

Commercial Litigation News

The Ten Commandments of Handling Franchise Dealer and Distributorship Litigation

In these turbulent economic times, companies that distribute through franchisees, dealers or distributors need to guard against the potential that they may become embroiled in litigation. It is more essential than ever that the independent entities that represent you in various channels of distribution adhere to standards that build your brand and reputation. Tough times also require difficult choices to be made that may not benefit individual franchisees, dealers or distributors, but which benefit the economic health of the company or the balance of your distribution channel.

A little advance planning can assist you in implementing the changes you need to make to your business. No matter the industry, a list of best practices can be reduced to ten simple guidelines. By adhering to these practices or adapting them to your specific business model, your dealer or wholesaler relations will be improved—even when litigation does not occur. Litigation can be avoided or favorable outcomes enhanced. Taking steps to avoid litigation risk is just good business.

One must recognize the unique aspects of franchise or distributor litigation. No matter what the financial impact of the individual dispute, franchise and distributor litigation are among the hardest fought and most important cases facing your company. For a company, the outcome of litigation may determine its ability to carry out business plans across the entire franchise or distribution system. For example, a simple cleanliness and appearance case at one location

may threaten a company's ability to carry out an ambitious or expensive remodeling, upgrade or image effort as to all units. Noncompliance by even one franchisee or distributor can affect a company's ability to dictate image, quality or service across all outlets. The outcome of such litigation is important, not only to the participants but to all the other franchisees or distributors within the system that operate under your trademark or business model.

On the other side of the equation is a franchisee's or distributor's entire life's work or business. The "but for" of noncompliance by the franchisee with your business plan or policies is often termination. Litigation must be conducted in an atmosphere with all the sympathies that accompany the importance of the case to both parties. The time to level the playing field of sympathies is not after a dispute occurs, but by following best practices now—the Ten Commandments:

I. There Are Only Two Issues in Every Franchise or Distributor Dispute

- The trademark; and
- Credibility—who is telling the truth?

The bedrock of this type of dispute starts and ends with your trademark and business model. This is what the Company shares with all franchisees or distributors who comply with company policy. By establishing that the actions

of the noncompliant franchisee threatens the good name of the company or its trademark, the playing field is leveled. The dispute must be seen from the perspective of the consumer and your other distributors. If the company is seen as only protecting its trademark and good name, and not merely as punitive in its relation with one or more franchisees, then its goal is reached. In order to wrap oneself in the trademark, the company must be able to show that it has made consistent efforts over time to build its brand and its network. If the sudden concern for your trademark or goodwill only started with this particular defendant, much of the high ground will be sacrificed. The concern for the trademark and business model must be one that has been long held, well communicated and enforced consistently over time.

Second, every franchise or distributor case seems to pit the franchisee's action or inaction against the policies of the company. You will be faced with arguments that not all franchisees have been treated equally with regard to enforcement of your policies. The franchisee will try to paint the problems you raise as insignificant or due to causes beyond the franchisee's control. The defendant often blames the company for causing conditions that led to the infraction. The credibility of company witnesses and the franchisee in establishing these conflicting arguments is paramount.

II. Whenever Possible, Be the Plaintiff

- Be proactive and file an action as a plaintiff-franchisor.

The Company should bring suit rather than waiting for the franchisee to file suit. In most cases, the parties' dispute reaches a level where the prospect of litigation is clear. Although counterintuitive, experience shows that being proactive usually reduces the time and cost involved with most disputes. It also postures a case differently when the company seeks a declaratory judgment that the termination is proper, rather than responding to a claim of wrongdoing brought by its distributor. It is also interesting to note that franchisees can

often find a lawyer to file a case on a contingent fee basis, but usually find it more difficult to obtain counsel to defend a suit brought by the company on a contingent fee basis. Suits are often handled much more efficiently if the franchisee is paying costs for defending the case instead of prosecuting on a contingent fee basis.

III. Update Your Franchise or Distributor Agreements Regularly

- History does repeat itself—learn and profit from experience and the case law.

Many companies are operating with different agreements for different franchisees or distributors, depending upon which form of agreement they originally signed. Others have not updated their form contracts for years, and are operating under written agreements that may not reflect current practices or law. Often programs, rental rebates, special pricing, promotion dollars or other ways of operating that have developed over time are not even covered by your agreement. In order to change methods of delivery, pricing, hours of operation or other terms, flexibility must be built into the agreement.

Over the years, case law in your industry or related industries may suggest best practices that should be incorporated in your documents. Make sure that your documents include the potential for future changes. For example, your documents may permit assignment by your franchisee, but not the company. You may carry three grades of product, and desire at some point to distribute four or two. Is it clear that you have the right to make such changes? Anticipate the unforeseen by building choice into your documents.

IV. Train Your Field People

- Problems occur where “the rubber hits the road.”
- Train your franchisees or distributors.

The focus of disputes often centers on the relationship or actions taken by your company’s field people in connection with the franchisee. Franchisees often claim they did not follow a procedure because they were never told or trained before the dispute arose. Allegations of “bad blood” or personal animus by the field representative are common. A good training program, or at least intermittent training of both field people and franchisees, can prevent “misunderstandings.” Good communication can often prevent or blunt arguments related to specific acts or statements made by field personnel.

Training of field people and the franchisees or distributors also helps to promote uniformity. Training materials and workshops are also evidence of the company’s concern for its trademark and policies. In today’s marketplace, most companies have fewer field people who cover much larger areas. Tenure of field representatives is often much less than the historical average. Training and communication can sometimes compensate for these changes.

V. Communicate, Communicate, Communicate

- When policies, procedures, standards or changes in marketing plans are well communicated, they are more often easily enforced.

Bad news and change are never well received, but if properly communicated, a lot of emotion can be taken out of the equation. If you are going to make big changes, tell franchisees what challenges the company might face. Tell them changes in policies and procedures that are under study to meet the challenges. When announced,

make sure the changes are announced to each franchisee. Consider the method and the messenger. No one likes to hear information second hand or after others have already been apprised. Good communication is probably the most important aspect of successful change.

For example, if the company has too many franchisees or distributors, it may need to make changes. The problem may be solved geographically. It may require a look at minimum size of distributor, i.e., 1,000,000 units or greater. The central problem may cause other challenges, such as poor service, high overhead, slower delivery, etc. By correcting one problem—to too many franchisees—you may be able to address a host of other issues that need improvement system-wide. Through communication, you can deliver the rationale for the needed change, and signal to the entire network that change will result in a better system after a possibly difficult transition.

Communication can also be used to correct past deficiencies. For example, if image issues have been neglected and the company recognizes this, communicate a new goal and a reasonable timeline for compliance. This way, your new-found vigor for enforcement will not be plagued by the past inaction.

Sometimes the simple act of having a personal visit or phone call from field people before announcements by mail arrive can make all the difference. Good communication can often blunt some of the personal feeling that often causes franchisees to react, too often, by filing litigation.

Finally, you should consider what role technology can play in your communication. Contracts, company policies, codes of conduct and other important information can be placed on a Web site. This information can be reissued from time to time as a reminder. This does not displace the need for more personal communication, but it can centralize some portion of communication, and eliminate total reliance on field people as the only vehicle to communicate and document your efforts.

VI. Maintain, Create and Reissue Important Franchise and Contract Documents—Maintain Uniformity

- Statements of franchisee or distributor policy.
- Maintenance policies.
- Image or cleanliness standards.
- Procedures for approval of assignment.

Uniformity is another key aspect of enforcing your policies and protecting your good will. A central argument by most franchisee litigants is to paint any given dispute as a personal one, and not really related to the policy the company is trying to enforce. A franchisee always attempts, if possible, to point to other franchisees committing the same acts without consequence.

It is advisable, when possible, to put major policies or standards in written form. Contracts themselves may not adequately spell out what is expected in the areas of maintenance or image. If you only have a standard assignment clause in your contract, you may want to consider procedures for approval of assignment. Do you allow assignees who are multi-branded? Do you have minimum financial criteria? What are the factors you will or might consider to reasonably withhold consent to assignment?

Also consider, where appropriate, a franchisee or distributor policy or code of conduct. This is just another way to communicate what is expected. No doubt, when a dispute erupts, the problem franchisee will have violated one or more of your standards. Such policies are also a good place to make clear that a franchisee or dealer has a right to appeal or discuss with other managers the actions or directives of the lower-level field personnel. Having a formal chain of command can help avoid claims of personality disputes with a field person, or claims of poor communication.

VII. When Given Enough Rope, a Truly Bad Franchisee Will Hang Himself

- Give ample notice, not just statutory or contractual notice, when possible.
- Give second notices or second chances, when possible.
- Consider sending the same warning or message by different people.
- Use the statement of dealer rights or contract as a tool; i.e., get it initialed.

A truly recalcitrant franchisee or distributor, like a tiger, usually does not change its stripes. Be sure to document all defaults and give ample time for compliance. Another great tactic in these situations is to be able to show that the franchisee was given ample time and several chances to comply. When termination or nonrenewal is finally required, you may consider a termination that can be cured before an effective date by full compliance. Make the franchisee choose termination over compliance.

VIII. Separate the Message of Compliance from the Threat of Termination

- Try not to discuss lease, franchise or contract termination or nonrenewal at the same time you are seeking compliance.
- Avoid the appearance of pretext.

Often in hindsight, the request for compliance and the threat of termination or non-renewal become intertwined. For example, a discussion of pricing on the same visit as a discussion of termination for lack of cleanliness and appearance becomes a threat to terminate if suggested pricing is not followed when litigation later ensues. Consider sending different messages from different parties and at distinctly different times. Separate your communication seeking compliance from the communication of consequences for noncompliance.

IX. Contact Your Legal Department or Outside Counsel Early—Document, Document, Document

One of the best ways to minimize the potential for litigation or to increase your chances for success is to engage counsel early to assure proper procedures are followed in notifying and counseling the franchisee on compliance issues. A good rule of thumb is never to raise termination with a franchisee or distributor before raising this possibility with counsel.

A central issue in most cases revolves around whether the issue raised by the company to justify termination is bona fide or whether it is merely a pretext for getting rid of the troublesome distributor. If the requests for performance become intertwined with communication of the penalty for noncompliance, it may be difficult to avoid the conclusion that the distributor has been threatened, and it may be difficult for the company to focus on the real issue of non-performance. Do not discuss consequences until an adequate record has been made that the distributor has been notified of noncompliance.

X. It's the Trademark

- In all you do, stress that termination is for the good of the brand and for the thousands of other franchisees, distributors and the consumer.

A judge or jury often cares less about either the company or the particular franchisee than they do about other good franchisees and the public who are affected by the dispute.

If the focus of your efforts is to build your brand and protect the profitability of your business for yourself and your distributors, you are not only preparing for potential litigation, but are taking steps to strengthen your business. Remember that litigation is a dispute viewed through the lense of hindsight. Actions you take that seem reasonable today may be seen in the rearview mirror as insufficient. The purpose of these Ten Commandments is an attempt to assure that the actions you take as necessary to protect your business cannot be twisted if you find yourself justifying those actions in future litigation.

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