BY RICHARD S. MULLIGAN

# Rightful Termination: Getting It Right

One of the most difficult things to impress upon start-up franchisors is the amount of time, resources, and manpower it takes to establish a uniform system and, equally important, to monitor compliance with that system.

To protect the integrity of a brand concept and the goodwill it wishes to establish, the franchisor must devote the manpower necessary to investigate and monitor compliance with all aspects and provisions set forth in the franchise agreement. Established franchisors understand the cost and realize they must protect their brand's goodwill from franchisees who cut corners, run poor operations.

Some franchisee activities are easier to monitor than others. Failure to timely pay royalties or advertising fees is easily detected by accounting staff or computer systems, but others require investigation by a staff of trained specialists. No franchisor takes termination of a franchisee lightly, and often there are protracted lawsuits and arbitrations to determine whether the franchisee's claim of wrongful termination is valid.

Most franchise agreements require the franchisee to comply with all federal, state, and local laws with regard to the business the franchise is associated with. A breach of this failure to obey all laws can cause the franchisee to be terminated. Certain defaults are non-curable. Conviction of a felony or crime involving moral turpitude or an offense the franchisor believes injures its system are just a few customary non-curable defaults.

A recent Federal District Court case in New Jersey has shed some light on the implications of an "obey all laws" clause in a franchise agreement and the interplay of that clause with the default clause. In *Dunkin' Donuts Franchised Restaurants LLC v. Strategic Venture Group, Inc.* (Nov. 2010), a District Court found that Dunkin' had rightfully terminated a franchise agreement where it had proof (based on internal investigations conducted by the franchisor) that the franchisee was not properly reporting certain benefits it gave to its employees as income and was not properly withholding taxes on such benefits. The franchisee paid some employees' rent and deducted it as a business expense, but did not report it as taxable income for payroll or other income tax purposes. The relevant provisions of the applicable franchise agreement are:

• Obey all laws clause: "Franchisee shall comply with all civil and criminal laws, ordinances, rules, regulations and orders of public authorities pertaining to the maintenance and operation of the Unit, including, but not limited to, those relating to health, safety, sanitation, employment, environmental regulation and taxation."

• Non-curable default: "Franchisee is convicted or pleads guilty or 'nolo contendere' to a felony, a crime involving moral turpitude, or any other crime or offense that Franchisor believes is injurious to the System(s), the Proprietary Marks or the goodwill associated therewith, or if Franchisor has proof that the Franchisee has committed such a felony, crime or offense."

Importantly, the Court found that for these violations to be deemed a non-curable default, as pursuant to the language of the franchise agreement, Dunkin' need only prove the elements of the violation by a preponderance of the evidence and not beyond a reasonable doubt, which would be the standard required for conviction. Further, Dunkin' did not need to prove that the franchisee's violations of tax laws damaged the franchise itself, because the issue at hand was whether Dunkin' could rightfully terminate the franchise agreement and do so without providing the franchisee with a cure period.

The Court also noted that, upon Dunkin's determination that the franchisee was in default of the franchise agreement and such default was non-curable, it properly gave notice of termination in accordance with New Jersey Franchises Practices Act. This underscores the idea that a franchisor must be in compliance with both the franchise agreement itself and the franchise laws governing the applicable state. The Court found that Dunkin's actions were rightful and that it complied with its franchise agreement and other applicable state franchise law.

Another area franchisees must be mindful of is the U.S. Department of Labor's (DOL) stepped-up activities to enforce wage and hour laws. Recent cases in Illinois (where the DOL recovered $240,000 in back wages for 62 low-wage restaurant workers) and Ohio (where a franchisee recently paid back wages for 159 current and former employees) underscore the need for franchisees to comply with those provisions of the franchise agreement that call for compliance with federal labor laws. Depending on the franchise agreement, there may be a cure period, but if the DOL has assessed damages, this type of violation may be non-curable.

Franchisees must be cognizant of the monetary defaults that may cause them to lose their business, but they also need to pay attention to those non-monetary defaults, which are sometimes referred to as "technical defaults" and may appear to blend into the boilerplate of the franchise agreement. A franchisee is responsible to read the agreement, so if there are questions about what might cause the agreement to be terminated and a franchisee to lose its business and investment, then ask questions and seek answers. If the franchisee obeys all laws, then that aspect of the franchise agreement will never cause it problems. ■

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