CONTRASTING PERSPECTIVES ON FRANCHISE TERMINATIONS

From the Franchisor's Perspective—Terminating the Troubled Franchisee in Michigan

By David R. Janis

This article examines the process of terminating a franchisee in Michigan from the perspective of the franchisor. While it offers suggestions for issues a franchisor should consider during the franchisee termination process and tips for franchisors when interpreting the Michigan Franchise Investment Law, it is suggested that a franchisor keep in contact with its attorney throughout the termination process.

One of the most difficult jobs of a franchisor is dealing with a troubled franchisee. Whether it be a franchisee not complying with the franchise handbook, providing poor customer service and damaging the value of the franchisor's name and good will, or falling behind on royalties and advertising fees, the franchisor needs to act carefully but decisively in dealing appropriately with the troubled franchisee.

Depending on the provisions in the franchise handbook and franchise agreement, the franchisor likely has a range of options for dealing with the troubled franchisee. However, if a business decision is made that it is in the franchisor's best interest to terminate the troubled franchisee, the franchisor must ensure that it is complying with not only its franchise handbook and franchise agreement, but also with the Michigan Franchise Investment Law (MFIL).[1]

The Michigan Franchise Investment Law

Michigan and 18 other states have passed legislation making it illegal for a franchisor to terminate a franchise agreement without good cause. Of course, the obvious question any franchise attorney asks first is, "What is good cause?" Luckily, MFIL provides some, though perhaps not sufficient, guidance on that question.

Section 27 of MFIL states that any provision contained in a document relating to a franchise is void and unenforceable if it:

> permits a franchisor to terminate a franchise prior to the expiration of its term except for good cause. Good cause shall include the failure of the franchisee to comply with any lawful provision of the franchise agreement and to cure such failure after being given written notice thereof and a reasonable opportunity, which in no event need be more than 30 days, to cure such failure.[2]

FAST FACTS

- "Good cause" exists to terminate a franchisee when the franchisee fails to comply with a lawful provision of the franchise agreement.
- If the franchisor plans prudently, it can prepare its franchise agreement and handbook to leave very little guesswork when determining if good cause exists to terminate a franchisee.
- One popular way to ensure more predictability and reduce costs is to mandate arbitration to terminate a franchisee.

Grounds for Terminating a Franchisee and What Constitutes Good Cause

Other than simply stating that good cause exists to terminate a franchisee when the franchisee fails to comply with a lawful provision of the franchise agreement, Section 27 does not offer further guidance regarding what constitutes "good cause." Similarly, there is very little caselaw regarding what constitutes good cause to terminate a franchisee. While state court cases interpreting MFIL on this issue are scarce, in *Two Men and a Truck/International, Inc v Two Men and a Truck/Kalamazoo, Inc,*[3] the United States District Court for the Western District of Michigan held that a franchisor was within the statute to terminate a franchisee that violated the parties' franchise agreement by failing to pay royalties and advertising fees and failing to file monthly sales reports with the franchisor.[4] While it is comforting to know that the *Two Men* court reached the right decision, it is hardly earth shattering that a franchisor is within its rights to terminate a franchisee who has failed to pay owed royalties and fees and adhere to the terms of the franchise agreement.

Although caselaw does not offer much guidance concerning what constitutes good cause, the language in Section 27 provides the franchisor with a great deal of discretion when terminating a franchisee, as long as the franchisor is wise when drafting the franchise agreement. Section 27 of MFIL allows the franchisor to terminate for any failure to comply with the franchise agreement, meaning the franchisor, as the master of its franchise agreement, has the ability to include a range of foreseeable circumstances that would place the franchisee in default and, hence, at risk of termination. The prudent franchisor can make sure the agreement includes all possible scenarios that should put the franchisee in default and on the track to termination. This leaves very little guesswork for the franchisor (or a court) when determining whether good cause exists to terminate the franchisee, provided the applicable provisions of the franchise agreement are clear, unambiguous, and, of course, lawful.

Since every business model is different, franchisors will have unique default/termination provisions in their franchise agreements. However, some common grounds for default and, therefore, termination include the following:

- The franchisee files for bankruptcy or no longer meets a certain solvency level.
- The franchisee is failing to operate the franchise in accordance with the franchise handbook.
- The franchisee sells or transfers the franchise without permission from the franchisor.
- The franchisee is violating federal, state, or local laws relating to the operation of the franchise.

These are some examples of circumstances that will typically cause a franchisor to seek termination of a franchisee and should be considered when drafting a franchise agreement.

The Termination Process

It is also important to remember that regardless of which provision of the franchise agreement is violated, a franchisor must provide the franchisee with written notice of the default and a "reasonable opportunity" to cure the default. While MFIL does not

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provide guidance on what constitutes a reasonable opportunity to cure, Section 27 states that a franchisor is under no obligation to provide more than 30 days for the franchisee to do so.

Once the franchisor provides written notice to the franchisee that it is in default by failing to comply with the franchise agreement and the franchisee fails to cure the default, the franchisor is permitted under MFIL to terminate the franchisee. The franchisor should be aware, however, that this is often not the end of the process. Often, the franchisee will initiate a civil lawsuit claiming that the franchisor breached the franchise agreement by terminating. In connection with these lawsuits, franchisees commonly seek injunctive relief enjoining the franchisor to honor the franchise agreement and retain the franchisee as part of the franchise system until the conclusion of the lawsuit.

One strategy that can be used to lessen the likelihood of this type of litigation is to include a provision in the franchise agreement obligating the parties to arbitrate any disputes. In such cases, once the franchisee fails to cure its defaults after receiving written notice, the franchisor can file a claim for arbitration against the franchisee. As part of its claim, the franchisor can seek any financial damages incurred, such as unpaid royalties or other fees, as well as a formal termination of the franchisee.

Frequently, the franchisee knows it is in default under the franchise agreement and does not challenge the relief sought in the arbitration. In these instances, an award is easily obtained by the franchisor. However, even if the franchisee does contest the relief sought, arbitration allows the franchisor to control costs, move at a faster pace than judicial litigation, and obtain an enforceable determination regarding whether it was within its rights to terminate the franchisee.[5]

Once the arbitration is completed and an award is issued, the franchisor's next step is to file a simple complaint in Michigan circuit court to confirm the arbitration award. While this article is not meant to discuss the procedures for confirming, vacating, or modifying arbitration awards through the Michigan courts, it should be noted that MCR 3.602(I) states that an arbitration award filed with the court "within one year after the award was rendered may be confirmed by the court, unless it is vacated, corrected, or modified, or a decision is postponed, as provided in this rule."[6]

Further, MCR 3.602(L) states that a judgment entered by the court confirming the award "has the same force and effect, and may be enforced in the same manner, as other judgments."[7] This allows the franchisor to pursue and collect any unpaid royalties or other fees by all usual means for collecting judgments.

While this article is just a broad overview of the considerations and procedures available to franchisors when terminating a franchise agreement, hopefully it offers guidance on what the franchisor must consider to be as efficient as possible while also following the requirements of MFIL. ■

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FOOTNOTES

1. MCL 445.1501 *et seq.*
2. MCL 445.1527(c).
3. *Two Men and a Truck/International, Inc v Two Men and a Truck/Kalamazoo, Inc*, 955 F Supp 784 (WD Mich, 1997).
4. *Id.* at 786.
5. It should be noted that MFIL declares as void any provision in a franchise agreement that requires an arbitration to take place outside the state of Michigan. MCL 445.1527(f). This does not mean that the parties cannot arbitrate outside the state of Michigan. It only means that such an agreement cannot be in the franchise agreement and must instead be in a separate document or agreement.
6. MCR 3.602(I).
7. MCR 3.602(L).