Enforcing Termination Obligations of Franchise Agreements

Rupert Barkoff

New York Law Journal

August 29, 2016

The success of franchise systems is highly dependent upon the proper functioning of trademark enforcement. It is essential that when franchisees are not operating in accordance with standards and are not meeting their financial obligations, the franchisor have the right to terminate the franchise and enforce post-termination obligations of the former franchisee. In its franchise agreement, the franchisor typically has been granted, upon termination of the franchise relationship, the right to demand, among other things, that the franchisee de-identify, not compete, assign the phone number of the former franchisee to franchisor, and the return of its confidential operating manuals. Yet what happens when the franchisee refuses to comply with these obligations?

There are numerous judicial precedents and legal articles written about what a franchisor should provide in its franchise agreements to protect itself when a post-termination situation arises. If the franchisor does not take action when the franchisee fails to comply, the franchisor's failure to protect its marks could lead to the loss of those marks and the legal rights that accompany their ownership. Moreover, failure to enforce post-termination obligations of a former franchisee can lead to chaos in the franchise system.

When a franchisee goes AWOL, the harm to the franchise system may go viral. Customers may find that they cannot trust the quality standards represented by the marks and consequently shift their business to other providers. And if one franchisee gets away with non-compliance, this may lead other franchisees to ask themselves: Why should I play by the rules when others don't? Why should I continue to pay my royalties?

Under these circumstances, the franchisor's first line of attack will be to terminate the franchise agreement and sue the franchisee, seeking monetary damages and, if needed, ask for a preliminary injunction to prevent the prohibited behavior, if the former franchisee continues to operate, until the case comes to conclusion. The request for a preliminary injunction may be critical because the franchisor and its franchise system could suffer irreparable harm while the lawsuit slowly winds itself toward completion.

In order to obtain the preliminary injunction, the franchisor must prove: (1) it would suffer irreparable harm if the defendants were not enjoined from operating its business at the same location; (2) the franchisor would have a likelihood of success on the merits; (3) the injunction would not result in any greater harm to the defendants compared to the plaintiff's harm if the injunction is not granted; and (4) it was in the public interest to enjoin the defendants' operation of their business, in violation of the franchise agreement. If a preliminary injunction is granted, franchise termination litigation often reaches final conclusion quickly, with the former franchisee running up the white flag of surrender, and moving on with his or her life.

But there are occasions where the former franchisee will not give up the fight. In these situations, the franchisor will continue to press its demand for damages, and is likely to file a motion to hold the former franchisee in contempt should he or she not comply with the terms of a preliminary injunction. The same may prove true after the case has gone to trial and the franchisor is awarded damages and a permanent injunction. The situation in this circumstance is that the franchisor has failed to obtain the result it deserves. There has been no justice. What can the franchisor do to protect its rights and franchise system?

The burden of moving the dispute to final resolution is at this point on the franchisor. Procedure requires that it must file a motion asking that the franchisee be held in contempt and request a show cause hearing. It must demonstrate what the court has required the franchisee to do, and not do, such as not competing with the franchisor, or transferring the telephone number for the business to the franchisor. Next, the franchisor must prove that the franchisee has not complied with the terms of the injunction. And finally, the franchisor must demonstrate that it has been harmed by the franchisee's noncompliance.

Many believe that judges do not like to issue orders of contempt, and will bend over backwards not to hold a franchisee in contempt. At the same time, it can be expected that the judge might take strong action against the franchisee who has refused to comply with the terms of an injunctive order. That conduct is a clear affront to the court's power. And where the franchisee has not even attended the show cause hearing, totally ignoring the power of the court, anger from the judge is even more likely to appear.

In a case in Michigan in May, a judge who found a franchisee in contempt went so far as to incarcerate two individuals involved in it.

Three Cases

Three recent franchise cases illustrate how this scenario plays out in the real world, and how courts will protect the interests of the franchisor.

In the first case, *H&R Block Tax Services v. Judy Strauss*,[1] the Northern District of New York granted a preliminary injunction against the former franchisee when the franchisee had failed to adhere to the terms of the franchise agreement regarding post-term non-competition. The franchisee had agreed not to solicit clients who had been customers of the former franchisee, and not to compete within a specified distance of the franchisee's former business location. The former franchisee also refused to assign its phone number to the franchisor.

In deciding to grant the franchisor's requested preliminary injunction, the court noted that the former franchisee's continuing to conduct its tax business within the contractually prohibited territory made it more difficult for the franchisor to replace the terminated franchisee and provide an orderly transition to the former franchisee's successor. Sometime after the preliminary injunction request had been granted, the franchisor filed a motion requiring the franchisee to show cause as to why it should not be held in contempt for its continuing failure to abide by the terms of the injunction, and the court granted the franchisor's motion.

In the second and third cases, *Domino's Pizza Franchising v. VTM Pizza*,[2] and *Meineke Car Care Centers v. ASAR*,[3] the procedural aspects of the case were similar to those in *H&R Block*. In *Domino's*, in the Western District of North Carolina, the plaintiff franchisor had been awarded a permanent injunction prohibiting the former franchisee from conducting a pizza restaurant in the same location where it had been operating before suit was brought, and the defendant had been ordered, among other things, to stop using the phone number that had been previously used by the defendant.

When the former franchisee failed to comply with the terms of the injunction, Domino's filed a motion to show cause as to why a contempt order should not be issued. A notable fact in this case is that the former franchisee showed no willingness to defend or otherwise participate in the show cause hearing. The final decision in this case was that the former franchisee be held in contempt.

And finally, in *Meineke*, in the Eastern District of Michigan, the facts showed that the former franchisee failed to comply with a default order that, among other things, prohibited the former franchisee from competing against Meineke at the former franchisee's location and within a radius of six miles of any other Meineke center. A permanent injunction was issued, and when the former franchisee failed to comply with the order, Meineke filed a motion requesting that a show cause hearing be conducted.

Remedies

While the procedural histories of the three cases are similar, there were interesting differences as to how the courts dealt with the problems before them.

In *H&R Block*, the court awarded the plaintiff an amount equal to the amount of royalties that would have been paid to H&R Block for the period when the former franchisee continued to operate unlawfully, had the franchise agreement not been terminated. The additional amount payable to H&R was $17,200, plus an award of $15,616 for attorney fees incurred in pursuing the contempt remedy. The court also extended the noncompete period by one year, to compensate the plaintiff for the opportunities missed during the so-called tax season.

In *Domino's*, the court ordered that each of the defendants pay its former franchisor $100 for each day following the issuance of the permanent injunction the former franchisee wrongfully continued to operate. After 21 days, the penalty would increase to $300 per day per defendant until the operation of the restaurant ceased. And in *Meineke*, the court ordered that the defendants be incarcerated until the noncompliance with the court's final order in the litigated proceeding was cured.

This was the only published decision within the last two years where any of the parties has been incarcerated for contempt, but the court in *Meineke* showed no reluctance to use this remedy. As the court stated in its Show Cause Order, "the Court has broad discretion in fashioning coercive remedies to ensure compliance with its orders…a person found to be in contempt may be, among other things, imprisoned or fined indefinitely until he complies with the orders of the court."[4]

How effective are these remedies? The additional accruing of debt is only effective to the extent that the defendants have the ability at some point to pay off the debts.[5] On the other hand, incarceration is probably a very effective way to get the defendant's attention, but the defendant must be found in order for him or her to be incarcerated. As long as the former franchisees' businesses are still operating, this is not likely to be a problem.

In other words, there can be justice for those who are willing to go the distance, and the noncomplying parties are solvent, but it will be expensive and take a long time for the judicial system to demonstrate its power over parties to litigation.

Endnotes:

1. No. 1:15-CV-0085 (LEX/(FK), 2015 WL4094649 (N.D.N.Y. July 7, 2015), Bus. Franchise Guide ¶15,593 (N.D.N.Y. July 7, 2015).

2. No. 3:14-CV-129-RJC, 2016 WL820952 (W.D.N.C. March 2, 2016), Bus. Franchise Guide ¶15,709 (W.D.N.C. March 2, 2016)

3. No. 15-13312, 2016 WL2907966 (E.D. Mich. May 19, 2016), Bus. Franchise Guide ¶15,771 (E.D. Mich. May 19, 2016).

4. See *Meineke*, at p. 7.

5. Debtors' prisons were common in Colonial America for persons who failed to pay their debts. See generally Stefan A. Riesenfield, Enforcement of Money Judgments in Early American History, 71 Mich. L. Rev. 691 (1972-1973).

Rupert M. Barkoff is chairman of the Franchise Team at Kilpatrick Townsend & Stockton in Atlanta.