with Citlalli Grace, Esq. Dispute Resolution Services Manager, CPR: International Institute for Conflict Prevention and Resolution (Mar. 6, 2017).

8. See 9 U.S.C. §§ 1-16.

9. See *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333, 338 (2011); *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983); *Choice Hotels Int'l, Inc. v. BSR Tropicana Resort, Inc.*, 252 F.3d 707, 709-10 (4th Cir. 2001); *Alford v. Dean Witter Reynolds, Inc.*, 975 F.2d 1161, 1164 (5th Cir. 1992); *Lomax v. Woodmen of the World Life Ins. Soc'y*, 228 F. Supp. 2d 1360, 1362 (N.D. Ga. 2002); *Senda v. Xspedius Commc'ns, LLC*, No. 4:06-cv-1626-DJS, 2007 WL 781786 (E.D. Mo. Mar. 13, 2007); *Marolda v. Claremont Labor Ins. Servs., Inc.*, No. A107138, 2005 Cal. App. Unpub. LEXIS 4730 (Cal. Ct. App. May 31, 2005); *St. Paul Fire & Marine Ins. Co. v. Barge*, 483 S.E.2d 883 (Ga. Ct. App. 1997).

the implied covenant of good faith and fair dealing. The franchisee should also request the appointment of a special arbitrator to issue an interim order directing the parties to continue to operate pursuant to the existing franchise agreement until the arbitrator issues an award. This prevents the franchisor from exercising its post-termination or expiration remedies under the franchise agreement. If the arbitration rules do not grant the arbitrator power to issue preliminary relief or the franchise agreement otherwise provides, you may have to file an action in court to request the preliminary injunction.

D. *Litigation*

If the franchise agreement requires that the franchisee file a complaint with a court having jurisdiction over the parties and the issues, the franchisee's complaint should request a declaratory judgment asking the court to declare that certain terms of the renewal franchise agreement are either unconscionable or breach the implied covenant of good faith and fair dealing. The complaint should also ask for a preliminary injunction directing the parties to continue to operate pursuant to the existing franchise agreement until the court rules on the merits of the action and issues a declaratory judgment.

If litigation is the preferred or required strategy, because many franchisees are, or will soon to be, similarly faced with the terms of the renewal franchise agreement, ideally they should organize to challenge the terms of the renewal franchise agreement. This entails finding and funding a franchisee that is soon up for renewal that resides in, or whose franchise business operates in, a state having a franchise relationship law or a public policy that supersedes the choice of law provision in the franchise agreement and grants franchisees protections not afforded by federal law,¹⁰ or a state having no franchise relationship law.

For example, sixteen states and two U.S. territories have franchise relationship laws that regulate the franchisee's right to renew to some extent: Arkansas,¹¹ California,¹² Connecticut,¹³ Delaware,¹⁴ Florida,¹⁵ Hawaii,¹⁶ Illinois,¹⁷

10. There is no federal franchise relationship law. The Amended Federal Trade Commission Franchise Rule (FTC Franchise Rule) does not regulate the terms of the franchise agreement. It is merely a presale disclosure requirement. 16 C.F.R. Part 436. The FTC Franchise Rule requires a franchisor to disclose in Items 17(b) and (c) the renewal or extension of the term of the franchise agreement and the requirement for the franchisee to renew or extend.

11. See ARK. CODE ANN. § 4-72-204.

12. See CAL. BUS. & PROF. CODE § 20025.

13. See CONN. GEN. STAT. § 42-133f.

14. See DEL. CODE ANN. tit. 6, § 2552 (stating that the franchisor is not permitted to include provisions in the franchise agreement that permit unjust renewal because this would violate Delaware's public policy and that a franchisor cannot unjustly refuse to deal with a franchisee with which the franchisor has been dealing for at least two years).

15. See FLA. STAT. § 686.409.

16. See HAW. REV. STAT. § 482E-6.

17. See 815 ILL. COMP. STAT. 705/20.

Indiana,¹⁸ Iowa,¹⁹ Michigan,²⁰ Minnesota,²¹ Mississippi,²² Missouri,²³ Nebraska,²⁴ New Jersey,²⁵ Puerto Rico,²⁶ U.S. Virgin Islands,²⁷ Washington,²⁸ and Wisconsin.²⁹ A number of these jurisdictions have franchise relationship laws that have “anti-discrimination” provisions requiring franchisors to treat franchisees in the same manner, including dealing with renewal. However, a survey of these state franchise relationship laws indicates that a renewal franchise agreement with materially different terms offered uniformly to all new and renewing franchisees may be permissible if commercially reasonable and made in good faith.

For franchisee attorneys, further research should be done on the franchise relationship law and public policy of the state where the franchisee resides, or where the franchise business operates, to determine whether that state affords the franchisee greater rights than the laws of the state designated in the franchise agreement.

II. Using Unconscionability and the Implied Covenant of Good Faith and Fair Dealing in Court Challenges

Although we are aware of no decision that specifically holds that the typical renewal provision is unenforceable as it is unconscionable, or that a franchisor that refuses to collectively negotiate the terms of a renewal franchise agreement violates the implied covenant of good faith and fair dealing, recent cases in favor of franchisees are trending in that direction. For example, in *Vylene Enterprises, Inc. v. Naugles, Inc.*, the Ninth Circuit ruled that the franchisor failed to negotiate the renewal franchise agreement in good faith because it offered a new franchise agreement that was commercially unreasonable and the franchisor knew or should have known that the franchisee would reject its terms.³⁰

Similarly, in *Tatan Management v. Jacfran Corp.*, the U.S. District Court for the District of Puerto Rico ruled in favor of the franchisor, but stated concerns with unilateral changes to franchise agreements.³¹ In *Tatan*, the

18. See IND. CODE § 23-2-2.7-3.

19. See IOWA CODE § 237A.10(8).

20. See MICH. COMP. LAWS § 445.1527.

21. See MINN. STAT. § 80C.14.

22. See MISS. CODE § 75-24-53.

23. See MO. REV. STAT. § 407.405.

24. See NEB. REV. STAT. § 87-404.

25. See N.J. STAT. ANN. § 56:10-5.

26. See 10 P.R. LAWS ANN. § 278a.

27. See 12A V.I. CODE § 132.

28. See WASH. REV. CODE § 10.100.180.

29. See WIS. STAT. § 135.03 (“No grantor, directly or through any officer, agent or employee, may terminate, cancel, fail to renew or substantially change the competitive circumstances of a dealership agreement without good cause. The burden of proving good cause is on the grantor.”).

30. 90 F.3d 1472 (9th Cir. 1996).

31. 270 F. Supp. 2d 197 (D.P.R. 2003).

plaintiff, a former children's clothing franchisee, sued its franchisor, claiming termination or nonrenewal of the franchise agreement in violation of Puerto Rico Dealers' Contracts Act.³² Puerto Rico law prohibits franchisors from refusing to renew a franchisee's contract, except for just cause, so the franchisee moved for summary judgment to bar the termination.³³ The district court denied the franchisee's motion because the franchisee failed to meet certain, express conditions of the franchise agreement's renewal provision, but the court expressed grave concerns regarding the lawfulness of the "then current standard form" franchise renewal clause:³⁴

The Court has doubts as to the lawfulness of requiring the execution of the then current standard form of the franchise agreement and the execution of a release. The first condition potentially runs contrary to Law 75 by allowing the principal to unilaterally alter the terms of the agreement, 10 P.R. Laws Ann. § 278a, while the execution of the release seems to clash with Law 75's provision that the rights provided under the statute cannot be waived, *id.* § 278c.³⁵

In a New York-based case, *Bronx Auto Mall, Inc. v. American Honda Motor Co., Inc.*, a multi-line automobile dealer brought action to enjoin the manufacturer from terminating the franchisee's dealership.³⁶ The U.S. District Court for the Southern District of New York granted injunctive relief and an appeal was taken to the Second Circuit. The dealer argued that it was unreasonable to demand that certain substantial renovations be made at the dealership as a prerequisite for renewal. The district court held, and the Second Circuit affirmed,³⁷ that the manufacturer could not use the franchisee's noncompliance with conditions imposed on renewal of the franchise agreement as grounds for termination because the manufacturer failed to establish the reasonableness of the conditions.

Similarly, in *Beilowitz v. General Motors Corp.*, Beilowitz, an automobile parts distributor, sued its manufacturer for violation of the New Jersey Franchise Practices Act (NJFPA).³⁸ In what the U.S. District Court for the District of New Jersey referred to as a "Hobson's choice,"³⁹ Beilowitz was required "either to accede to [General Motors]'s new business plan, which would result in the loss of forty percent of Beilowitz's revenue, or, after a twenty-three-year-long relationship with GM, to be cut out of doing any business with [General Motors] at all."⁴⁰ In the suit, Beilowitz, seeking a preliminary injunction, claimed that General Motors' actions violated the

32. *Id.*

33. *Id.*

34. *Id.* at 206.

35. *Id.*

36. 934 F. Supp. 596 (S.D.N.Y. 1996), *aff'd*, 113 F.3d 329 (2d Cir. 1997).

37. *Id.*

38. 233 F. Supp. 2d 631 (D.N.J. 2002).

39. *Id.* at 633 ("Thomas Hobson, an English liveryman who lived in the seventeenth century, required his customers to take the horse nearest to the stable door or none at all. Accordingly, a 'Hobson's choice' refers to an apparently free choice that offers no real alternative.")

40. *Id.*

NJFPA, which prohibits “a franchisor’s termination, cancellation, or failure to renew a franchise without good cause.”⁴¹ The court noted that: “[i]t is a violation of the NJFPA to cancel a franchise for any reason other than the franchisee’s substantial breach, even if the franchisor acts in good faith and for a bona fide reason.”⁴² In granting the preliminary injunction, the court took issue with the fact that “GM ha[d] not alleged that [Beilowitz] substantially breached” any agreement and, rather, “ha[d] generously lauded Beilowitz” in the past for his outstanding performance.⁴³ Accordingly, the court held that, “[b]ecause GM ha[d] offered no reason, other than a change in its business strategy for its failure to renew the . . . franchise,” Beilowitz “ha[d] a likelihood of success on his claims under [the NJFPA].”⁴⁴

On the other side of the issue are cases finding the “then current standard form” franchise renewal clause acceptable. In *Meyer v. Kero-Sun, Inc.*,⁴⁵ the U.S. District Court for the Western District of Wisconsin, applied the Wisconsin Fair Dealership Law to a wholesale kerosene heater distribution franchise in determining whether the franchisor had properly terminated the franchisee.⁴⁶ The court held that the franchisor’s actions to undermine the exclusivity provision of the franchise agreement did not constitute a “termination” of the franchise agreement.⁴⁷ In fact, when discussing “treat[ing] a change in competitive circumstances⁴⁸ as a termination or nonrenewal,” the court went so far as to say, “[a]lthough interesting and novel, the theory is nonsense.”⁴⁹

In *Ziegler Co., Inc. v. Rexnord, Inc.*, the Supreme Court of Wisconsin dealt with the issue of when a franchisor can change its policies and procedures in how it does business with its franchisees and, in consideration of the Wisconsin Fair Dealership Law, held: “The essential requirements of the statute allow a grantor to impose changes which must include those designed to accommodate the grantor’s own economic problems. Any contrary interpretation of the statute would place all risk of loss due to fundamental economic change on the grantor in perpetuity.”⁵⁰

In *Ziegler*, the court noted a plethora of other cases—in Wisconsin and elsewhere—related to unilateral and system-wide changes of minor terms of the franchise agreement.⁵¹ Finding that the franchisee refused to substan-

41. *Id.* at 644.

42. *Id.*

43. *Id.*

44. *Id.*

45. 570 F. Supp. 402 (W.D. Wis. 1983).

46. *Id.* at 404.

47. *Id.* at 406.

48. Under Wisconsin precedent, a “change in competitive circumstances” means that the franchisor used its superior bargaining power to change not merely the franchise agreement, but also the circumstances of the business itself. See *Jungbluth v. Hometown, Inc.*, 548 N.W.2d 519, 524 (Wis. 1996).

49. *Meyer*, 570 F. Supp. at 406.

50. 433 N.W.2d 8, 12 (Wis. 1988).

51. *Id.* at 12–13.

tially comply with essential, reasonable, and nondiscriminatory requirements sought to be imposed by the franchisor, the court held that there was good cause to terminate, cancel, or fail to renew the relationship at the expiration of the contractual term.⁵²

In *Wisconsin Music Network, Inc. v. Muzak Ltd. Partnership*,⁵³ the licensee of a music subscription service sued the licensor seeking to prevent the licensor from terminating the license agreement. Before the U.S. District Court for the Eastern District of Wisconsin, the licensee sought a preliminary injunction to prevent modifications to the license agreement, namely, the inclusion of a program that enabled the franchisor to compete with the other biggest providers of subscription programmed music.⁵⁴ The Seventh Circuit affirmed the denial of preliminary injunctive relief under the Wisconsin Fair Dealership Law, holding that “the new terms of the license agreement were essential and reasonable because they enabled [the franchisor] to offer a national service” and that there was a “competitive need to offer national customers national treatment.”⁵⁵ Notably, however, the court in *Wisconsin Music Network* found that, just because the licensor did not seek to impose the contractual change on other, unexpired agreements, this did not support the licensee’s argument that the terms were nonessential; rather, because all expired contracts contained the new terms and it was “not unreasonable for [the licensor] to rewrite its license agreements in an orderly fashion,” the court found no wrongdoing by the licensor.⁵⁶

In yet another case under the Wisconsin Fair Dealership Law, the Seventh Circuit in *East Bay Running Store, Inc. v. NIKE, Inc.* affirmed the grant of summary judgment against the distributor and in favor of Nike.⁵⁷ In *East Bay*, the distributor “engaged in the business of retail sales of athletic shoes and . . . apparel,” including Nike products.⁵⁸ Upon the launch of the Nike Air product brand, the distributor created a “flourishing mail-order business for NIKE products.”⁵⁹ For the next six years, the distributor’s sales climbed to the point where Nike Air products “accounted for twenty-nine percent of [the distributor]’s total sales and fifty-five percent of [its] NIKE sales.”⁶⁰ In October 1987, “NIKE notified all of its dealers in the United States” that it would no longer make Nike Air products “available for resale by mail, catalog, or electronic means.”⁶¹ The “purpose of imposing the restriction was to prevent ‘free-riding’ and to insure that the consumers of the Nike Air product line received personal individualized

52. *Id.* at 14.

53. 5 F.3d 218 (7th Cir. 1993).

54. *Id.*

55. *Id.* at 224.

56. *Id.*

57. 890 F.2d 996 (7th Cir. 1989).

58. *Id.* at 997.

59. *Id.* at 998.

60. *Id.*

61. *Id.*

attention.”⁶² Suit followed in the Circuit Court for Marathon County, Wisconsin, where, before removing the matter to federal court, the court entered an ex parte restraining order.⁶³ In granting summary judgment, which was affirmed by the Seventh Circuit, the U.S. District Court for the Western District of Wisconsin “concluded that NIKE’s non-discriminatory, system-wide indirect sales limitation did not ‘substantially change the competitive circumstances’ of [the distributor] and, as such, did not implicate” the Wisconsin Fair Dealership Law.⁶⁴ On appeal, the Seventh Circuit held, “[b]ased on the non-discriminatory nature of NIKE’s ‘no mail-order’ policy, we hold that the requirement of good cause was not triggered in this case.”⁶⁵

In *Home Instead, Inc. v. Florance*, Florance, the franchisee, signed an addendum to the franchise agreement that he could maintain his territorial exclusivity if he met certain billing quotas, including a \$30,000 per month quota “from the end of the fifth year of operation of the Franchise Business through the end of the term of this Agreement or any renewal terms of a renewal agreement.”⁶⁶ Upon renewal, Home Instead attempted to impose a \$70,000 billing quota.⁶⁷ In denying Florance’s preliminary injunction application, the U.S. District Court for the District of Nebraska found that Florance had no likelihood of success on the merits, holding that Florance had agreed to sign the “then current franchise agreement upon any renewal,” which included an increased billing requirement.⁶⁸ Ultimately, the Eighth Circuit reversed on appeal and remanded the matter back to the district court for the sole reason that the terms of the agreement were ambiguous on the issue of whether the \$30,000 was a floor or ceiling.⁶⁹ The Eighth Circuit’s decision did not change the ultimate opinion that Florance’s obligation to sign the then current franchise agreement permitted Home Instead to increase the billing requirement.⁷⁰

Similarly, in *G.I. McDougal, Inc. v. Mail Boxes, Etc., Inc.*, the California Court of Appeal found “that the renewal [agreement] was not a breach of the implied covenant of good faith and fair dealing.”⁷¹ Under California law, “[t]he implied covenant has no existence independent of the express terms of the contract, and cannot impose substantive duties or limits on contracting parties beyond those in the specific terms of their agreements.”⁷² Accordingly, because the applicable renewal provision “contain[ed] no ex-

62. *Id.*

63. *Id.*

64. *Id.* at 998–99 (quoting *Remus v. Amoco Oil Co.*, 794 F.2d 1238 (7th Cir.)).

65. *Id.* at 1001. A similar result, also under the Wisconsin Fair Dealership Law, was reached in *Bressler’s 33 Flavors Franchising Corp. v. Wokosin*, 591 F. Supp. 1533 (E.D. Wis. 1984).

66. 721 F.3d 494, 496 (8th Cir. 2013).

67. *Id.*

68. *Home Instead, Inc. v. Florance*, No. 8:12CV264, 2012 WL 4327041, at *4 (D. Neb. Sept. 20, 2012).

69. *Home Instead, Inc.*, 721 F.3d at 496.

70. *Id.*

71. 2012 WL 90083, at *10 (Cal. Ct. App. Jan. 12, 2012).

72. *Id.*

press contractual obligation to renew the franchise on the same terms as in the original franchise agreement,” there was no breach of the implied covenant of good faith and fair dealing.⁷³ In a similar case applying California law, *West L.A. Pizza, Inc. v. Domino’s Pizza, Inc.*, the U.S. District Court for the Central District of California found no violation of the implied covenant of good faith and fair dealing based on “Domino’s failure to offer ‘reasonable’ renewal terms.”⁷⁴ In dismissing the franchisee’s implied covenant cause of action, the court stated: “Once again, the franchise agreement expressly permits Domino’s to condition renewal on materially different terms consistent with the ‘then current form’ of its standard agreement. In offering West L.A. store # 8306 a renewal franchise on those terms, Domino’s has not frustrated Plaintiffs’ rights to receive the benefits of the parties’ bargain.”⁷⁵

Although there are cases on both sides of these issues, most cases rejecting application of the implied covenant are based on Wisconsin and California law. The more recent cases in other jurisdictions have shifted away from this approach, leaving the door open for franchisees to argue that good faith and fair dealing requires that franchisors at least negotiate over renewal terms with their franchisees.

III. Judicial Notice That Certain Franchise Agreement Provisions Are Unconscionable

Numerous courts throughout the country have begun to take judicial notice of the fact that the typical franchise agreement is a “contract of adhesion” that contains many unconscionable terms.⁷⁶ Parties having disproportionate bargaining power enter into the franchise agreement; its provisions are not subject to arm’s-length negotiation between parties of comparable bargaining power, notwithstanding the party line of the franchisor community that the typical franchise agreement is negotiated by knowledgeable franchisors and franchisees of equal bargaining power.⁷⁷ Franchises are usually offered by a franchisor on a non-negotiable “take it or leave it” basis.⁷⁸ Franchisees sign the franchise agreement containing provisions that are pat-

73. *Id.*

74. 2008 WL 362708, at *10 (C.D. Cal. Feb. 26, 2008).

75. *Id.*

76. *See, e.g.*, *Indep. Ass’n of Mailbox Ctr. Owners, Inc. v. Super. Ct.*, 34 Cal. Rptr. 3d 659, 668 (Ct. App. 2005) (“Case law has recognized that franchise agreements can have some characteristics of contracts of adhesion.”).

77. *See Brock v. Baskin-Robbins USA Co.*, 113 F. Supp. 2d 1078, 1087 (E.D. Tex. 2000) (stating that a franchisee, often composed of an individual or a small business, does not have equal bargaining power to a national franchisor with counsel when the form contract is not open to negotiation).

78. *Id.*

ently “commercially unreasonable.”⁷⁹ Courts have begun to recognize that the most egregious terms, in which franchisees relinquish valuable rights without getting anything in return, may not be enforceable.

For example, in *Kubis & Peryszk Associates, Inc. v. Sun Microsystems Inc.*, a forum selection clause requiring a New Jersey franchisee to litigate a dispute with a California franchisor in California rather than in New Jersey was found by the Supreme Court of New Jersey to be “presumptively invalid because [it] fundamentally conflicted” with New Jersey’s public policy of “swift and effective judicial relief.”⁸⁰ The court stated:

Though economic advantages to both parties exist in the franchise relationship, disparity in the bargaining power of the parties has led to some unconscionable provisions in the agreements. Franchisors have drafted contracts permitting them to terminate or to refuse renewal of franchises at will or for a wide variety of reasons, including failure to comply with unreasonable conditions. Some franchisors have terminated or refused to renew viable franchises, leaving franchisees with nothing in return for their investment. Others have threatened franchisees with termination to coerce them to stay open at unreasonable hours, purchase supplies only from the franchisor and at excessive rates or unduly expand their facilities.

* * * *

[W]e hold that forum-selection clauses in franchise agreements are presumptively invalid, and should not be enforced unless the franchisor can satisfy the burden of proving that such a clause was not imposed on the franchisee unfairly on the basis of its superior bargaining position. *Evidence that the forum-selection clause was included as part of the standard franchise agreement, without more, is insufficient to overcome the presumption of invalidity. We anticipate that a franchisor could sustain its burden of proof by offering evidence of specific negotiations over the inclusion of the forum-selection clause and that it was included in exchange for specific concessions to the franchisee.* Absent such proof, or other similarly persuasive proof demonstrating that the forum-selection clause was not imposed on the franchisee against its will, a trial court should conclude that the presumption against the enforceability of forum-selection clauses in franchise agreements subject to the [New Jersey Franchise Practices] Act has not been overcome.⁸¹

As such, the Supreme Court of New Jersey found that forum selection clauses in franchise agreements are presumptively invalid without additional evidence of additional consideration from the franchisee; simply put, they cannot be just included in the boilerplate language.⁸² If such a clause is automatically included, it is inherently unconscionable.

79. See *In re Vylene Enters., Inc.*, 90 F.3d 1472, 1477 (9th Cir. 1996), *as amended on denial of reb’g and reb’g en banc* (Sept. 12, 1996) (stating that the proposed franchise agreement was commercially unreasonable).

80. 680 A.2d 618, 626 (N.J. 1996).

81. *Id.* at 621, 627–28 (citing *Westfield Ctr. Serv., Inc., v. Cities Serv. Oil Co.*, 432 A.2d 48 (N.J. 1981) (emphasis added)).

82. *Id.*

IV. Expansion of *Sun Microsystems* to Other Material Changes and Jurisdictions

It is the authors' opinion that the logic of *Sun Microsystems* should apply in all jurisdictions with greater force to a renewal provision in a franchise agreement that requires a franchisee to sign the franchisor's then current form of franchise agreement. When such an agreement contains material changes unilaterally made by the franchisor without specific negotiation with the franchisees that are adverse to the economic and business interests of franchisees, there is substantial public interest in the fairness of those changes.

This is a far greater right a franchisee is relinquishing in giving the franchisor carte blanche to change the terms of the relationship than merely agreeing to litigate in the franchisor's home state. This type of renewal provision, if it was not subject to specific negotiation in exchange for specific concessions to the franchisee, should be unenforceable as a matter of public policy. If courts refuse to recognize this argument, the alternative argument is that the franchisor is acting in bad faith in failing to negotiate with its franchisees concerning the material changes contained in the renewal franchise agreement.

VI. Use of the Implied Covenant in Achieving *Sun Microsystems*' Goals

One of the newest arrows in a franchisee's quiver when dealing with such clauses is the franchisor's breach of the implied covenant of good faith and fair dealing. Courts in most states have recognized that the implied covenant of good faith and fair dealing applies to all parties to a contract, including parties to franchise agreements.⁸³ A fair number of states recognize an independent cause of action for breach of this implied covenant of good faith and fair dealing.⁸⁴

83. See *Burger King Corp. v. Weaver*, 169 F.3d 1310 (11th Cir. 1999).

84. See *Era Aviation v. Seekins*, 973 P.2d 1137, 1139 (Alaska 1999) (Alaska); *Wells Fargo Bank v. Ariz. Laborers, Teamsters & Cement Masons Local No. 395 Pension Trust Fund*, 38 P.3d 12, 28 (Ariz. 2002) (Arizona); *Sutherland v. Barclays Am./Mortg. Corp.*, 53 Cal. App. 4th 299, 314 (1997) (California); *Buckman v. People Express, Inc.*, 530 A.2d 596, 599 (Conn. 1987) (Connecticut); *Airborne Health, Inc. v. Squid Soap, L.P.*, 984 A.2d 126 (Del. Ch. 2009) (Delaware); *Scheck v. Burger King Corp.*, 798 F. Supp. 692, 694 (S.D. Fla. 1992) (Florida); *Best Place Inc. v. Penn Am. Ins. Co.*, 920 P.2d 334 (Haw. 1996) (Hawaii); *Dayan v. McDonald's Corp.*, 466 N.E.2d 958, 971 (Ill. 1984) (Illinois); *Del Vecchio v. Conesco, Inc.*, 788 N.E.2d 446, 451 (Ind. Ct. App. 2003) (Indiana) (noting that "a claim that an implied covenant of good faith and fair dealing has been breached is really a claim of breach of fiduciary duty"); *United Consumers Club, Inc. v. Bledsoe*, 441 F. Supp. 2d 967, 981-82 (N.D. Ind. 2006) (Iowa); *Howard v. Ferrellgas Partners, L.P.*, 2011 WL 3299689, at *6 (D. Kan. Aug. 1, 2011) (Kansas); *Ranier v. Mount Sterling Nat. Bank*, 812 S.W.2d 154, 156 (Ky. 1991) (Kentucky); *Brill v. Catfish Shaks of Am.*, 727 F. Supp. 1035, 1039 (E.D. La. 1989) (Louisiana); *Me. Farms Venison, Inc. v. Peerless Ins. Co.*, 853 A.2d 767 (Me. 2004) (Maine); *Anthony's Pier Four, Inc. v. HBC Assocs.*, 583 N.E.2d 806 (1991) (Massachusetts); *People v. Vanrevendam*, No. 266511, 2007 WL 1201832, at *2 (Mich. Ct. App. Apr. 24, 2007) (quoting *Hammond v. United of Oakland, Inc.*, 483 N.W.2d 652, 655 (Mich. Ct. App. 2002)) (Michigan); *In re Hennepin Cty. 1986 Recycling Bond Litig.*, 540 N.W.2d 494, 502 (Minn. 1995) (Minnesota); *Limbirt v. Miss. Univ.*

However, some states hold that such a cause of action cannot exist wholly independent of the express terms of the contract.⁸⁵

Under the rationale established by a number of good faith franchise cases, if the renewal provision in the existing franchise agreement is specific as to what the changed terms will be on renewal, the court should uphold these changed terms. If these changed terms are not specified in the renewal provision of the existing franchise agreement, any changes made unilaterally by the franchisor ought to be measured against the implied covenant of good faith and fair dealing to determine their reasonableness.

Franchisors may argue that they cannot be acting in bad faith by unilaterally changing the terms of the franchise agreement upon renewal because the existing franchise agreement states that the terms of the renewal franchise agreement may contain materially different terms, including higher royalty fees, reduced exclusive territories, etc. The implied covenant of good faith and fair dealing cannot overrule the express terms of the franchise agreement.⁸⁶ However, the express terms of the renewal franchise agreement are not set forth in the renewal provision. Let's assume the existing franchise agreement provides for a 5 percent royalty fee but also says that the franchisor reserves the right to increase the royalty fee up to 7 percent in the renewal franchise agreement. When the renewal franchise agreement containing a 7 percent royalty fee is submitted to the renewing franchisee, the franchisee has no ground for complaint. However, if the existing franchise agreement provides for a 5 percent royalty fee but the renewal provision says only that the renewal franchise agreement may contain a higher royalty fee, what if the renewal franchise agreement contains a 100 percent royalty fee? Of course, that is ludicrous, but it makes an important point.

for Women Alumnae Ass'n, Inc., 998 So. 2d 993, 998 (Miss. 2008) (Mississippi); Housley v. Mericle, 57 S.W.3d 360, 363 (Mo. Ct. App. 2001) (Missouri); Phelps v. Frampton, 170 P.3d 474, 482 (Mont. 2007) (Montana); NEB. REV. ST. ANN. § 1-304 (Nebraska); A.C. Shaw Constr. v. Washoe Cty., 784 P.2d 9, 10 (Nev. 1989) (Nevada); N.H. REV. STAT. ANN. § 382-A:1-304 (New Hampshire); Sons of Thunder, Inc. v. Borden, Inc., 690 A.2d 575, 587 (N.J. 1997) (New Jersey); United Wholesale Liquor Co. v. Brown-Forman Distillers Corp., 775 P.2d 233, 235 (N.M. 1989) (New Mexico); Rowe v. Great Atl. & Pac. Tea Co., 385 N.E.2d 566 (1978) (New York); Sunset Beach Dev., LLC v. Amec, Inc., 675 S.E.2d 46, 57 (N.C. Ct. App. 2009) (North Carolina); N.D. CENT. CODE § 51-07-01.1(2) (North Dakota); OHIO REV. CODE ANN. § 4517.01 (Ohio); 47 OKLA. STAT. ANN. § 565.2 (Oklahoma); Best v. U.S. Nat'l Bank, 739 P.2d 554, 557 (Or. 1987) (Oregon); Martrano v. Quizno's Franchise Co., LLC, 2009 WL 1704469 (W.D. Pa. June 15, 2009) (Pennsylvania); R.I. GEN. LAWS § 31-5.1-4(B)(4) (Rhode Island); Williams v. Riedman, 529 S.E.2d 28, 36 (S.C. Ct. App. 2000) (South Carolina); S.D. CODIFIED LAWS § 57A-1-304 (2008) (South Dakota); TENN. CODE ANN. § 47-25-1503 (LexisNexis 1989) (Tennessee); TEX. BUS & COM. CODE § 1.304 (LexisNexis 2003) (Texas); UTAH CODE § 70A-1A-304 (Utah); VT. STAT. ANN. tit. 9A, § 1-304 (Vermont); VA. CODE ANN. § 8.1A-304 (Virginia); WASH. REV. CODE § 62A.1-304 (Washington); WIS. STAT. §§ 218.0101-.0163 (Wisconsin); WYO. STAT. ANN. § 34.1-1-203 (Wyoming).

85. See, e.g., G.I. McDougal, Inc. v. Mail Boxes, Etc., Inc., 2012 WL 90083, at *10 (Cal. Ct. App. Jan. 12, 2012).

86. See Life Plans, Inc. v. Sec. Life of Denver Ins. Co., 800 F.3d 343, 356 (7th Cir. 2015); see also Burger King Corp. v. Weaver, 169 F.3d 1310, 1318 (11th Cir. 1999).

Somewhere between 5 percent and 100 percent, the franchisor crossed a red line. That red line is created by the covenant of good faith and fair dealing.

Like many of the cases cited in this article, courts have been trending against requiring franchisees to sign a franchisor's then current franchise agreement that contains material changes unilaterally made by the franchisor.⁸⁷ The question then becomes

at what point when the franchisor unilaterally makes increases in the royalty rate or other payments, or changes or eliminates another material term of the franchise agreement, such as significantly reducing or eliminating an exclusive territory, is the franchisor acting in bad faith? Any rational person would conclude that a franchisor must act in good faith in materially changing the terms of a renewal franchise agreement. Of course, the proper approach is to hold the exercise of discretion in check, preferably through negotiation with the franchisee, or through imposition of the implied covenant of good faith and fair dealing by an arbitrator or a court.⁸⁸

Although the franchisor may have the contractual right to condition the renewal of the franchise relationship, any material changes in the terms of the new franchise agreement that are commercially unreasonable and adverse to the legitimate economic and business interests of the franchisees should be subject to specific negotiation with its franchisees in good faith. For a franchisor to unilaterally make material adverse changes to the terms of the franchise relationship and impose these changes on its franchisees on a nonnegotiable "take it or leave it" basis, is an act of bad faith and an actionable breach of the covenant of good faith and fair dealing. This is particularly true if this action is coupled with the threat of termination of the franchise agreement and the automatic and immediate imposition of a restrictive and punitive covenant not to compete that may place a significant number of franchisees out of business and thousands of employees out of work.

VII. Conclusion

The franchise relationship should be a continuing "win-win" business arrangement for both sides. Where the franchisor gets greedy and imposes renewal terms that upset the franchise business model, franchisees should organize and first try to negotiate the issues on a system-wide basis. If the franchisor refuses to negotiate, the franchisee must go through the dispute resolution procedures. Franchisees should pick the ideal franchisee with a choice-of-law provision in a state that affords some protection against unilateral changes to file the declaratory judgment action. In such a scenario, the franchisee will be protected against the material changes to the terms of the renewal franchise agreement that are unconscionable or violate the covenant of good faith and fair dealing.

87. See, e.g., *Kubis & Perszyk Assocs., Inc. v. Sun Microsystems, Inc.*, 680 A.2d 618, 626 (N.J. 1996).

88. KEITH KANOUSE, *COLLECTIVE NEGOTIATIONS OF FRANCHISE AGREEMENTS* 5 (2015).

