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Avoiding Litigation Over Changes to the System

Franchised brands are increasingly focused on implementing significant system changes. This trend is largely driven by maturing brands whose “makeovers” are necessary to keep the brand attractive and relevant and by technological advances that are essential to operating efficiencies.

The biggest hurdle to system change is often franchisees that balk at the cost and time involved in making the change. Several recent lawsuits illustrate that, when this happens, there is a real risk of becoming embroiled in resource-draining litigation.

For example, Wendy’s recently brought suit against its fourth largest franchisee who had challenged Wendy’s right to require extensive remodeling to its restaurants and upgrades to the point-of-sale system. After the franchisee’s refusal, Wendy’s sued to force compliance. The franchisee countered with its own claims against Wendy’s and has asked the court to declare that it is not required to perform the upgrades. The case is currently making its way through the courts, and the parties have a long (and expensive) road ahead with trial set for late 2016. A loss for Wendy’s could be a serious blow to its ability to maintain system and brand uniformity. But even a litigation victory for Wendy’s does not mean that the franchisee will readily comply; it could continue in its refusal and risk termination. Either way, both the franchisor and franchisee will incur significant costs and damage to their relationship as a result of this system-change based litigation.

Another example is the recently decided case of *Dunkin' Donuts v. Claudia III* where the franchisor terminated the franchisee for failure to remodel its stores then sought a preliminary injunction to force the franchisee to stop operating as unlicensed Dunkin' Donut stores. In 2014, the court refused the franchisor's request for preliminary injunction because it could not show that it would suffer irreparable harm as a result of the franchisee's refusal to timely remodel. Dunkin' and its franchisee litigated the case to summary judgment, and just last month—almost a full year after the initial decision—the court entered judgment for Dunkin' on all counts. The court also entered a permanent injunction preventing the franchisee from operating its stores as unlicensed Dunkin' Donut shops. While ultimately successful, the franchisor's insistence on system-wide compliance proved time-consuming and costly.

Given the time, expense, and uncertainty inherent in litigation, what can franchisors do to mitigate their risks and hopefully avoid litigation? Here are some tips:

Plan in Advance. Franchisees typically point to the franchise agreements or state franchise laws as the basis of their refusal to implement mandatory changes. Contain these risks through advanced planning and effective drafting of franchise agreements and disclosure documents. State-of-the-art agreements contain not only express terms permitting franchisors to modify the system and brand standards but also mechanisms that permit franchisors to respond to unforeseen developments.

Review the Existing Franchise Agreements. One of the first steps in the roll-out of system changes is to analyze, under each franchise agreement, the franchisor's right to require compliance with, and the franchisees' obligation to implement, the proposed system changes. Though time consuming, only through understanding each agreement then in effect can franchisors truly assess the risks associated with requiring compliance with system changes. Franchisors are well advised to plan their brand changes with the understanding that any given franchisee that resists will do so under its own agreement, which might not be the newest or most prevalent form or which might be a non-standard form altogether.

Which contractual provisions are most useful or relevant depends on the nature of the upgrades contemplated. But some common things to consider are: What do the agreements say about mandatory upgrades? Are specific things like décor, fixtures, and software or technology addressed? Are there contractual limitations around timing or frequency of, or costs associated with, mandatory system changes? Must the franchisor implement the changes first? Does the franchisor have additional rights at renewal or transfer?

Analyze the Franchise Laws. Likewise, the franchisor should review the relevant state relationship statutes and case law to determine whether it can require the change without violating applicable law.

Involve the Franchisees. Success or failure in implementing change often comes down to franchisee buy-in—in particular, planning how to encourage franchisee participation. Franchisees who feel like partners in the process and who are allowed to see the benefit of the change are more likely to willingly implement the change. We have seen franchisors involve franchisees in several ways such as running a pilot test at franchisee locations, involving franchisee advisory boards, and providing positive incentives like royalty rebates. Regardless of if or how a franchisor involves the franchisees, the franchisor should consider the value of things like notice, reasonable periods to comply, and consistent communication in structuring the system change.

Changes to the system are an inherent and necessary part of franchising—they are important to the brand's competitiveness and as a result, are important to every brand stakeholder. Advanced planning can help avoid missteps which can lead to costly and time-consuming litigation. Assessing respective contractual and statutory rights and obligations and taking steps to mitigate or avoid litigation risks must be key components of the roll-out plan for any significant system change.

For questions or more information regarding this Alert, please contact us.

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