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Ch-ch-ch-ch-changes: Implementing System Changes, Upgrades and New Directions Under Existing Franchise Agreements

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I. Introduction*

Much of the consumer appeal of franchised brands is uniformity and predictability—a mirrored and consistent experience no matter which outlet is visited. But a hidden irony for many franchised businesses is the need for regular adaptation to accommodate market shifts to remain competitive. Indeed, "[f]ranchise systems are not static, but rather, are involved in a constant maturation process".[1] This paper will focus on business and legal strategies for franchisors to maximize their chances for implementing successful system change mid-term through the enforcement of existing contractual provisions and modifications to the standards of operations set forth in the Operations Manual (as opposed to at the time of renewal or transfer).

There are countless reasons a franchisor might be motivated to modify the franchise system. In general, the impetus for change is the same as for other businesses; actuated by market forces, consumer trends or culture shifts, franchise networks pivot to accommodate, to remain relevant, and to thrive. These path corrections need not be solely reactive, but may also constitute proactive market positioning. Competitive and consumer pressures in the franchise context often necessitate changes across the whole network simultaneously. The franchisor also faces contractual and other legal impediments to effecting system-wide change over a short period of time. System-wide change may include any of the following:

- New products or services: changing cultures, demographics, or clientele tastes or demands might suggest that a new product or service should be offered which may require franchisees to invest in new equipment and training;
- New public image: if the franchisor wants to improve the company's public image, there may be a need to update branding or advertising across the network;
- Technology: efficiency or security concerns can require a system-wide technology update, such as back-of-house systems to enable network-wide customer loyalty programs;
- Pricing strategy: the franchisor may wish to employ new pricing strategies to invigorate the entire brand and attract new customers;[2]

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[1] Richard M Asbill, Jerry Leon Lovejoy & Ann Hurwitz, "Reshaping the System: Cooperative Strategies for Overcoming Business and Legal Obstacles to Change in the Mature Franchise System" (Paper delivered at the ABA Forum on Franchising, Orlando, Florida, 11-13 October 1995) at 1.

[2] This paper will not address the anti-trust or competition issues that may arise from the manipulation of pricing strategies in a franchise network. For pricing issues generated by use of the Operations Manual, see Lisa Pender Morse & Craig R Tractenberg, "The Operations Manual: Legal Traps for the Unwary Franchisor" (Paper delivered at the ABA Forum on Franchising, New Orleans, LA, 18-20 October 2000) at 11.

- Regulatory change or quality control: new laws or guidelines for handling certain products or material may require near-immediate and universal change;[3]
- New acquisition: the franchisor may need to harmonize a newly acquired brand with existing holdings; or
- Uniformity: the franchisor may simply wish to re-establish uniformity over an aging network by enforcing existing franchise agreement provisions.

Any system-wide alterations are likely to meet some resistance from franchisees. In a complex web of interconnected relationships, major changes in a franchised business can quickly ripple across the network. Franchisees must already meet a lengthy list of obligations and will naturally be unwilling to add divergent strands to the web, particularly as deviations from the original design accumulate and as costs to implement the changes escalate. This is of particular concern in more mature systems and in systems where franchisee market share (and profits) have already been lost to new competition. Nevertheless, the reputation and goodwill of a national, recognized, and trusted brand is worth protecting, and franchisors have primary responsibility for setting brand protection standards and ensuring the system remains relevant to consumers. Franchisors must be willing to exercise such responsibility by creating a mindset for change as early as possible in the relationship and laying appropriate legal and relational groundwork.

The complexity of franchise networks permits a number of avenues for change, some of which are more cumbersome than others. While change is possible through the negotiation of amendments to franchise agreements, or even the creation of a new form of agreement for new and renewing franchisees, this paper will focus on the enforcement of existing contract provisions and modifications to the Operations Manual to implement system change. Theoretically, these tools should allow for quicker and easier ways to implement system-wide changes. If the franchisor has prepared appropriately by building in a foundation for change, there should be no need for renegotiation, re-drafting, or dealing with the technical aspects of franchise-specific legislation, such as disclosure or "good cause" termination concerns. It will also be harder for franchisees to hold out if there is no need to sign new agreements. In general, as proposed changes increase in complexity, so too do the methods required for implementation[4]; nevertheless, franchisors can grease the wheels for some very significant changes through proactive planning and transparent communication with their franchisee community.

While broad-scale changes can seem overwhelming, franchisors successfully modify their systems on a regular basis. Large-scale changes are a consistent fault line for franchisee relationships, but they are also what keep the system competitive and

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[3] While food standards are the obvious example, privacy law should not be ignored here. As data becomes a currency and privacy rules (and rulings) adapt in response, whole systems of data manipulation, trading, and sharing may need to change on very short timelines. In Canada, a private right of action under Canada's Anti-Spam Legislation (SC 2010, c 23) comes into force in the Summer of 2017, and countless retail businesses will be affected.

[4] Gillian Scott et al, "Winds of Change: Tried Techniques for Effectively Managing Risk When Implementing System-Wide Changes" (Paper delivered at the IFA Annual Legal Symposium, Washington, DC, 15-17 May 2016) at 8.

attractive to new franchisee candidates. Successful system-wide changes are built on a foundation of: careful planning and preparation for flexibility in critical franchise documents; a well-constructed business plan for the change and its associated transition process; and responsive communication and/or collaboration with franchisees.

II. Preparing for Change

Making change on a grand scale has many traps. The best way to avoid them is to anticipate them as early as possible – ideally before signing the franchise agreement. Certain types of changes can be easily anticipated and accounted for up front. Product or service changes are common in some industries (such as quick serve restaurants), as are image updates that may require changes to branding, including the company's primary trade-marks and the concept's trade dress. If the franchisor plans accordingly, even major changes can occur without the need to re-negotiate or re-sign franchise agreements.

With this in mind, there are two effective means of orchestrating changes without a new contract. For smaller, day-to-day system changes, the Operations Manual should provide sufficient flexibility. For more substantial (or "material") changes, a well-drafted franchise agreement will often provide the leeway required. Obviously, whether a franchisor can use these tools depends on whether they are available, so franchisors must anticipate likely changes and plan accordingly. Large networks pivot like the Titanic—building in the flexibility described below should allow the system to make changes in a more nimble fashion.

A note of caution is warranted here as not all changes are equal, especially from the perspective of individual franchisees in large systems. Franchisors may have to customize changes for particular franchisee circumstances by offering financial incentives, giving concessions, or allowing staged or extended periods of time for implementing the changes. Furthermore, while proper preparation is a significant advantage for franchisors angling to make system-wide changes, it is not a licence for unlimited, unilateral, and immediate change, and due regard must be given to the impact of the change on each particular franchisee and on the franchisee network as a whole. Nonetheless, having the following tools in place should help establish a franchisor's contractual authority to make systemic changes, which is an essential precondition.

A. Franchise Agreements

The relationship between a franchisor and its franchisee is fundamentally contractual. Thus, whether a franchisor has the ability to implement system-wide changes will necessarily require an assessment of its contractual authority. While the fickle market often dictates whether change should occur, the franchise agreement determines whether such change can occur. Indeed, "the express terms of the franchise agreement will [often] be dispositive of any franchisee action with respect to system-wide change".[5] Franchise

[5] Scott, *supra* note 4 at 20.

agreements should therefore explicitly contemplate—and permit—a broad range of system-wide modifications.

There are many advantages to coordinating change through the franchise agreement. First among them is the ability to institute significant system-wide alterations to a degree impossible via changes to the Operations Manual. The franchisor's right to implement changes to the system is supported by existing case law, regardless of the financial impact on the franchisee. There is also no need for re-negotiations or re-drafting, as the parties have already agreed to any express wording in the franchise agreement. Thus, it is theoretically straightforward to justify and implement such changes. For these reasons, franchise agreement provisions are the main tools for substantial franchise system modifications.

Express contractual language, however, is not always a complete defence when changes are challenged by franchisees. Contractual discretion is limited by the duty to act in good faith, a duty that is read into every franchise contract.[6] Furthermore, not all franchise agreements will have the necessary flexibility built in; re-negotiating and re-writing all franchise agreements to create a more flexible foundation may have to be its own long term change project as agreements are renewed or as franchised rights are transferred to new franchisees entering the system. Nevertheless, the best way to prepare for change is to draft it into the franchise contracts.

A dual strategy can help ensure a change-friendly franchise agreement: first, include general terms that build flexibility into the contractual foundation; and second, incorporate specific provisions contemplating particular anticipated changes.

1. General Contractual Terms

Franchise agreements should anticipate general change by building flexibility into the contractual framework. A good place to start is by creating leeway in the definitions section. Contract definitions should be drafted to make it clear to franchisees at this early stage that certain changes are possible and indeed are contemplated. Crystalizing product lists, services, or equipment is unnecessarily restrictive and inappropriate for most sectors of the market. For example, retailers and restaurant chains will not want to limit themselves to an exhaustive list of products or menu items. Open-ended definitions minister (at least partially) to this concern.

Some of the more common definitions that might be useful to franchisors contemplating change are as follows[7]:

[6] The duty of good faith and fair dealing will be discussed below. This paper will not address some of the more standard risks to contractual performance that are not franchise-specific, including fraud and misrepresentation claims that arise from the sale process.

[7] Please see the Appendix for further examples.

> **"Products"** means all goods and merchandise of any kind or type whatsoever which have been approved by the Franchisor, from time to time and in its discretion, for sale in or from the [Restaurant/Store], whether supplied to the Franchisee by the Franchisor, its Affiliates or a third party;
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> **"Services"** means [description of services offered by Franchisor] and any such other ancillary or related services provided by the Franchisee in connection with the operation of a Franchised Business as the Franchisor may designate from time to time;
>
> **"System"** means the uniform standards, procedures, methods, techniques, materials, marketing identity, specifications and know-how formulated and developed by or on behalf of the Franchisor as they may be added to, changed, modified, withdrawn or otherwise revised by the Franchisor in its discretion from time to time for the operation of a Franchised Business;
>
> **"Trademarks"** means those trademarks, trade names, designs, graphics, logos and other commercial symbols as the Franchisor may designate from time to time, to be used in connection with the operation of a Franchised Business, whether or not they are registered or the subject of application, including but not limited to the trademarks [trademarks of Franchisor], and variations or combinations of the trademarks (including any colors claimed as a feature of the trademarks), in word or design form.

While the foregoing definitions have some flexibility built in and should make the franchisor's intent to allow for system change clear, these definitions must be coupled with covenants to provide/implement/purchase the products, services, or equipment. For example:

> In order to maintain the high quality and uniform standards, methods, procedures, techniques and specifications associated with the Products and the Services, the Trademarks and the System, and to promote and protect the goodwill associated therewith, the Franchisee and the Principal (where applicable) agree as follows (at the Franchisee's sole expense unless otherwise indicated):
>
> - to sell the Products and only the Products, and offer only those Services that have been approved in writing by the Franchisor. The Franchisee acknowledges that the Products authorized for sale may vary from time to time and from [NAME OF FRANCHISE SYSTEM] to the Franchised Business at the Franchisor's discretion based on local or regional market considerations, particular covenants or restrictions in the Lease for the Authorized Location, or for test market purposes;
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> - to purchase all Products and Services from Approved Suppliers only, as designated from time to time by the Franchisor, which suppliers may include Affiliates of the Franchisor;

- to implement and at all times operate the Information Systems and POS System as the Franchisor may designate or approve from time to time (including replacement or upgrading of same whenever the Franchisor determines that all or any part of the Information Systems or POS System may have become obsolete or technologically outdated) and that are appropriate for the Franchisee's operation as a [NAME OF FRANCHISE SYSTEM] Franchisee and strictly in accordance with instructions from the Franchisor or as outlined in the Manual, and to permit the Franchisor to have physical and remote electronic (by way of modem or otherwise) access to the Information Systems and POS System at any time and from time to time.

Alternatively, franchisors may rely on a general change or reservation of rights provision with very broad language. While these have proven a fairly wide shield in court challenges involving menu and pricing changes,[8] the franchisor is relying on a court's interpretation. In addition, as soon as a dispute goes to litigation, the franchise network has already been damaged. For reasons described below, it is preferable to be able to point to specific language for anticipated changes as opposed to merely relying on general change provisions.

Franchisors can also consider incorporating a non-waiver provision, an example of which would read as follows:

> The failure of the Franchisor to exercise any right, power or option given under this Agreement, or to insist upon the strict compliance with the terms and conditions of this Agreement by the Franchisee and the Principal shall not constitute a waiver of the terms and conditions of this Agreement regarding any other or subsequent breach of such terms and conditions or default under this Agreement, nor a waiver by the Franchisor of its right at any time after such breach to require strict compliance with all terms and conditions of this Agreement.

A non-waiver provision can help accommodate change decisions that are already authorized but have not been enforced. Enforcing previously-neglected provisions is not without legal risk, as waiver, estoppel, and even disclosure issues may arise. Still, such provisions are a means to institute system change if many contract clauses have been left dormant (sometimes by a previous franchisor). Regardless, unenforced provisions are not a backdoor to contract modification and this provision should not be relied upon exclusively. If a new franchisor is confronted with unenforced provisions, it must first seek to understand why the provisions were neglected and determine if any representations have previously been made. Ideally, any major new enforcement of existing provisions should be accompanied by a "New Day" letter. These circulars alert franchisees of new enforcement policies by indicating which provisions will be enforced, the purpose of such new enforcement, and the timing of the change.[9]

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[8] Scott, *supra* note 4 at 18-20.

[9] *Ibid* at 7.

2. Specific Provisions for Material Changes

While general terms are useful for laying the foundation for change, specific provisions that contemplate particular changes are preferable as means to implement significant modifications. Indeed, "where the contemplated change is considered 'material', courts may require specific language in the franchise agreement conferring upon the franchisor the authority to make the proposed material change".[10] Furthermore, where the proposed change deals with aspects of the system addressed in a specific clause, courts will apply the specific clause instead of the general reservation of rights clause, the latter being shakier ground upon which to rely.[11] Finally, including such provisions in a franchise agreement alerts the franchisees to the specific types of changes to expect and makes clear the obligation to comply with or implement such changes.

For many franchisors, some changes are easily foreseeable and the franchise agreement should authorize such alterations to the system. For instance, a restaurant would likely want the flexibility to change menu items and the authorized products or ingredients in their food items. Almost all businesses would likely desire the option of re-branding if necessary. Some examples of contract provisions contemplating specific change are set out below.[12]

The following is an example of an Authorized Menu clause. Note the explicit authorization to make modifications:

> The Franchisee acknowledges that it is in the interest of the Franchisee, the Franchisor and all other [NAME OF FRANCHISE SYSTEM] Franchisees that the uniform standards, methods, procedures, techniques and specifications of the System must be fully adhered to by the Franchisee. Accordingly, the Franchisee shall offer for sale only the Products and the Services of such menu items and other food and beverage Products as Franchisor designates and approves in writing from time to time for sale by the [Restaurant] as set out in the Manual or otherwise. The Franchisee must offer for sale from the [Restaurant] all items and only those items listed as menu items and other approved food and beverage products. *The Franchisor has the right to make modifications to these items from time to time, and the Franchisee agrees to comply with any modifications. The Franchisee agrees that the Franchisor may from time to time add or delete authorized Products and/or Services upon notice to the Franchisee.* The Franchisee may not offer or sell any other Product or Service at the Authorized Location without the Franchisor's prior written consent.

The following is an example of an Authorized Products and Ingredients clause, similarly expressly permitting modifications:

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[10] *Ibid* at 23.

[11] *887574 Ontario Inc. v Pizza Pizza Ltd.*, [1995] OJ No 936.

[12] Please see the Appendix for further examples.

> The Franchisee must use in the operation of the Franchised Business and in the preparation of menu items and other food and beverage products only the proprietary and non-proprietary ingredients, recipes, formulas, techniques, processes and supplies Franchisor designates, and prepare and serve the menu items and products in such portions, sizes, appearance, taste and packaging, all as the Franchisor specifies in the Manual or otherwise in writing. *The Franchisee acknowledges and agrees that Franchisor may change these requirements periodically and that the Franchisee is obligated to conform to the then-current requirements.* The Franchisee acknowledges that the [Restaurant] must at all times maintain an inventory of ingredients, food and beverage products and other Products, materials and supplies that will permit operation of the [Restaurant] at maximum capacity. The Franchisee must place a minimum initial order for Products, ingredients and supplies as set out in the Manual or as we may designate in writing in connection with your particular [Restaurant] opening.

Within the trademarks provisions of the franchise agreement, the possibility of wholesale change should be made clear:

> In the event it becomes advisable at any time in the discretion of the Franchisor for the Franchisee to modify or discontinue use of any of the Trademarks, including the [PRIMARY BRAND NAME OF FRANCHISE SYSTEM] trademark, or use one or more additional or substitute names or marks, the Franchisee agrees to do so. Any costs associated with such changes will be borne solely by the Franchisee.

The word "system" is often used to describe the entire network, illustrating its role as the identity of a franchised business. Thus, most franchise agreements will make it clear in several places that the "System" is liable to be changed regularly. It is important to make this as explicit as possible with a specific change provision:

> The Franchisee recognizes that variations and additions to the System will be required from time to time to preserve and enhance the public image of the System, to accommodate changing consumer trends and to ensure the continuing efficiency of the System generally. The Franchisee acknowledges and agrees that the Franchisor may, from time to time, upon written notice to the Franchisee add to, subtract from or otherwise change the System, through the Manual or otherwise in writing. These changes may include, without limitation, the adoption of new or modified trademarks and trade names, new products, services, renovations, equipment, fixtures, furnishings and signs, and new techniques relating to the sale, promotion, and marketing of the Products and Services and other products and services. The Franchisee agrees to promptly accept, implement, use and display all such changes to the System in the conduct of the Franchised Business, at the Franchisee's sole cost.

It is also important to include the franchisor's right to compete with the franchisees through various methods. This type of provision should open the door for the franchisor to embrace in-territory alternate distribution models (such as internet sales), nontraditional locations, and national or institutional accounts, allowing for flexibility in how the franchisor gets its products and services to market. The clause should also explicitly permit the franchisor to acquire (or be acquired by) a competitor. Franchise mergers can be risky, but they can also pay serious dividends in the form of significant and immediate growth for the franchisor, as well as increased economies of scale and buying power across brands that serve to benefit franchisees.[13] Addressing these types of "encroachment" issues is usually done in a "reservation of rights clause," an example of which follows:

> Nothing in this Agreement will preclude the Franchisor from directly or indirectly establishing, operating, distributing, selling, licensing or franchising the distribution or sale of products or services under the Trademarks, through any distribution channel or method.
>
> The Franchisor expressly reserves the following rights for itself and/or its Affiliates:
>
> - the right to develop, market, own, operate or participate in any other business under the Trade-marks or any other trade-marks;
> - the right to establish and operate or grant any other person the right to establish and operate a Franchised Business located anywhere under any terms and conditions the Franchisor deems appropriate and regardless of their proximity to the Authorized Location or their actual or threatened impact on sales of the Authorized Location;
> - the right to develop, use and license the use of, at any location, proprietary marks other than the Trademarks, in connection with the operation of a program or system which offers products or services which are the same as or similar to and which may compete with the Franchised Business;
> - the right to develop, market, own, operate or participate in any business other than a Franchised Business under the Trademarks or any other trademarks;
> - the right to acquire the assets or ownership interests of one or more businesses providing products and services similar to those provided by the Franchised Business, and franchising, licensing or creating similar arrangements with respect to such businesses once acquired, wherever these businesses (or the franchisees or licensees of these businesses) are located or operating;
> - the right to be acquired (in whole or in part and regardless of the form of transaction), by a business providing products and services similar to those

[13] The right to be acquired might wisely be accompanied by a provision granting the franchisor the power to assign all of its rights under the franchise agreement. Please see the Appendix for an example.

provided by the Franchised Business, or by another business, even if such business operates, franchises and/or licenses a business involved in the offer or sale of products or services which are the same as or similar to and which may compete with the Franchised Business; and

- the right to establish a website to promote the Franchisor and/or the Franchised Business, which website may, in the Franchisor's discretion, include a page specific to each Franchised Business.

Note that the provision above permits the Franchisor to compete, directly or indirectly, with the Franchised Business and would need to be modified for use in a franchise model that grants franchisees an exclusive territory. Even if such language is present in a franchise agreement, a franchisor that is openly and significantly competing with its franchisees must still consider possible, including breach of good faith, contract breach, misrepresentation or even fraud.

B. Operations Manuals

A franchise network's Operations Manual is another useful vehicle to effect system-wide changes. The Operations Manual is a "word picture of the franchise system" that anatomizes the day-to-day procedures that constitute the System[14]; it is the main tool for the franchisor to maintain uniformity, quality, and control over the daily operations of franchises. The Manual can address concerns as discrepant as accounting, advertising, construction, design, equipment, insurance, management, and even crime prevention.[15] Thus, changes to the Operations Manual—however minute—can have an outsized impact on the entire franchise network.

There are many advantages to making system changes through the Operations Manual. Small changes can ripple across the network as all franchisees respond to system modifications. Thus, changes can be made system-wide at one time, rather than the gradual implementation that might be necessary if franchise agreements are not uniform in their flexibility. These changes are also easy to make and justify; it is expected that the "System" will change regularly, especially if that fact is specifically articulated in the franchise agreement. There is not likely to be a significant amount of franchisee pushback (unless there is an attempt to surreptitiously increase fees or make wholesale changes to the business model) and Operations Manuals often include detailed operational procedures to guide the implementation of the change. Finally, many Manual changes address day-to-day operational obligations that are not disclosed in detail in franchise disclosure documentation, meaning the franchisor can avoid dealing with some

[14] Morse, *supra* note 2 at 1.

[15] The minute detail in an Operations Manual also runs the risk of creating liability, especially with recent joint employer concerns. A full discussion of Operations Manuals is not within the scope of this paper, including the concomitant control and intellectual property concerns. See Morse, *supra* note 2 at 18.

onerous legislative obligations (such as disclosure, FDD amendments, and registration) as it interacts with prospective franchisees.[16]

Of course, there are some drawbacks to relying on the Operations Manual to effect changes. The Manual is not an appropriate vehicle for significant alterations; it is not a backdoor to fundamental modifications and "material" changes should still be done by way of the franchise agreement. As a method of unilateral system modification, changes implemented via the Operations Manual should be limited to those that were reasonably foreseeable at the time of contract execution.[17] Franchisees are unlikely to assume the role of quiet spectators if the changes make significant deviations from the franchise model or require a substantial financial commitment. However, procedures can be built into the franchise agreement describing the process for implementing system changes, stretching the timeframe in which the new systems must be implemented, or capping a franchisee's required cash commitment to Operations Manual changes.[18]

There also remains the risk of breaching the duty of good faith and fair dealing, even if all of the above cautions are taken into account. Regardless, the Operations Manual is the clearest and easiest way to make a large number of minor changes with major impacts across the network.

The seeds of a dynamic Operations Manual are planted in the franchise agreement, beginning with a carefully open-ended definition:

> **"Manual"** means, collectively, any operations manuals, policy manuals, training manuals, bulletins, policies, rules of operation, video tapes, computer software, pamphlets, memoranda, formulas or recipes, directives, instructions, books and other materials (whether in written, machine readable, electronic or any other form) setting out the standards, procedures, methods, techniques and specifications of the System as the same may be amended, revised, withdrawn or replaced from time to time;

This definition must be coupled with a covenant to comply with the Manual, including some of its more specific prescriptions. This is particularly useful to account for common operations changes, such as those dealing with product handling, trade dress, or technology:

> In order to maintain the high quality and uniform standards, methods, procedures, techniques and specifications associated with the Products and the Services, the Trademarks and the System, and to promote and protect the goodwill associated therewith, the Franchisee and the Principal (where applicable) agree as follows (at the Franchisee's sole expense unless otherwise indicated):

16 Scott, *supra* note 4 at 16.

17 *Ibid* at 7.

18 *Ibid* at 7-8.

- to comply with all mandatory standards, methods, procedures and specifications from time to time prescribed by the Franchisor in the Manual or otherwise in writing relating to the appearance or operation of the [Restaurant] and Franchisee's operation as a [NAME OF FRANCHISE SYSTEM] Franchisee;

- to implement and at all times operate the Information Systems and POS System as the Franchisor may designate or approve from time to time (including replacement or upgrading of same whenever the Franchisor determines that all or any part of the Information Systems or POS System may have become obsolete or technologically outdated) and that are appropriate for the Franchisee's operation as a [NAME OF FRANCHISE SYSTEM] Franchisee and strictly in accordance with instructions from the Franchisor or as outlined in the Manual, and to permit the Franchisor to have physical and remote electronic (by way of modem or otherwise) access to the Information Systems and POS System at any time and from time to time; and

- to accept all major credit cards and utilize payment processors as designated by Franchisor in the Manual or otherwise;

Due to the Manual's signal importance to the franchise system, it is also wise to have a specific Manual change provision:

> The provisions of the Manual (as revised from time to time) and the mandatory standards, methods, procedures and specifications applicable to the System and the Franchisee's operation as a [NAME OF FRANCHISE SYSTEM] Franchisee, and such revisions made thereto from time to time by the Franchisor shall constitute provisions of this Agreement and the Franchisee shall comply with same as if fully set forth herein.
>
> The Franchisor shall have the right to add to, modify, withdraw from or otherwise revise the provisions of the Manual from time to time as provided for in this Agreement or to maintain the goodwill associated with the System and the Trademarks, provided that no such revision shall alter unreasonably the Franchisee's fundamental rights under this Agreement except to the extent permitted under Section ● of this Agreement and shall be made in good faith and in accordance with reasonable commercial standards.

A well-prepared franchise agreement with integrated Operations Manual provisions is a potent tool for instituting a wide variety of system changes.

III. Implementing Change

When a franchisor decides to implement a system-wide change, the first step is a due diligence process reviewing all franchise agreements to evaluate the contractual flexibility available. Not all franchise agreements in a network are identical, especially in a large system. The franchisor needs to determine if there is authority to make the change on the scale desired. It can then begin to construct a plan for implementation and franchisee buy-in.

Even if there is contractual authority to make the change, the franchisor must still be aware of statutory and common law obstacles to effecting the change. Absolute discretion does not exist; all exercises of contractual discretion must be filtered through the obligation of good faith and fair dealing permeating all franchise agreements. Franchise-specific legislation further dictates the manner in which franchisors can interact with franchisees. The complexity, urgency, and scope of the proposal will also have an impact on the change plan: Can it be enforced uniformly and consistently? Must it be implemented all at once or can it be gradual? Sometimes there is no practical choice but to do it quickly (such as a new menu or product line or the institution of a national accounts program), but some changes may be effectively rolled out on a slower timescale (such as trade dress or payment methods).

Besides strictly legal concerns, the franchisor will need to consider the franchisor-franchisee relationship(s) before implementing the change. Even with authority, franchisors should rarely institute major changes—especially those involving significant financial commitments—without advance notice to and consultation with franchisees. The complex structure of large franchised networks makes the franchisee relationships essential, and involving franchisees along the way will be critical for achieving a successful transition. It also allows the franchisor a degree of control over the perception of the change. If there is no contractual authority for the modification (or if it is ambiguous), the franchisor will have to be more creative and more reliant on the relational suggestions below.

The major pitfalls along the route of implementing system-wide change are: (A) the obligation of good faith and fair dealing and (B) the various modalities and complexities of franchisee involvement in the change process. The hurdles to successfully implementing change are often more about the relationships than the law itself.

A. Good Faith and Fair Dealing

Good faith and fair dealing has particular relevance to franchise law due to the variety of ways it can be invoked and its unique impact in a relationship-dependent business model. While the duty often arises from the express terms of a franchise agreement, the common law also implies a duty of good faith on all parties to a franchise contract. In addition, certain US states and Canadian provinces impose a duty of good faith and fair dealing on parties to franchise agreements via franchise-specific legislation. Legislators clearly consider the duty of good faith to be an important check on franchise relationships and the duty's nature and scope are routinely debated in court.

Nevertheless, as currently understood, good faith and fair dealing is not an additional term or an overriding prescription that alters express contractual provisions. Rather, it informs the manner of performance of any contractual discretion or enforcement of any contractual obligation. This is particularly relevant for system changes, as building flexibility into a franchise agreement necessarily incorporates a degree of discretion, especially when relying on broad, general change provisions.

Contract performance and exercises of discretion are heavily context-specific, and the duty of good faith will continue to be refined by jurisprudence. While the case law that informs the content of the duty of good faith will be discussed further below, Scott et al. distil the North American jurisprudence down to four guiding principles:

- The franchisor's motive matters;
- Contractual discretion must be exercised reasonably;
- The courts will defer to the franchisor's business judgment; and
- Engaging in meaningful dialogue with franchisees regarding the change will aid in defending allegations of a breach of good faith.[19]

Unless the franchisor has a nefarious motive for implementing change, the best way to demonstrate good faith is to show a strong business case for exercising the franchisor's discretion to modify the system.

B. Franchisee Communication and Consultation

It is often wise to involve franchisees in the change process; how that communication and consultation strategy is managed will have a significant impact on the success of the change. The franchisor-franchisee relationship is critical to the health of the network. While not all change decisions can reasonably be made with system-wide participation, an effort should be made to involve franchisees where appropriate. Implementing change over the voice of franchisee objections may not be sustainable in the long run.

Much like contractual preparations, the franchisor must lay the groundwork for change in advance. It is crucial to have a plan for each individual change and set goals for implementation. This plan should address the mechanics and purpose of the change itself by including a detailed and well thought-out business case. It should also contain a strategy for franchisee buy-in.

Franchisees should know that occasional system change is inevitable. However, that does not mean that franchisors will not have to overcome some resistance, especially in larger networks. The change (and the network) is far more likely to be successful if the franchisor and franchisees commit—together—to make the modification.

1. Creating a Business Case for Change

Franchisors must be prepared to make a business case for network-wide change, and there will often need to be a clear economic reason in the foreground. The nature,

[19] Scott, *supra* note 4 at 29-30.

scope, and timing of a proposed change must then be planned and evaluated. If this change can be convincingly justified, that justification quickly becomes the most important tool for franchisee buy-in. A convincing business case is an invaluable tool for securing franchisee support for system change. This has special relevance if there is no explicit authority for unilateral change in the franchise agreement. Furthermore, as long as there is a sound business case, courts appear very respectful of a franchisor's business judgment regarding a system change.[20]

Of course, if so much depends on a business case, that case must be built on diligent research. This research should include an analysis of the customers, culture, competition, demographics, and future of the market in which the franchise network is situated. The franchisor should identify all potential positive and negative impacts of instituting the considered modification. The goal is to demonstrate a return on investment for the entire network, even if it is only in the long run.[21] A change that is effectively a backdoor to increasing licence fees or that provides no benefit to the franchisees will meet zealous resistance. If undergoing multiple changes simultaneously or consecutively, the franchisor should factor them all into the business case and projection so that a holistic, informed business opinion can be developed.

This research must also encompass a significant appreciation for the prospective change's impact on the franchisee relationships. The potential benefits and drawbacks of the change on all franchisees must be considered. This will include identifying any potential causes of action that may be levelled against the franchisor for the change. Franchisees are not typically homogeneous—changes will affect individual franchisees differently, especially in large networks spread across diverse areas. Not all modifications will benefit all franchisees, even if the broader business case is sound.

The business case research will help the franchisor to identify the risks and control the perception of the change in advance. The franchisor will likely have to "sell" the change to some (or all) of the franchisees, so it must be aware of the concerns as soon as possible. "Selling" will be particularly difficult where the change cannot be dressed up as a business opportunity, such as a behind-the-scenes technology or distribution channel upgrade. Furthermore, the franchisor will likely need to convince a significant majority of the franchisees to accept the modification. Unless that threshold is met, it may not make sense to go ahead with the change in the face of franchisee objections,

[20] *Ibid* at 35. See, for example, *Fairview Donut Inc. v The TDL Group Corp.*, 2012 ONSC 1252.

[21] The return on investment need not be as purely "financial" as the phrasing implies. An update to replace superannuated technology can improve efficiency, the customer experience, or network integration and achieve benefits that are not immediately quantifiable. See Lorinda Church et al, "Franchising and Technology: Staying Current and Managing Change" (Paper delivered at the IFA Annual Legal Symposium, Washington, DC, 15-17 May 2011) at 3.

regardless of the persuasiveness of the business case.[22] The damage to the network and potential litigation costs may not be worth the system upgrade.

If the proposed change involves introducing a new product or service, the franchisor should explore whether it is possible to pilot test the change before expanding it to the rest of the network. Pilot testing can allow the franchisor to refine the modifications, observe any impacts, and document the effects for the business plan.[23] Any operational hurdles can be identified early and any actual damages will usually be much smaller. Pilot testing at corporate locations has the added benefit of showing that the franchisor has "skin in the game," too — a demonstration of good faith. If there are no corporate locations, the franchisor may need to be more creative by soliciting the involvement of franchisees with whom it has a good relationship or by using some of the financial incentive plans outlined below.

Research will inform the change strategy—a strategy that should include not only how to make the change, but how to secure broad franchisee support. A solid business case with convincing projections is something of a trump card for system-wide changes. Despite some predictable objections, it can override many of the concerns outlined in this paper, although the franchisor will need to consider and address any franchise disclosure issues raised by the use of such projections.

2. Communicating Changes to the Network

Franchisors must also be strategic in communicating with franchisees about network modifications. How and when changes are communicated can impact the success of the alteration and the health of the franchisee relationships. With respect to timing, the franchisor has a delicate balance to strike. If the decision to implement a system-wide change is shared before adequate research has been done, the franchisor may not be able to convincingly answer the questions that will surely arrive.[24] If the franchisees then become suspicious and concerned, the franchisor may have unwittingly granted them plenty of time to organize coordinated opposition to the modification before a solid case can be developed.[25]

On the other hand, if the franchisor does not involve the franchisees until the change plan is effectively finalized, the franchisor may lose the benefit of relevant input from experienced franchisees and be forced to "sell" the system change to others without the possibility of an influential endorsement from prominent franchisees or a Franchisee

[22] Asbill, *supra* note 1 at 18-19. To the extent that a threshold of franchisee adoption is set, franchisors should consider whether it is wise to disclose that threshold publicly—it might create a larger risk of holdouts.

[23] *Ibid* at 5.

[24] Scott, *supra* note 4 at 38.

[25] Church, *supra* note 21 at 28.

Advisory Council.[26] The loss in trust may not be worth the ability to develop the plan in private.

Practically speaking, the franchisor must attempt to reconcile these two potential problems. For example, the franchisor can still develop the plan for change in relative secrecy and only seek the franchisees' input when it is close to finalized; however, there needs to be an opportunity for meaningful franchisee contributions. One solution is to develop the bulk of the plan but highlight potential alternative strategies and solicit feedback from the franchisee association or council on those options.[27]

Some changes will be urgent or will not lend themselves to group discussion. Nevertheless, the franchisor should still inform the franchisees of a coming change as soon as appropriate. If the franchisor can clearly articulate a change proposal, back it up with a business case, and provide the franchisees with an opportunity for feedback (even if not amending power), it will be well on its way to successful implementation.

3. Franchisee Advisory Councils and Franchisee Associations

The franchisor should also carefully consider to whom the proposed change will be communicated. In this respect, Franchisee Advisory Councils (FACs) and (in some systems) independent franchisee associations can be valuable interlocutors, both with respect to the proposed change itself as well as the change "sales process."

FACs and independent franchisee associations can provide useful input on the proposed change itself. Experienced franchisees can offer suggestions for implementation or even help test the modification and submit feedback. The franchisor might even consider encouraging the creation of standing or ad hoc committees to deliberate on changes.[28] Another benefit of running changes through a FAC or association is the ability to get a sense of the contentious issues before the change has been rolled out. Furthermore, if the franchisor wishes to pilot test a new product or service, a FAC or association is a good way to find potential candidates.[29]

FACs and franchisee associations can also be instrumental in building broader support among franchisees for the system change. In this sales process, the franchisor should attempt to conscript the help of those who can present the modification in the best

[26] Scott, *supra* note 4 at 38.

[27] Asbill, *supra* note 1 at 16.

[28] Scott, *supra* note 4 at 38-39. Examples of standing committees include those dedicated to Marketing, Operations, Development, Profit, or Technology.

[29] While every system change is different, pilot testing is a good opportunity to demonstrate good faith and help build a business case. As such, FAC or franchisee association meetings can give a good sense of who is likely to support or object to a modification. It may be useful to request franchisees who typically resist system changes to take part in the pilot project as a show of good faith. In other circumstances, it might be better to select keen franchisees who are likely to help build a business case.

possible light. If the franchisor can get the support of a FAC or association, they can become network ambassadors for the change and significantly aid in obtaining franchisee buy-in. The franchisor's relationship with the FAC or franchisee association, or even with prominent franchisees, will be of paramount importance if the change is of borderline benefit or is part of a series of system alterations. Inversely, a poor relationship with franchisees involving a lack of trust or communication can quickly founder a change. While not all brands have FACs or franchisee associations,[30] that does not mean that the franchisor cannot solicit feedback. Certain prominent or experienced franchisees can play a similar role, although without the useful administrative framework.

Influential franchisee involvement can also be helpful in the case of post-implementation disputes. Prominent franchisees can support and communicate with their dissatisfied peers and, if necessary, apply some pressure to implement the change. If a dispute escalates to litigation, courts appear more receptive to changes when there is evidence of franchisee buy-in:

> Additionally, the Court referred extensively to Tim Hortons' mechanisms for consulting with franchisees on products, methods, and other issues in general and to Tim Hortons' extensive consultation with the franchisees on the menu and pricing changes at issue in the case. The Court's emphasis on this evidence suggests that formal and well-documented consultation with franchisees prior to implementing changes to the franchise system will assist the franchisor in defending allegations of breach of good faith and fair dealing from those franchisees. Tim Hortons' conduct in this case is often referred to in Canada as the "gold standard" for implementing system-wide change.[31]

Ideally, the franchisor should aim for an open and genuine relationship with franchisees. The following are some sample strategies for franchisors to foster collaborative relationships with franchisees:

- Hold regular meetings with franchisees, including "town meetings" for executives of the franchisor to present any proposed changes to franchisees personally;
- Participate actively in franchisee meetings and collaborate on agendas and discussion points;
- Make sure the FAC or association has diverse representation, is able to report freely and directly to the franchisee network and participate in the FAC or association orientation activities for new members;
- Be frank, open, and willing to accept constructive criticism and feedback;
- Be accountable and respectful by acknowledging difficulties or areas that could be improved;
- Be responsive to franchisee suggestions, including prompt follow-up; and

[30] See the Appendix for a sample provision granting the franchisor the right to establish an advisory council.

[31] Scott, *supra* note 4 at 35-36, citing to *Fairview Donut Inc. v The TDL Group Corp.*, 2012 ONSC 1252.

- Include FAC or association representatives in the brand's orientation programs for new franchisees.[32]

If, despite attempts to communicate and/or collaborate, the franchisees refuse to support the proposed change, the franchisor may still have the authority to follow through unilaterally – depending, of course, on contractual language. However, exercising this authority and disregarding franchisee opinion creates a serious risk of long-term damage to the franchise network. If system modifications are urgent, sensitive, or highly technical (and therefore unsuited to broad consultation), it would still be wise for the franchisor to update the franchisees by giving background information and the reasons for the change. Ideally, franchisors and franchisees would collaborate fully and openly on all changes; in reality, this is unlikely. Even if franchisee suggestions are not (or cannot be) followed, it is good practice to hear their concerns and foster open communication.

4. Incentives

If, despite the franchisor's best efforts, the above tactics are insufficient to garner support for the change, the franchisor may have to provide incentives to encourage franchisee participation and manage naysayers. The franchisor can usually expect some challenges to proposed changes, especially in large systems, so it may have to consider providing incentives even in cases of a broadly worded agreement that clearly allows for system change. Furthermore, incentives can be a useful way to get early participation and develop an evidence-based business case. Either way, the change plan should include a strategy for dealing with holdouts that addresses possible incentives. As a general rule, it is likely better for the long-term health of the network to encourage early participation rather than discourage abstention.

Incentives can be a good way to establish early adopter programs; these can function as tests to help develop a business case. Such programs allow franchisors to fine-tune the proposed change, gather data on the positive and negative impacts, and can build momentum for broader implementation in the future. If successful, they can serve to demonstrate value or dispel doubt by "quantifying the costs, disruption and ease of implementation to the franchisees".[33] As in other testing projects, it is important for the franchisor to pick the right participants for its programs and be open about the results. This means not only including a representative sample of franchisees, but may mean selecting franchisees who have historically been critical of franchisor decisions.

Incentives can also help foster franchisee support in situations: where the franchisor lacks the contractual authority to force the system change unilaterally; where the business case favours the franchisor more than the franchisees; and where there is initial pushback from franchisees on the proposed change.[34] The franchisor may also

[32] See Asbill, *supra* note 1 at 18 and Scott, *supra* note 4 at 37-38.

[33] Scott, *supra* note 4 at 40.

[34] *Ibid*.

have to provide meaningful incentives if early adopter or business cases fail, or if it simply wants to expedite the change process.

Incentives come in many forms and are not limited to direct financial assistance. Some examples include:

- Financing or arranging for favorable financing or lease terms from third parties;
- Sharing the cost of equipment or personnel;
- Short-term royalty reductions;
- Special marketing programs or contributing advertising funds from other sources;
- Reduced prices on required products;
- Deferring or offsetting costs in other areas, like non-essential image updates or purchases;
- Compensating—financially or territorially—for the loss of rights after an acquisition or new distribution channel encroaches on a franchisee's territory; or
- Increasing the term of the agreement or lengthening the timeframe for the change (or a different change being implemented).[35]

As permitted by relevant agreements, a franchisor can force through the change if incentives are insufficient to convince holdouts. However, the franchisor should be certain of its contractual authority, and it is preferable to wait until a significant majority of franchisees have accepted the modification (and been convinced of its value). One way or another, the franchisor cannot typically avoid having to convince a majority of franchisees. Still, a few persistent franchisees may put up enough of a battle to destroy the value-proposition. A final caution is that the timing of the incentives may be relevant: later incentive offers may frustrate franchisees who were early adopters of the change, and there will be pressure to distribute the incentives equally.[36]

C. Managing "Flux"

A frequent by-product of changes in large networks is a liminal state of old/new systems, especially for major modifications. This state is generally uncomfortable for a franchise network; losing uniformity is a loss of the hallmark of a franchised system, and the brand could be damaged as a result. Not only might the franchisor find itself dealing with simultaneous "old" and "new" franchises and franchise concepts, it might be forced to offer more than one type of support or training. Beyond simply offering consumers different products in different locations, a franchisor may also be forced to maintain different technology systems and service options within the same network. Sometimes this is not administratively or financially possible and it can have a detrimental impact on the brand and consumer experience. A prolonged state of "flux" can even have the undesirable effect of alienating early adopters and new franchisees who have bought into the new concept and are frustrated by the negative side effects of the dual system.

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[35] See Asbill, *supra* note 1 at 18 and Scott, *supra* note 4 at 40.

[36] Asbill, *supra* note 1 at 20.

As system changes are implemented, a franchisor might find itself in such a state of "flux" if:

- Only some franchise agreements permit the change;
- For technical reasons, the change needs to be rolled out gradually;
- A national brand has staggered the rollout by geography, volunteers, system integration, etc.; or
- Incentives or shared capital costs of the upgrade have forced a tiered implementation.

If the franchisor is the cause of the staggered implementation of the system-wide change, the franchisor may need to consider providing financial relief (i.e., a reduction in advertising fee contributions) to those franchisees still operating under the old system. The franchisor should also consider whether the dual system needs to be addressed in the franchise disclosure document.

While much of the foregoing relational advice has eschewed strict legal principles, all franchise guidance must be informed by its judicial and statutory underpinnings. This is particularly true of the broad, contextual prescriptions like good faith and fair dealing. While franchisors typically aim to avoid litigation, general principles gain shape and context in judicial proceedings; important lessons can be learned from case law. The numerous moving parts in a network-wide system change can only be assessed from a legal perspective with an overview of franchise statutes and the judicial deliberations that animate their expression.

IV. Judicial Perspectives on System Change

Franchisors largely control their ability to implement system-wide changes through the franchise agreement. Though the franchise agreement is the primary driver in determining what a franchisor can and cannot do, franchisors are also bound by the duty of good faith and fair dealing.[37] Furthermore, franchisors must comply with specific state relationship statutes that govern their conduct. These limitations on system change will be further explained in this section through discussions of key cases, along with recommendations for franchisors based on the case holdings.

A. Breach of Contract

1. Summary of Relevant Cases

Relevant case law suggests that clear contractual language in support of a system change, even a broad reservation of rights, is sufficient to defeat breach of contract claims from franchisees opposing changes to the system.

[37] The duty of good faith can be explicitly included in a contract but whether included or not, courts typically imply the duty and will conduct a similar analysis regardless of whether it is implied or contractual.

a) Clear Contractual Language

Common types of change that a franchisor may implement include altering distribution, changing product offerings, modifying design or architecture of franchise locations and technology upgrades. The cases in this section give examples of those types of changes and illustrate that no matter the type of change, explicit language in the franchise agreement will usually protect a franchisor in a breach of contract action.

First, a franchisor may modify its system by altering or adding distribution channels. Modifications related to distribution can raise concerns for franchisees who may fear competition from new channels, resulting in loss of sales. In *Carlock v. Pillsbury Co.*[38], Pillsbury, the franchisor and parent company of Haagen-Dazs, began selling its ice cream at convenience stores and supermarkets as opposed to solely through its franchised Haagen-Dazs shops. Franchisees suffered loss in sales and brought a breach of contract suit claiming that the convenience store and supermarket sales were inconsistent with the franchise agreement, which stated that "[f]ranchisor has created unique products of the highest quality, sold in the finest establishments." The court rejected the franchisees' claim for two reasons. First, the contractual language relied on by the franchisees was merely precatory and meant only to establish the franchisor's efforts to build goodwill. Second, and more importantly, the franchise agreement clearly provided for the franchisor's ability to sell its product through any channel in a separate provision that stated, "Franchisee acknowledges and agrees that Franchisor and the Haagen-Dazs trademark owner has the right and may distribute products identified by the Haagen-Dazs trademarks not only through Haagen-Dazs shoppes but through any other distribution method which may from time to time be established." Thus, based on this clear reservation of rights language, the franchisor did not breach the agreement by implementing new distribution channels.

Another common system change that a franchisor may want to implement is a change in the types of products or services being offered to customers. Product or service changes may disrupt the expectations of franchisees who have grown comfortable with established offerings. In *Economou v. Physicians Weight Loss Centers of America*[39], franchisees brought a breach of contract claim against Physicians Weight Loss Centers of America (PWLC), which offered a system for marketing a low calorie diet, when PWLC changed the diet being offered. Originally, PWLC offered a 700-calorie per day diet to customers, but in response to health concerns, the franchisor changed the program to a 900-calorie diet. Franchisees asserted that this change, which decreased the weight-loss guarantee franchisees could offer to customers, dramatically reduced sales. The court held there to be no breach of contract based on the explicit language in the franchise agreement reserving for PWLC "the right to modify or change the System . . . ." The court held that even this broad language expressly permitted the franchisor to modify the system, including the products offered by franchisees.

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[38] *Carlock v Pillsbury Co.,* 719 F. Supp. 791 (D.Minn. 1898).

[39] *Economou v Physicians Weight Loss Centers of America*, 756 F. Supp. 1024 (N.D. Ohio 1991).

Another type of change that is common for franchisors to implement is a modification in the appearance of franchised businesses, which may necessitate costly renovations to brick and mortar locations. In *Johnson v. Arby's, Inc.*[40], Arby's established a new, more expensive building design, and required all new restaurant locations to be constructed using the new design. Plaintiff, an Arby's developer, had agreed to open a specific number of restaurants and sought a declaratory judgment that Arby's could not require him to implement the new design on his yet to be constructed units. Though the franchisee argued that the requirement was a breach of the developer agreement[41], the court held there to be no breach because the developer agreement expressly permitted Arby's to modify building specifications by stating, "Arby's reserves the right in its sole discretion to vary its specifications, standards and operating practices and requirements . . .."

As evidenced by the cases cited in the previous two paragraphs, broad reservations of a franchisor's rights within the franchise agreement can defeat a breach of contract claim. *Bores v. Domino's Pizza LLC*[42] illustrates the outer limit of how broad of language a franchisor can use in a franchise agreement and remain guarded from breach of contract issues. In that case, a group of franchisees brought a breach of contract claim against Domino's after Domino's required all franchises to purchase and implement a new computer system. The franchisees argued that this requirement was in breach of their standard franchise agreement, which did not expressly say that Domino's could require franchisees to purchase software from Domino's. The agreement instead stated that that Domino's would provide "specifications" for "computer hardware and software" and that franchisees "may purchase items meeting [Domino's] specifications from any source." While franchisees argued that Domino's was only permitted to impose specifications and not require purchase of specific software *from* Domino's, the court held that the broad language permitted Domino's to do just that. The court determined the plain and ordinary meaning of "specification" to mean either a list of component parts *or* a specific, finished product, such as the software required by Domino's. The court further clarified that the language "from any source" did not alter the meaning of specification because in some instances, like this one, there may simply only be one source.

Although these four cases touch on different types of system changes, they all demonstrate the same point – contractual language permitting a change will stand up to a breach of contract challenge. The next two sections will alternatively illustrate

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[40] *Johnson v Arby's Inc.*, Bus. Franchise Guide (CCH) ¶ 12,018 (E.D. Tenn. Mar. 15, 2000).

[41] The developer's breach of contract claim was based on a provision in the developer agreement that said, "all licenses to be issued during the term of this Agreement will contain generally the same terms and conditions as are being uniformly offered to other licensees similarly situated at time [of] issuance." The developer alleged that Arby's was not imposing the new building design requirement consistently among its franchisees, thus breaching the agreement. Ultimately, the developer was unable to offer evidence that Arby's was inconsistently enforcing the requirement.

[42] *Bores v Domino's Pizza LLC*, 489 F. Supp. 2d 940, 946 (D. Minn. 2007), enforcement denied 2007 WL 3312272 (D. Minn. Nov. 6, 2007) and rev'd and remanded 530 F.3d 671 (8th Cir. 2008).

exceptions to this rule regarding material changes and franchisor course of performance where even clear language cannot protect a franchisor from a breach of contract claim.

b) Material Changes

While explicit reservations of power typically shield franchisors from breach of contract liability for common system changes, the situation differs when it comes to material changes. Generally, in a franchise context, material changes are those that would influence a reasonable prospective franchisee in deciding whether or not to purchase a franchise. Basic contractual language can raise issues for franchisors attempting to implement material changes to the franchise system. Though the previously discussed cases demonstrate that courts tend to permit broad system-wide changes under standard contractual reservations of power, the next case shows that material changes to a franchise system are not permitted as freely. Courts may only permit material system modifications when the franchise agreement contains specific language contemplating them.

In *Bird Hotel Corp. v. Super 8 Motels Inc.*[43], franchisor Super 8 required that franchisees offer a customer loyalty program. In conjunction with implementing the program, franchisees were required to pay an additional fee for participating in the program. The broad language in the franchise agreement that Super 8 tried to rely on to implement this change said that Super 8 "may, from time to time, make revisions in or amendments to such rules of operation. . . ." The court interpreted this language to only allow general changes but not specific *material* changes such as the imposition of a fee, holding that Super 8 was not permitted to "unilaterally impose a fee . . . greater than what is provided for in the language of the Agreement . . . ." Therefore, a franchisor seeking to make material changes to the system, particularly the implementation of a new fee, will likely not be able to rely on standard contract language that contains a broad reservation of rights. If a franchisor is able to anticipate future material changes it will want to make, specific language accounting for the change should be included in the franchise agreement.

c) Course of Dealing

When interpreting the language of a franchise agreement, a court may look to the behavior of the parties over time to make sense of how they intended the relationship to function. Consistent behavior over time can establish a course of dealing or performance between the parties that courts may rely on when ruling on a breach of contract claim. The first case discussed in this section will show that even in the face of clear language permitting a franchisor to make system changes, a court may consider contradictory behavior by a franchisor that indicates intent other than what is spelled out in the franchise agreement. The second case demonstrates an instance where the court analyzed party behavior in order to make sense of overly broad and vague contractual language.

[43] *Bird Hotel Corp. v Super 8 Motels Inc.*, 246 FRD 603 (D. S.D. 2007).

When deciphering the terms of a franchise relationship, a court may be more persuaded by a course of performance than the language of the agreement itself, even when the course of performance is contradictory to the language. In *Montgomery Mall Service, Inc. v. Motiva Enterprises, Inc.*[44], a plaintiff franchisee operated a retail gas station and had entered into a supply agreement with the franchisor, Motiva Enterprises. The franchise agreement gave the franchisor the right to set prices. Initially the defendant franchisor and its predecessor in the agreement had structured wholesale prices so that pricing was consistent for the entire county of Montgomery (where the franchisee was located). Later, the franchisor instituted a change in this pricing structure that resulted in a single franchisee having the highest prices in Montgomery County. Accordingly, the franchisee was unable to compete and lost a substantial amount of sales. The franchisor argued that the clear provisions in the contract allowed it to establish the new pricing structure. However, the franchisee argued that the pricing change was inconsistent with the prior course of dealing, which established consistent pricing throughout Montgomery County. Based on the possibility that course of dealing in this instance may have negated the express contractual provision, the court denied the franchisor's motion to dismiss.

Similarly, in *Stuller Inc. v. Steak 'N Shake Enters.,* the court considered the course of performance between the parties to interpret broad language in the franchise agreement related to pricing changes. When overly broad contractual language is used to reserve rights for franchisors, courts may rely on extrinsic evidence or course of dealing to determine the meaning of the language. In *Stuller v. Steak 'N Shake Enters.*[45], a franchisee sought a declaratory judgment that it did not have to comply with franchisor Steak 'N Shake's attempted implementation of a menu with set pricing and mandatory promotions. While the franchise agreement did give the franchisor the right to make changes to the "System," the Court agreed with the plaintiff franchisee that the language of the franchise agreement was ambiguous as to whether or not pricing changes were part of the "System." Given the ambiguity, the court turned to extrinsic evidence to make a determination. Prior versions of the franchise agreement contained a provision giving franchisees sole discretion over pricing, but the current agreement did not. While the absence of this provision could indicate that control over pricing belonged to the franchisor, the court found otherwise based on available evidence. Specifically, the court gave weight to negotiations between the parties indicating no intention to change pricing practices and memoranda from those negotiations showing that the parties intended the franchisee to have control over pricing. Steak 'N Shake's franchise disclosure document also stated that franchisees had control over prices. Ultimately, the court held that the franchisee did not have to comply with franchisor's policy change regarding set pricing.

2. Recommendations for Franchisors

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[44] *Montgomery Mall Service, Inc. v Motiva Enterprises, Inc.*, Bus. Franchise Guide (CCH) ¶ 11,839 (D. Md. Oct. 4, 1999).

[45] *Stuller, Inc. v Steak N Shake Enterprises, Inc.*, 2011 WL 2473330 (C.D. Ill. June 22, 2011), aff'd 695 F. 3d 676 (7th Cir. 2012).

While the available cases largely support a franchisor's ability to defeat a breach of contract claim with broad language, best practices dictate a more comprehensive strategy in drafting the franchise agreement. As discussed above, in order to better defend against breach of contract claims, franchisors should supplement the broadly-worded language reserving the right to change various aspects of the franchise system with more focused terms. Although it is difficult to anticipate what the future may bring in terms of opportunities for system growth and evolution, available case law demonstrates that the more specific language is, the more clearly a court may interpret it. Some aspects of a system that are likely to evolve over time and that lend themselves to more targeted contractual treatment include technology, marketing strategies, and alternative channels of distribution. For example, we recommend that franchisors reserve the right to not only change technology requirements in the future, but also to impose additional fees and alter the manner of payment of existing fees.

When franchisors review their franchise agreements as part of their annual update, they frequently look back and incorporate changes that address the actual issues that arose over the previous year. It's important that franchisors look forward as well, trying their best to foresee material changes they may want to implement in the future. Additionally, as evidenced by the final two cases cited above, it is crucial for franchisors to establish a course of performance that is consistent with their franchise agreement. In a breach of contract claim, courts may consider behavior of the parties when interpreting the contract, and patterns of behavior *inconsistent* with the contract could ultimately invalidate express terms.

B. Good Faith and Fair Dealing

1. Summary of Relevant Cases

Regardless of whether a franchise agreement expressly requires good faith and fair dealing by the parties, U.S. courts typically enforce an implied duty to act in good faith. Historically, challenges related to good faith and fair dealing have caused more problems for franchisors than breach of contract claims because franchise agreements generally have pro-franchisor language that can be used to support a system change. In rare instances, courts have concluded that, so long as a franchisor complies with the provisions of a franchise agreement, the franchisor cannot act in bad faith. However, the more common approach is that, even in the face of express language that permits a franchisor to make certain system changes, a court will evaluate whether or not the franchisor acted reasonably. This section will briefly summarize two cases that illustrate the exception to this rule before demonstrating the majority approach in more detail.

a) Minority Approach

Some courts take the approach that if a franchisor acts in compliance with the franchise agreement, the franchisor acts in good faith. In *Clark v. America's Favorite*

Chicken Co.[46], America's Favorite Chicken Company (AFC), the franchisor parent company of Popeye's Fried Chicken, acquired Popeye's competitor, Church's Fried Chicken. To differentiate between the two franchises, AFC established two different marketing strategies with Church's being marketed in lower-income urban areas and Popeye's being marketed in suburban and higher-income urban areas. When a Popeye's franchisee alleged that the new marketing campaign hurt its businesses by preventing it from advertising less expensive menu options and brought suit for breach of the implied covenant of good faith and fair dealing, the court found no breach. The court held that there cannot be a breach of good faith and fair dealing when a franchisor acts in accordance with the franchise agreement and here, the franchisor contractually had the right to adopt and develop competing franchise systems and therefore also had the right to market those systems effectively.

A different court followed similar logic in *La Quinta Corp. v. Heartland Properties LLC*[47] where a franchisor, as permitted by the franchise agreement, required its franchisees to purchase and utilize a new computer system, costing each franchisee approximately $35,000. A franchisee brought a claim against the franchisor alleging breach of the implied covenant of good faith and fair dealing. The court held the system upgrade did not violate the duty of good faith because the upgrade was expressly permitted in the franchise agreement, further stating that ". . . it would be a contradiction in terms to characterize an act contemplated by the plain language of the parties' contract as a bad faith breach of that contract."

b) Majority Approach

While courts periodically defer to the franchise agreement in analyzing good faith claims, they generally evaluate alleged breaches based on whether the franchisor's discretion, as expressly permitted by the contractual language, was exercised reasonably. In determining a franchisor's reasonableness, courts place importance on a franchisor's consideration of a decision's impact on franchisees, the franchisor's motives, and the business rationale for a franchisor's actions.

(1) Impact on Franchisees

A franchisor's consideration (or lack thereof) of the system change's impact on franchisees is critical to a court's determination of franchisor reasonableness. In *Carvel Corp. v. Baker*[48], Carvel implemented a new distribution channel when it initiated a supermarket program though which it sold its products at grocery stores. Prior to this system change, Carvel ice cream had been sold exclusively at Carvel retail stores, many of which were operated by franchisees. When Carvel brought an action seeking a declaratory judgment that its system change did not violate its franchise agreements, a

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[46] *Clark et al. v America's Favorite Chicken Co. et al.*, 110 F.3d 295 (5th Cir. 1997).

[47] *La Quinta Corp. v. Heartland Properties LLC*, 603 F.3d 327 (6th Cir. 2010).

[48] *Carvel Corp. v Baker*, 79 F. Supp. 2d 53 (D. Conn. 1997).

group of franchisees brought a counterclaim alleging breach of the implied covenant of good faith. While the franchise agreements in question either expressly gave Carvel authority to implement the program or simply did not forbid it, the court explained that a party to a contract can act in accordance with the terms of that contract, but nevertheless violate the implied duty of good faith.[49] Critical to the court's analysis was an examination of the potential benefits to Carvel that resulted from the implementation of the supermarket program and the potential benefits or detriments that the program inflicted on franchisees. While ultimately finding there to be an issue of fact as to whether or not Carvel had exercised good faith, the court considered whether the system change primarily benefited Carvel or was good for both Carvel and its franchisees. The court's focus in *Baker* highlights the importance of franchisor reasonableness in terms of benefit to the whole franchise system as opposed to benefit to the franchisor's bottom line. It is not enough for franchisors to simply comply with contracts while making self-serving business decisions – they must act with consideration of how their actions impact franchisees.

(2) Franchisor Motive

In addition to the effect of the system change on franchisees, courts place importance on a franchisor's motive when determining whether the franchisor acted in good faith. In *National Franchise Association v. Burger King*[50], a group of franchisees, in their capacity as members of the National Franchise Association, challenged Burger King for imposing a set value menu and mandating maximum prices. Franchisees alleged that in making this change, Burger King violated its contractual and implied duties to exercise good faith in setting maximum prices for franchisees. The franchisees' claim alleged that the new pricing caused the franchisees to suffer financial losses and possibly face bankruptcy. In evaluating whether Burger King acted in bad faith, the court stated that to act in bad faith within a contractual context means that a party has invoked a contract provision for a purpose contrary to that of the contract. The court clarified that this question hinges on reasonableness, explaining that if it can be shown that no reasonable person would have exercised discretion like the allegedly breaching party, one can infer that the party had an ulterior motive. Here, the court analyzed both Burger King's intentions and the franchisees' reasonable expectations. The court found no evidence indicating that Burger King had any motives other than promoting the performance of its franchisees and accordingly, found no showing of bad faith.[51] This case essentially highlights the importance of a franchisor's motive in determining reasonableness. An

[49] Plaintiffs in this case involved two groups of franchisees operating under different franchisee agreements. One version of the franchise agreement neither expressly permitted nor expressly denied the implementation of a distribution change like the one in this case. The other agreement expressly permitted it. Thus, at any rate, Carvel did not directly violate the terms of either form of franchise agreement.

[50] *Nat'l Franchise Ass'n v Burger King Corp.*, 715 F Supp. 2d 1232 (SD Fla. 2010).

[51] The court makes a distinction between the contractual duty of good faith discussed here and the implied duty of good faith. The court says that there cannot be a cause of action for a breach of the implied duty of good faith unless there is an allegation that an express term of the contract has been breached.

ulterior motive contrary to the goals of the franchise agreement is a clear indicator of bad faith by the franchisor.

Joc, Inc. v. Exxonmobil Oil Corp.[52] provides an example of a bad faith ulterior motive and demonstrates that when a franchisor seeks to deny a franchisee of its reasonable expectations under the franchise agreement, it is acting in bad faith. In this case, franchisees alleged that Exxon breached the implied covenant of good faith in a number of ways, including engaging in pricing practices that prevented franchisees from operating profitably. The court stated that the claim would hinge on whether Exxon had exercised "its discretionary authority arbitrarily, unreasonably, or capriciously, with the objective of preventing the other party from receiving its reasonably expected fruits under the contract." Ultimately, the court denied Exxon's motion to dismiss, finding that franchisee successfully stated a bad faith claim by alleging that Exxon knew its pricing decisions prevented franchisee from receiving the benefits they reasonably expected under the contract. The *Joc, Inc.* decision further confirms that in evaluating bad faith, courts place great emphasis on motive, as well as consideration of how changes will impact franchisees (as discussed in the previous section). The next section will discuss when courts look outside of franchisor motive to the actual business rationale behind franchisor decisions.

(3) Business Rationale

Besides impact on franchisees and franchisor motive, courts also consider business rationale when evaluating franchisor reasonableness. Unlike the analysis of franchisor motive, which focuses on whether a franchisor had a self-serving purpose, the analysis of business rationale focuses simply on whether the system change makes logical business sense. *In re Sizzler Restaurants Int'l, Inc.*[53] indicates that when courts analyze business rationale, they are concerned with the actual rationale behind the decision and whether it was based on sound business judgment, as opposed to the ultimate outcome of a franchisor's implementation of a system change.

In the Sizzler case, a franchisee alleged that Sizzler Restaurants had acted in bad faith when implementing a system-wide change related to its restaurant concept and marketing. Sizzler Restaurants had been operating with two different marketing models – one being a buffet concept and the other being a grill concept. Sizzler, having previously focused mainly on the buffet concept, shifted its marketing focus to the grill model. Though the franchisee claimed this marketing change was made in bad faith, the court held that the franchisee "failed to establish that Sizzler acted dishonestly or outside accepted commercial practices, or did so with improper motives, or arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties."[54]

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[52] *Joc, Inc. v Exxonmobil Oil Corp.*, 2010 WL 1380750 at *5 (D.N.J. Apr. 1, 2010).

[53] *In re Sizzler Restaurants Int'l, Inc.*, 225 B.R. 466 (Bankr. C.D. Cal. 1998).

[54] *Id.* at 5.

In coming to this conclusion, the court evaluated Sizzler's reasons for and rationale behind the marketing decision. First, the grill concept generated more revenue than the buffet concept. Second, Sizzler franchisees were generally struggling to maintain quality of the food offerings in the buffet. Third, Sizzler conducted and relied on marketing studies that indicated "diminished customer value perception" of Sizzler related to the buffet concept. Sizzler's decision to reorient its marketing was also supported by the marketing committee of Sizzler's board of trustees and the National Sizzler Franchise Association. Accordingly, the court granted summary judgment in favor of Sizzler on the claim that it had breached the implied covenant of good faith and fair dealing in the course of the marketing change. The Sizzler case makes clear that no matter the ultimate result of a business decision, a court will look at the reasoning behind it to evaluate whether a franchisor acted in good faith. The case also provides a good framework for the steps a franchisor can take to ensure it is making sound business decisions and thereby acting in good faith toward its franchisees. The next section illustrates a contrasting situation in which a franchisor, based on no sound business judgment, acted in clear bad faith.

(4) Clear Bad Faith

When a franchisor egregiously makes selfish business decisions that not only harm franchisees but are also unsupported by any study, market research, or other rationale, a franchisor, without a doubt, has acted in bad faith. *Amos v. Union Oil Co. of California*[55] illustrates such an instance of a franchisor acting in a self-serving manner with flagrant disregard for how its actions will affect franchisees and without a clear business rationale. In this case, franchisee gasoline dealers brought a claim alleging breach of duty of good faith against franchisor Union Oil Company of California (Unocal) when Unocal discontinued sales of a special grade gasoline and replaced it with a more common type of gasoline for only Unocal's Northwest dealers. Unocal, nonetheless, charged its dealers a similar high price for this inferior substitute product. When, to cover their costs, dealers had to sell the commonplace gasoline to their customers at a correspondingly high price, dealers were unable to compete with other gasoline dealers selling the same product to customers at lower prices.

Evidence indicated that Unocal conducted no studies on how this change would affect dealers but still recognized this risk of volume loss and simply ignored it. Unocal nevertheless implemented the change, knowing that the common product was priced too high to be competitive, yet all the while expecting its dealers to remain competitive in the marketplace. Unocal conducted no advertising to facilitate the product change and essentially used this product change in the Northwest region as a trial run for the whole system. Next, Unocal discontinued another of its premium products, but lied to its dealers by selling them an inferior product while labeling it as the discontinued premium product and invoicing it as such. Lastly, an internal communication at Unocal indicated that it clearly knew of the hardship it was causing its Northwest dealers. The memorandum stated, "Due to rapid erosion of competitive prices and our attempt to extract as much as

[55] *Amos v Union Oil Co. of California*, 663 F. Supp. 1027 (D. Or. 1987).

possible from the marketplace, we have placed our dealer organization in a very uncompetitive position. It is essential that we provide price relief as soon as possible." However, Unocal provided no such relief. A jury found Unocal to have breached both the implied and contractual duties of good faith and fair dealing.

c) Canadian Approach

The Canadian perspective on the duty of good faith and fair dealing accords generally with the American "Majority Approach" outlined above. While the context and express wording of the franchise agreement underlying the dispute is fundamental, even strict adherence to its terms is insufficient to ward off any claims of a breach of good faith. The duty of good faith and fair dealing applies to the performance and enforcement of the express contract terms and the exercise of any discretion under the franchise agreement.

The leading case on good faith in Canadian franchising is *Fairview Donut Inc v The TDL Group Corp*.[56] While the case addresses a series of important franchise issues—including class action availability, contract breach, and the pricing of products within franchise systems—Justice Strathy also conducted a comprehensive overview of the duty of good faith in the franchise context. After Tim Hortons instituted a lunch menu and a conversion to the "Always Fresh" baking method (which required franchisees to invest in new equipment), some franchisees responded to the new costs by launching a class action with a lengthy list of allegations. With respect to good faith, the franchisees claimed that Tim Hortons breached its duty of good faith by: misrepresenting costs and savings; exploiting their "captive supply" and placing unreasonably high costs on the franchisees; refusing to address franchisee concerns; and requiring franchisees to sell the lunch menu items at costs that prevented them from earning a profit.

In dismissing the franchisees' claims, Justice Strathy outlined the source, nature, and content of the duty of good faith and fair dealing. At common law, franchise contracts have unique characteristics that give rise to the duty of good faith[57]; it is widely accepted that this duty is codified directly into the provincial franchise statutes.[58] Good faith relates to the performance and enforcement of the franchise agreement.[59] Thus, while the parties' conduct must be considered in the context of and in conjunction with the contract that the parties have made, good faith is not a standalone duty that replaces or amends

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[56] 2012 ONSC 1252 [*Fairview Donut*], additional reasons 2014 ONSC 776, aff'd 2012 ONCA 867, leave to appeal to SCC refused, 35207 (16 May 2013).

[57] *Fairview Donut*, *supra* note 56 at para 497. These factors include unequal bargaining power at contract inception, the non-negotiable nature of most franchise contracts, and a power imbalance throughout the relationship.

[58] *Ibid* at para 495, citing to *Landsbridge Auto Corp v Midas Canada Inc*, 2009 CarswellOnt 1655 at paras 24 and 59 (SCJ); *Machias v Mr. Submarine Ltd*, 2002 CarswellOnt 1176 at para 114 (SCJ); *1117304 Ontario Inc v Cara Operations Ltd*, 2008 CarswellOnt 6444 at para 66 (SCJ). See, for example, section 3 of *The Arthur Wishart Act (Franchise Disclosure), 2000*, SO 2000, c 3.

[59] *Fairview Donut*, *supra* note 56 at para 500.

the express terms.[60] Good faith is also a "minimal standard": it is only breached when a party acts in bad faith (conduct that is "contrary to community standards of honesty, reasonableness or fairness").[61]

In the performance of a franchise contract, the Superior Court elaborated on the content of the duty of good faith and fair dealing by extrapolating the following principles from a series of franchise cases[62]:

- A party may act self-interestedly, but must have due regard to the legitimate interests of the other party;
- The other party's interests are not necessarily paramount, so long as they are dealt with honestly and reasonably. The franchisor does not need to prefer the franchisee's interests—the franchisor is not a fiduciary;
- Good faith is a two-way street, meaning that franchisees also owe the franchisor a duty of good faith and fair dealing;
- Parties cannot act in such a way to eviscerate or defeat the objectives of the underlying agreement; and
- Where the franchisor is given discretion under the franchise agreement, that discretion must be exercised "reasonably and with proper motive," not "arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties."

In *Fairview Donut*, the Court found no breach of the duty of good faith and fair dealing. The franchise agreements explicitly permitted the changes in question, along with granting Tim Hortons the right to set the prices for supplies and ingredients (and even profit off of the sales). There was no evidence that Tim Hortons exercised such discretion arbitrarily, capriciously, or for an improper motive, and the changes did not deprive franchisees of the fundamental benefits of the agreements. On the contrary, Tim Hortons made the decision on the basis of sound business judgment with an eye to increasing franchise profitability and competitiveness overall. None of the franchisees became unprofitable as a result, and the decision was made "honestly and reasonably" with due consideration for the interests of the franchisees. In fact, Tim Hortons took reasonable measures to discuss the changes with the franchisees and obtain their support for the alterations. They also committed to train and prepare the franchisees for the changes. The collaboration underpinning the system changes has since been described as the "gold standard" for franchisee involvement in system-wide changes.[63]

Justice Strathy assessed that the plaintiffs were effectively asking the Court to re-write their contracts and force Tim Hortons to perform them in a manner the plaintiffs found commercially reasonable. However, there was no right to profit on individual menu

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[60] *Ibid* at paras 500-501.

[61] *Ibid* at para 499.

[62] *Ibid* at paras 499-503.

[63] Scott, *supra* note 4 at 36.

items: "There is nothing in the plaintiffs' franchise agreements that entitles them to make a profit on their franchises generally or on any particular product or product line".[64]

The key takeaways of *Fairview Donut* set the stage for all subsequent good faith arguments in Canada. The duty of good faith is not a standalone right but is tied to the express terms of the contract and the context of the entire relationship. The "determination of whether a party has breached the duty of good faith will require an examination of all the circumstances of the case"[65]: a single aspect of a franchisor's exercise of discretion cannot be singled out for evaluation. Furthermore, the case emphasizes the importance of business judgment and consultation. Canadian courts will respect the business judgment of franchisors when analyzing whether an exercise of discretion is based on a proper motive and part of a defensible business plan.

2. Recommendations for Franchisors

As the cases above indicate, defeating a good faith claim is less straightforward than defeating a breach of contract claim. While all of the prior recommendations about contractual language also apply to this section and provide the franchisor with a solid foundation in litigation, the franchise agreement alone will rarely be sufficient to prevail. Before implementing a system-wide change, franchisors should take reasonable business considerations into account. First, franchisors should ensure that motives for requiring change are consistent with the goals and expectations established in the franchise agreement, and they should contemplate how the change will impact franchisees. Franchisors must therefore consider the effect on the entire system, and not just the franchisor's own bottom line. Becoming a franchisee necessitates a certain level of trust, not just in the quality of the system and the strength of the licensed marks, but also in the franchisor to manage and grow the system in a manner that preserves the franchisee's ability to operate a profitable business.

Similarly, whether or not motive is called into question, franchisors need to be ready to defend system changes by establishing that they result from the franchisor's reasonable business judgment. One of the best ways to do so is to conduct due diligence prior to effectuating a change on a system-wide basis. This can include but is not limited to market studies, beta tests at company-owned locations or with certain franchisees, and seeking input from a franchisee association. Even if the results are not as intended, a franchisor will be in a much better place if they can defend the rationale behind the decision.

It should come as no surprise that the key to defeating a claim that the franchisor breached the covenant of good faith and fair dealing is making the type of reasonable business decisions that demonstrate careful planning and a respect for the interests of both parties in the franchisor-franchisee relationship. However, while these recommendations seem straightforward, it can be difficult to see the forest for the trees

[64] *Fairview Donut*, *supra* note 56 at para 519.

[65] *Ibid* at para 498.

when evaluating a prospective supplier that will generate additional rebate revenue for the franchisor, or implementing a new fee that will improve the franchisor's balance sheet.

C. Statutory Claims

1. History and Overview of Franchise Relationship Laws

Unfair business practices of the past, most rampant in the 1950s and 1960s, led to the development of franchise registration and franchise relationship laws, primarily effected throughout the 1970s. Some of the more common unfair practices that needed to be addressed were unjust terminations, lack of renewal rights, lack of right to assign franchises, encroachment by franchisors, and unreasonable performance standards.

While a general federal law governing franchise relationships has been proposed to address these issues, no such law has been enacted as of yet. At the federal level, the Federal Trade Commission issued its Rule on Franchising in 1979, which mandates pre-sale disclosures but does not govern the actual franchise relationship.

a) Federal Law Related to Franchise Relationships

While no generally applicable franchise relationship statute exists at the federal level, there are industry specific federal laws governing franchise relationships. The Petroleum Marketing Practices Act (PMPA)[66] applies to gasoline dealer franchisors and limits when a franchisor may terminate or refuse renewal.[67] Under the PMPA, discontinuance of the franchise relationship *is* permissible if a franchisee fails to comply with system changes made by the franchisor in good faith. The goal of the act is to protect gasoline retailers from unfair, arbitrary, or even discriminatory terminations or non-renewals by franchisors. A similar but less extensive federal act is the Automobile Dealer's Day in Court Act[68], which provides limited protection to automobile dealers from unfair or discriminatory supply allocation by manufacturers as well as unfair termination.[69]

[66] See 15 U.S.C. § 2802 (1978).

[67] See 15 U.S.C. § 2806 (1978):

> To the extent that any provision of this subchapter applies to the . . . of any franchise, or to the nonrenewal . . . of any franchise relationship, no State or any political subdivision thereof may adopt, enforce, or continue in effect any provision of any law or regulation . . . with respect to termination . . . of any such franchise or to the nonrenewal . . .of any such franchise relationship unless such provision of such law or regulation is the same as the applicable provision of this subchapter.

The PMPA pre-empts state laws related to termination or renewal of gasoline dealer franchise. See 103 A.L.R. Fed. 698 (Originally published in 1991) for a full discussion of various interpretations by different circuits of how the PMPA pre-emption provision applies.

[68] 15 U.S.C. §§ 1221*ff*.

[69] See Gene J. Brockland, "The Long and Winding Road: Automobile Dealers' Day in Court Act Turns 50" (2007) 63 J. Mo. B. 125.

b) State Law Related to Franchise Relationships

Franchise relationships are more heavily regulated at the state level through relationship statutes. State relationship statutes can either be generally applicable or industry specific. Generally applicable relationship laws exist in eighteen states.[70] In almost half of these states, the relationship law is incorporated into the state's franchise registration or disclosure law.[71] In a few of the states, there are separate disclosure and relationship laws.[72] Finally, a few states have only relationship laws and no disclosure laws.[73]

The main areas of focus in state franchise relationship laws, and accordingly, the areas that are most frequently litigated, are termination and renewal.[74] Like many aspects of the franchise relationship, rights related to both termination and renewal are largely governed by the franchise agreement. However, relationship statutes can impose additional restrictions on both of these aspects of franchising, either by requiring good cause for termination or nonrenewal or otherwise limiting the circumstances under which they are permissible. In relation to the subject matter of this paper, these statutory restrictions create hurdles for franchisors who may want to end relationships with franchisees who fail to implement system changes.

State relationship statutes can sometimes guard franchisees from "constructive termination," which occurs when system changes are so financially burdensome that franchisees cannot bear the cost. In those instances, the franchise agreement is effectively terminated because the franchisee cannot comply. State relationship statutes requiring good cause for termination can protect franchisees in these instances, though the franchisee will need to demonstrate that effect of the system change rises to the level of constructive termination.

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[70] See Appendix B for full list of state relationship statutes.

[71] See Thomas M. Pitegoff & Michael Garner, *Fundamentals of Franchising*, (2008) at 187.

[72] See *ibid.*

[73] See *ibid.*

[74] See *ibid.* State relationship statutes vary widely and affect numerous aspects of the franchise relationship. While termination and renewal are the primary focus areas, statutes also impose restrictions on changes in management, encroachment on franchisee territory, receipt of payments from third parties, and litigation or arbitration outside of the franchisee's state. See *ibid* at 187-88.

Furthermore, state statutes often require good cause for nonrenewal, but others, such as New Jersey and Wisconsin, prohibit franchisors from nonrenewal unless a franchisee materially breaches the franchise agreement.[75]

2. Summary of Relevant Cases

Relationship statutes, in general, create an additional hurdle for franchisors to overcome in avoiding litigation with franchisees. In addition to specific terms regarding termination or renewal, many state statutes impose good faith restrictions on franchisors, despite the fact that a good faith duty is oftentimes included in the franchise agreement, and is generally implied by courts even if it is not included in the franchise agreement. Accordingly, litigation based on state relationship statutes often focuses on allegations of bad faith that violate the applicable statute. The first case shows how relationship statutes can offer a franchisee additional protection from unreasonable franchisor practices., beyond that provided in the franchise agreement and implied.

Unreasonable performance expectations in conjunction with costly system changes can be detrimental to franchisees. The New Jersey Franchise Practices Act (NJFPA)[76] prohibits a franchisor from imposing "unreasonable standards of performance upon a franchisee."[77] In *Beilowitz v. General Motors Corp.*,[78] a franchisee distributor claimed that General Motors Corp. (GM) violated the NJFPA by requiring him to renew his contract with terms specific to GM's new marketing strategy. The new strategy would have required the franchisee to incur substantial financial loss. The court concluded that here, it was reasonably likely that GM did impose an unreasonable standard because in adhering to the new marketing strategy, the franchisee would have had to sacrifice $11 million in sales in the Philadelphia area, which was approximately forty percent of his overall sales.[79] Furthermore, in response to the estimated pre-tax operating loss of over $1 million that the franchisee was estimated to incur during the first three years of the new program, the court said, "It is clearly an 'unreasonable standard of performance' within the meaning of the NJFPA to require a franchisee to operate at a substantial financial loss while the franchisor attempts to implement a new and unproven marketing strategy."[80] Accordingly, the court found that the franchisee had a reasonably likelihood of success on his NJFPA claim, entitling him to a preliminary injunction.

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[75] New Jersey, Wisconsin and Puerto Rico have evergreen provisions related to renewal in state relationship statutes. See also: N.J. Stat. Ann. §56:10—5; Wis. Stat. §135.02(4)(a); P.R. Law 75, § 278.

[76] N.J.S.A. § 56:10–7 - 10-15.

[77] N.J.S.A. § 56:10–7(e).

[78] See *Beilowitz v Gen. Motors Corp.*, 233 F. Supp. 2d (D.N.J. 2002) at 631.

[79] See *ibid* at 643–44 (discussing critical facts that led to court's conclusion).

[80] *Ibid* at 644 (evaluating franchisor's actions in relation to NJFPA prohibitions).

The next two cases show instances where franchisors prevailed in light of applicable relationship statutes by acting in good faith and thus in accordance with the statutes. *Remus v. Amoco Oil Co*[81] presents an instance of a franchisee claiming to be injured by a franchisor's change to its pricing system. In *Remus*, the franchisee sued Amoco Oil Co. (Amoco) for violating the Wisconsin Fair Dealership Law (WFDL)[82], which prohibits substantial changes to competitive circumstances without good cause. The franchisee brought the claim after Amoco required franchises to commence a "discount for cash" program through which Amoco would reimburse its franchisees ninety-six cents for every dollar of credit card sales. The Seventh Circuit, in reasoning that the purpose of the WFDL statute is to protect franchisees from constructive termination by systematic changes that make it virtually impossible for franchisees to compete, held that this systematic change did not constitute constructive termination. The change did not hinder franchisees' competitive circumstances (in fact, it improved the franchisees' competitive circumstances), and therefore Amoco did not violate the statute.

The final case illustrates that a franchisor can comply with applicable statutes while making impactful business decisions, so long as the franchisor acts in good faith. In *Munno v. Amoco Oil Co.*[83], a franchisee gasoline dealer brought a claim against Amoco Oil Company (Amoco) for alleged breach of the federal PMPA, discussed above. In response to market conditions Amoco altered its method for charging rent from its franchisees, which for some franchisees (including the plaintiff) resulted in a rent increase. The franchisee refused to pay the increased amount and stopped paying rent altogether. Amoco refused to renew its agreement with the franchisee, based on the franchisee's refusal to pay rent in breach of the contract. The franchisee alleged that Amoco breached the PMPA, which permits franchisors to not renew when a franchisee fails to agree to changes in a franchise agreement if the changes were decided on by the franchisor in good faith. Here, the franchisee alleged that the change in rent amount was decided in bad faith. The court acknowledged that though the rent increase of 200-300% in this instance could be considered unreasonably harsh, Amoco undoubtedly made its decision to increase rent both "in good faith" and in the "normal course of business" as required by the PMPA.[84]

V. Conclusion

Franchised businesses will regularly require change and evolution in order to develop the business and mature. In implementing those necessary changes, there are a number of considerations franchisors must keep in mind.

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[81] *Remus v Amoco Oil Co.*, 794 F.2d 1238 (7th Cir. 1986).

[82] WI ST 135.01.

[83] *Munno v Amoco Oil Co.*, 488 F. Supp. 1114 (D. Conn. 1980).

[84] See *ibid* at 1117. Accordingly, the court entered summary judgment for defendant, Amoco. See *ibid* at 1121.

It is imperative for franchisors to prepare for changes to the extent possible, largely through a well thought out franchise agreement. When actually implementing the changes, it is critical for franchisors to act in good faith and with reasonable business judgment. To act in good faith requires franchisors to consider how changes will affect franchisees and to act with non-selfish motives. Reasonable business judgment requires due diligence by franchisors prior to making business decisions. Finally, throughout every phase of the franchise relationship, including change implementation, franchisors must remain cognizant of applicable franchise laws to ensure compliance.

<u>Appendix A:</u> Additional Sample Provisions

General Provisions

<u>Information Systems Definition</u>

"Information Systems" means the information systems, communications systems and related computer hardware, including, without limitation, credit or debit verification, information storage, retrieval and transmission, inventory control, purchasing, Customer information, pricing, accounting, order entry, communications, printing, scanning and/or electronic mail systems as the Franchisor may require from time to time for use in the operation of the System;

<u>General Franchisee Covenant + Marketing</u>

In order to maintain the high quality and uniform standards, methods, procedures, techniques and specifications associated with the Products and the Services, the Trademarks and the System, and to promote and protect the goodwill associated therewith, the Franchisee and the Principal (where applicable) agree as follows (at the Franchisee's sole expense unless otherwise indicated):

a. to participate in and adhere to all elements of all promotional, advertising and marketing programs including, without limitation, special discount or free coupon programs (where permitted by law), campaigns, flyers, newsletters and cooperatives, as well as all media, as the Franchisor may direct, and continuously exert the Franchisee's best efforts to promote and enhance the Franchisee's operation as a **[NAME OF FRANCHISE SYSTEM]** Franchisee;

Specific Provisions

<u>Maintenance and Improvements</u>

The Franchisee will, at Franchisee's expense, maintain all improvements, furniture, fixtures and Equipment located in the Authorized Location in first class condition at all times, in safe working order and repair, and will replace all worn, damaged, obsolete, out of style, mechanically impaired, malfunctioning or unsafe improvements, furniture, fixtures and Equipment with new replacement items of equal or better quality which shall conform in appearance and design to the then current approved designs and plans and specifications of Franchisor. The

Franchisee will install and use only furnishings, fixtures and Equipment which conform to specifications of design, colour, quality, performance and utility designated or approved in advance in writing by Franchisor.

The Franchisee will perform any repairs and replacements (including expansions, renovations, refurbishing, remodelling, refixturing and redecorating) to the [Restaurant] including the Equipment as the Franchisor from time to time may, in its discretion, determine are necessary or desirable to make the Franchised Business conform to the then current Retail Marketing Plan.

…

The Franchisee, at the Franchisee's sole expense, shall equip, furnish and otherwise improve the Authorized Location with such Equipment as Franchisor requires in writing from time to time in order to ensure a uniform appearance with recently constructed Franchised Business.

The Franchisee shall periodically modernize, remodel and/or redecorate the [Restaurant] and replace equipment in the [Restaurant] in order to reflect Franchisor's then current approved designs and requirements for the [NAME OF FRANCHISE SYSTEM] image ("Further Improvements"). All modernizing, remodelling, redecorating and Equipment replacement must conform to the Franchisor's then current [NAME OF FRANCHISE SYSTEM] quality standards and specifications and must be approved by the Franchisor in writing. The Franchisor may require the Franchisee to submit proof (e.g., photographs, invoices) that such remodelling and/or redecorating has been timely completed to the Franchisor's quality standards and specifications.

Authorized Equipment

The Franchisee acknowledges that it is in the interest of the Franchisee, the Franchisor and all other [NAME OF FRANCHISE SYSTEM] Franchisees that the uniform standards, methods, procedures, techniques and specifications of the System must be fully adhered to by the Franchisee. Accordingly, the Franchisee shall use only such Equipment and other items as are from time to time authorized in writing by the Franchisor. Upon the Franchisor's request, the Franchisee shall, at the Franchisee's own expense, remove any and all such items located at the Authorized Location used in connection with the Franchised Business which have not been so authorized by the Franchisor.

Franchisor will provide the Franchisee with specifications and requirements for all fixtures, furniture, decorations, leasehold improvements, signs, equipment, and computer systems including purchasing, pricing, accounting, order entry, inventory control systems and point-of-sale system that meets our specifications and requirements, including all future updates, supplements and modifications (the "POS System") as Franchisor may require from time to time for use in the operation of the [Restaurant] that meet Franchisor's specifications and standards ("Equipment") that the Franchisee must purchase in connection with the Franchised Business. The Franchisee may be required to purchase or lease any such Equipment from Franchisor or Franchisor's Affiliates, and Franchisor may, at its option and in accordance with Section ● elect to install and purchase any such Equipment required for the Initial Fit-Out of the [Restaurant]. The Franchisee shall pay the Franchisor or its Affiliates for the costs of any Equipment within 14 days of receipt of the Franchisor's invoice.

Pricing

The Franchisor reserves the right to specify in writing retail prices and/or to establish in writing minimum and/or maximum prices for Products sold or Services performed by the Franchisee. The Franchisee shall sell any such Products and Services at the specified retail prices or, if applicable, in accordance with the minimum and/or maximum retail prices established by the Franchisor from time to time, unless otherwise authorized by the Franchisor. If no retail price or maximum or minimum price has been specified or established by the Franchisor with respect to a particular Product or Service offered by the Franchisee, the Franchisee may sell such applicable Product or Service at any reasonable price the Franchisee chooses. The Franchisee acknowledges and agrees that the specified retail prices and maximum and minimum prices for the Products and Services the Franchisee and other [NAME OF FRANCHISE SYSTEM] Franchisees sell may vary from region to region to the extent necessary in order to reflect differences in costs and other factors applicable to such regions.

Insurance

The Franchisee shall purchase, and at all times during the Term shall maintain in full force and effect, such policies of insurance and in such amounts as are reasonably required by the Franchisor including, without limitation, comprehensive general liability, fire, business interruption and property insurance for and in respect of the Franchised Business. The Franchisor reserves the right to add to, change or otherwise modify the types of coverage, or the amounts or minimum amounts of such coverage, from time to time, to reflect industry practices and the effect or amounts of claims experienced by Franchisor.

Franchisor's Power to Assign

The Franchisor shall have the right to directly or indirectly sell, assign, transfer or otherwise dispose of or deal with any or all of its rights and obligations under this

Agreement to any individual, firm, association, bank, lending institution, corporation, partnership or other third party as it may in its discretion deem appropriate. In the event of any such transfer, Franchisor shall be released from any liability under this Agreement for the obligations transferred, except to the extent that such obligations relate to periods prior to such transfer.

FAC Provision

In order to provide a forum to exchange ideas and information between the Franchisor and [NAME OF FRANCHISE SYSTEM] Franchisees, the Franchisor reserves the right to establish an advisory council (the “Advisory Council”), the terms of reference of which shall be contained in the Manual and which shall be implemented in good faith and in accordance with reasonable commercial standards. The terms of reference shall set out the terms and conditions upon which the Franchisee may be eligible to participate on the Advisory Council.

<u>Appendix B:</u> Survey of State Franchise Relationship Acts

Jurisdiction	Statute	Provisions That Could Affect System Changes
AR	Franchise Practices Act, Ark. Code Ann. §§ 4-72-201 to 210	§ 4-72-206(3) prohibits a franchisor from requiring or prohibiting a change of management of a franchisee without good cause, stated in writing by the franchisor. § 4-72-206(6) prohibits a franchisor from refusing to deal with a franchise in a commercially responsible manner and in good faith.
CA	Franchise Relations Act, Cal. Bus. & Prof. Code, §§ 20000 to 20043 (West 2012)	n/a
CT	Franchise Law, Conn. Gen. Stat. §§ 42-133e to 42-133h (2013)	§ 42-133(f)(4) prohibits a franchisor from requiring or prohibiting a change of management of a franchisee without good cause, stated in writing by the franchisor. § 42-133(f)(5) prohibits a franchisor from imposing unreasonable standards of performance upon a franchisee.
DE	Franchise Security Law, Del. Code Ann. tit 6 §§ 2551 to 2557 (2013)	§ 2552(i) prohibits a franchisor from unjustly refusing to deal with a franchised distributor with whom the franchisor has been dealing for at least two years.
HI	Franchise Rights and Prohibitions, Haw. Rev. Stat §§ 482E-1 – 482E-12 (2012)	§ 482E-6(1) requires franchisors and franchisees to deal with each other in good faith. § 482E-6(2)(C) states that it is an unfair practice for a franchisor to discriminate between franchisees in any business dealing unless the discrimination is related to local or regional experimentation with or variations in products, services, business formats, or designs. § 482E-6(2)(E) places limitations on a franchisor's ability to encroach on a franchisee's exclusive territory.
IL	Franchise Disclosure Act, 815 Ill. Comp. Stat. 705/1 to 705/44 (2012)	§ 705/18 places limitations on when a franchisor may discriminate between franchisees in business dealings by only permitting it under certain listed circumstances.
IN	Deceptive Franchise Practices Act, Ind. Code 23-2-2.7- 1 to 23-2-2.7-7 (2012)	§ 23-2-2.7-1(3) makes it unlawful for a franchise agreement to contain a provision allowing substantial modification of the agreement by a franchisor without the franchisee's written consent.

Jurisdiction	Statute	Provisions That Could Affect System Changes
		§ 23-2-2.7-1(6) also makes it unlawful for a franchise agreement to contain a provision allowing price increases of goods provided by the franchisor to franchisee for private retail consumers prior to the franchisor officially notifying the franchisee of the increase. There are a few exceptions to this prohibition. 23-2-2.7-2(4) places limitations on a franchisor's ability to encroach on a franchisee's exclusive territory.
IA	Franchise Relationship Act, Iowa Code §§ 523H.1 – H.17 (2013) (1992 Act);	§ 523H.6 gives a franchisee a cause of action for monetary damages under certain circumstances when a franchisor encroaches on a franchisee's territory and causes an adverse effect on the franchisee's gross sales. The statute details the specific circumstances under which this provision applies. § 523H.10 requires that the franchisor and franchisee adhere to a duty of good faith in the performance and enforcement of the franchise agreement.
MI	Franchise Investment Law, Mich. Comp. Laws §§ 445.1501 - 445.1546 (2012)	n/a
MN	Franchise Law, Minn. Stat §§ 80C.01-80C.22 (2013)	n/a
MS	Franchises Law, Miss. Code Ann. §§ 75-24-51 - 75-24-63 (2012)	n/a
MO	Franchises Law, Mo. Rev.Stat. §§ 407.400 - 407.413 (2012)	n/a
NE	Franchise Practices Act, Neb. Rev.Stat. §§ 87-401 - 87-410 (2012)	§ 87-406(3) prohibits a franchisor from requiring or prohibiting a change of management of a franchisee without good cause, stated in writing by the franchisor. § 87-406(5) prohibits a franchisor from imposing unreasonable standards of performance upon a franchisee.

Jurisdiction	Statute	Provisions That Could Affect System Changes
NJ	Franchise Practices Act, N.J. Stat. Ann. § 56:10-1 - 56:10-15 (West 2013)	§ 56:10-7 prohibits a franchisor from requiring or prohibiting a change of management of a franchisee without good cause, stated in writing by the franchisor. § 56:10-7(e) prohibits a franchisor from imposing unreasonable standards of performance upon a franchisee.
RI	Fair Dealership Act, R.I. Gen. Laws §§ 6-50-1 - 6-50-9 (2012)	n/a
VA	Retail Franchising Act, Va. Code Ann. §§ 13.1.557 - 13.1.574 (2013)	n/a
WA	Franchise Investment Protection Act, Wash. Rev. Code §§ 19.100.010 - 19.100.940 (2013)	§ 19.100.180(1) requires that the franchisor and franchisee deal with each other in good faith. § 19.100.180(2)(c) places limitations on when a franchisor may discriminate between franchisees in business dealings by only permitting it under certain listed circumstances. § 19.100.180(2)(f) prohibits a franchisor who has granted a franchisee an exclusive territory from competing in that territory or granting a competitive franchise in that territory.
WI	Fair Dealership Law, Wis. Stat §§ 135.01 - 135.07 (2012)	§ 135.03 requires good cause for a franchisor to substantially change the competitive circumstances of a dealership. § 135.04 requires 90 days' notice for substantial changes in competitive circumstances