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Thinking Ahead Before Terminating: Buyback Rights and Rights of the Franchisor When the Franchisee is Not Successful

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1. Introduction

Franchising offers a powerful model for business expansion, combining the brand strength and operational systems of franchisors with the entrepreneurial drive of franchisees. However, this partnership is not without its challenges. Franchisees often encounter a range of struggles that can threaten the performance and reputation of the broader brand network. From financial difficulties and operational inefficiencies to misalignment with brand standards, underperformance among franchisees presents complex issues that demand careful management. When performance concerns persist, it becomes imperative for both parties to explore structured, equitable exit strategies that preserve goodwill, minimize exposure, and best serve the needs of the parties.

Balancing the need to uphold brand integrity with the importance of supporting independent operators requires a strategic and legally sound approach. This paper will examine some of the avenues available to franchisors and franchisees when working towards a mutually agreeable exit strategy. It highlights ways to identify struggling franchisees in order that the parties can put together a successful plan to right the ship where possible and minimize losses, considers both contractual mechanisms and practical negotiation strategies when addressing underperformance and franchisee pushback, and offers insights on how to handle disputes over performance and identified defaults. The paper also discusses items to consider when assessing whether to sell the franchised business, as well as how to structure a realistic sales process once that decision is made in order to maximize value for all parties. It also addresses franchisor buyback and step-in rights, lease assignment considerations, and relevant case law. The paper highlights key challenges, best practices, and practical solutions for both business teams and counsel alike.

2. Identifying Struggling Franchisees

2.1 Identifying Struggling Franchisees/Signs of Financial Trouble

Identifying trouble in a franchisee’s business is easier when the franchisor and franchisee have a relationship built on trust and open communication. Contractual requirements aside, a franchisee is more likely to share the details of their financial situation or other struggles if they have benefited from sharing information over time. The franchisor’s conversations with franchisees should start from the beginning of the franchise relationship – if a franchisee is used to the franchisor coming to them in good times, they likely will be more receptive to you when you have to go to them in bad times.

Franchisees are more likely to share and review financial statements with the franchisor’s support team if review and coaching sessions lead to increased trust and profitability for the franchisee. An experienced and knowledgeable franchisor can identify key ratios or performance metrics, like labor costs, where a franchisee is behind their peers in the franchise system and offer corrective solutions to put money in the franchisee’s pocket. This process helps improve successful franchise operations, as well as identify those who may be starting to struggle with profitability or debt obligations.

A personal situation with the franchise owner, like divorce, illness or death of a family member can often be a precursor to financial trouble within the business. But a franchisor may not be aware of these events in time to help minimize the impact on the business without a strong relationship between the franchisee and the franchisor support team. A franchisor may indirectly learn of trouble within a franchise by receiving calls or complaints from the franchisee's creditors, landlords, customers, or current and former employees. The franchisee could be making timely royalty payments to the franchisor while still falling behind on payment obligations to third parties.

Some franchisors have internal minimum performance benchmarks, such as revenue levels based on years of operation, that raise red flags when not met by the franchisee. Failure to meet these internal metrics may simply result in a conversation between the franchisor and franchisee as to the reasons why. Many franchise agreements also contain minimum performance requirements through sales thresholds or minimum royalty fees. Failure to meet contractual minimums could result in a formal default, which can be used as leverage to encourage an uncooperative franchisee to make necessary changes in the business, like following a recommended marketing plan, or list the business for sale. Failure to follow the franchisor's recommendations could result in termination for failure to meet the minimum performance requirements, opening up the territory for someone else to take over.

Regardless of how it happens, the sooner the franchisee's issues are identified, the better the chances all parties have for either putting together a successful plan to either right the ship or minimize the losses and move on through termination, transfer, or acquisition.

2.2 Forbearance Agreements

In some cases, it may be in the best interests of both the franchisor and franchisee to temporarily alleviate the pressures of royalties and other fees to stabilize the business long enough to reach a sale or just get through short term cash flow issues. A forbearance agreement, under which the franchisor agrees to delay its default and termination rights if certain conditions are met can be a useful tool in these situations. Conditions imposed by the franchisor under a forbearance agreement may include the franchisee actively marketing the business for sale, reducing the asking price, implementing a proscribed marketing plan, paying down debt, or producing updated and accurate financial statements, among other things. The forbearance plan could be developed collaboratively when all parties recognize the need early on, or more forcefully by the franchisor after a default notice has been sent and the clock is ticking for potential termination.

Ideally, the extra time provided by a forbearance agreement will allow both parties to recoup their investment either through the eventual sale of the business or the improved financial position of the franchisee. In addition, both parties may be able to avoid the expense, headaches, and potential embarrassment of the termination

process. But forbearance agreements should not be used when the extra time will only dig the franchisee's hole deeper. Neither party benefits from the franchisee digging itself deeper into debt when closure or termination was inevitable. Parties must seriously consider the franchisee's willingness to adopt the conditions imposed by the franchisor as well as their likelihood of success before forbearing default and termination rights.

3. Addressing Underperformance and Legal Considerations

3.1 Defaults and Dispute Resolution

Franchise agreements typically contain detailed provisions outlining various grounds of default that may trigger the franchisor's right to terminate the relationship. These defaults generally fall into two primary categories: curable and incurable defaults. Curable defaults often include failures to maintain brand standards, late royalty payments, or inadequate reporting and typically provide the franchisee with a specified period (commonly 30 days) to remedy the deficiency. Incurable defaults, by contrast, represent more severe breaches that fundamentally undermine the franchise relationship, such as bankruptcy filings, abandonment of the franchised business, unauthorized transfers of the franchise, violation of applicable laws, or criminal conduct that could damage the brand's reputation.

Franchisors must meticulously adhere to the precise notice requirements specified in the franchise agreement and any applicable franchise relations law.[1] Courts have frequently invalidated terminations where franchisors failed to strictly comply with these procedural requirements, even in cases involving substantive defaults by the franchisee.[2] This judicial emphasis on procedural compliance reflects the courts' recognition of the significant economic investment franchisees typically make and the potentially devastating consequences of termination.

Franchisors also must carefully document any issues regarding the franchisee's performance that led to default. If it is a health and safety violation for example, a franchisor may have pictures of the issues (e.g., rodents at a restaurant), detailed write-ups by any franchise consultant or coach who has visited with the franchisee, and documented notices to the franchisee about the issues. Documentation will support the franchisor's position in the event litigation is brought.

3.2 Handling Disputes Over Performance and Default Notices

When disputes arise regarding franchisee performance standards, savvy franchisors employ a systematic approach that combines rigorous documentation with strategic communication. Effective dispute management begins well before formal default notices are issued, with franchisors maintaining comprehensive records of performance

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[1] *See e.g.,* CAL. BUS. & PROF. CODE § 20020 (providing for a "reasonable opportunity, which in no event shall be less than 60 days from the date of the notice of noncompliance, to cure the failure).

[2] Michael Einbinder, Benjamin Reed & Stephanie Russ, *It Ain't Over 'Til It's Over: Creating, Enforcing, and Defending Remedies Short of Termination*, ABA 46TH ANNUAL FORUM ON FRANCHISING W-7, at 27-28 (2023).

metrics, inspection reports, customer complaints, and all remedial communications. These records serve as critical evidence should litigation ensue.

Many franchisors will issue warning notices or compliance reports prior to elevating the level of enforcement to a notice of default and ultimately threatening termination.[3] When performance issues persist, franchisors must carefully balance assertiveness with reasonableness by implementing a graduated response protocol—beginning with informal coaching, progressing to written warnings that reference applicable agreement provisions, and only then escalating to formal default notices.[4] Particularly contentious situations may warrant involving neutral third-party mediators who specialize in franchise relationships, potentially resolving disputes before they evolve into costly litigation while preserving the business relationship.

3.3 Franchisee Pushback on Underperformance Allegations

Franchisees frequently contest performance-related default notices by challenging the objectivity or consistency of the franchisor's standards enforcement. Common defensive strategies include allegations of discriminatory enforcement (claiming other franchisees with similar deficiencies were not similarly cited), assertions that performance standards were unilaterally modified without proper notice, or contentions that market conditions beyond the franchisee's control rendered compliance impossible. Inconsistent enforcement may lead to both a breach of the implied covenant of good faith and fair dealing claims in some jurisdictions or a statutory claim for discriminatory treatment in others.[5] Additionally, franchisees may argue that the franchisor's own actions—such as territory encroachment, inadequate training, or insufficient marketing support—materially contributed to the alleged underperformance.

Sophisticated franchisors anticipate these defenses by implementing system-wide performance evaluation protocols that are demonstrably objective, consistently applied, and properly documented. It is also important to have objectively reasonable performance criteria or minimum performance standards. If the franchise agreement contains minimum performance standards that are so high that the majority of franchisees are not satisfying them, such performance standards become unrealistic and, from a legal perspective, the materiality of such standard becomes questionable.

3.4 Legal Considerations When Enforcing Performance Clauses

Courts may apply a material breach standard when evaluating performance defaults, requiring franchisors to demonstrate that the alleged deficiencies substantially undermined the franchise agreement's purpose or deprived the franchisor of an expected

[3] *Id.* at 8-9.
[4] *See also*, Karen Marchiano, Glenn Plattner & Leonard Vines, *Roadmap for the Default and Termination Process*, ABA 35TH ANNUAL FORUM ON FRANCHISING, at 4 (2012).
[5] ARK. CODE ANN. § 4-72-202(7), HAW. REV. STAT. § 482e-6(2)(C), (H), 815 ILL. COMP. STAT. 705/18, IND. CODE § 23-2-2.7-2(5), MINN. R. § 2860.4400(B), WASH. REV. CODE § 19.100.180(2)(c), WISC. STAT. § 135.02(4).

benefit.[6] This judicial approach necessitates that franchisors distinguish between trivial operational issues and substantive violations that genuinely threaten brand integrity or financial viability. Furthermore, the covenant of good faith and fair dealing, implied in franchise relationships across many jurisdictions, requires franchisors to exercise reasonable discretion when enforcing subjective standards and to provide franchisees with meaningful opportunities to remedy deficiencies.

State franchise relationship laws add another layer of complexity, as many impose "good cause" or other requirements for termination that demand more substantive justification than mere technical violations of the franchise agreement.[7] For example, in California, the California Franchise Relations Act sets forth that franchisees generally may not be terminated if in substantial compliance with the franchise agreement.[8] If a franchisee is not reaching the minimum performance standards, but otherwise is compliant with the franchise agreement, are they in substantial compliance? What if they are at 90% of the performance standard as compared to 50% of the performance standard? In such states, it would likely require a substantial deviation from the performance standard before a franchisee may be found not to be in substantial compliance.

In light of the risks attendant to wrongfully terminating a franchise, exploring many of the solutions set forth in this paper may make both better business and legal sense rather than pursuing a default and termination for an underperforming franchisee.

4. Selling the Business

4.1 Selling to a New Operator, Whether a New or Existing Franchisee

Once the franchisee has put together a package containing items like accurate financial statements, an inventory of assets, and an organizational chart, the struggling business can be marketed for sale. There are several routes for finding an interested buyer. The franchisor's development team may be aware of candidates interested in the brand in the same geographic area, but, due to limited available territory or a potential bargain, such candidates might consider the re-sale. Third-party franchise brokers often have clients who are only interested in re-sales or turn-around projects, not start-ups. Business brokers focused on the industry, but not franchising, are often an unexpected source of buyers in these situations as well.

However, other franchisees within the brand can be the best pool of potential buyers. Interest can be sought out through the franchisor's support team, or informal channels, like franchisee word of mouth, potentially eliminating the expense of broker commissions. Experienced franchisees within the network are also likely to have the best understanding of the challenges within the struggling business and how easily they can

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[6] *See also*, Karen Marchiano, Glenn Plattner & Leonard Vines, *Roadmap for the Default and Termination Process*, ABA 35TH ANNUAL FORUM ON FRANCHISING, at 28 (2012).
[7] *See e.g.,* CAL. BUS. & PROF. CODE § 20020
[8] *Id.*

be overcome. The buyer's existing infrastructure may also offer operational efficiencies, shared labor, or other cost cutting strategies that someone new to the system would not bring.

4.2 Challenges in Selling an Underperforming Franchise

When a franchise unit struggles to meet performance benchmarks, selling the business often emerges as a potential exit strategy. However, this path presents numerous complexities that both franchisees and franchisors must carefully navigate. The market for underperforming franchise units is inherently limited, with potential buyers typically demanding significant discounts that might not align with the franchisee's financial recovery expectations. And potential buyers might look for concessions from the franchisor. For example, a buyer might request reduced performance standards for a period of time so the buyer can increase the franchise's performance without being immediately in default.

There is also the question of whether the business is ready to be sold.[9] Are there liabilities outstanding that might prevent a sale? Or issues with employees, vendors or operations that are not easily fixed or that need time to remedy? Sometimes operations will need to be brought into compliance before an earnest attempt can be made to sell the business.

4.3 Franchisees' Reluctance to Disclose Sale Efforts

Franchisees frequently conceal their intentions to sell underperforming units, driven by a complex interplay of psychological and practical concerns. This reluctance stems from several key factors: employees may become disengaged or seek alternative employment upon learning of a potential sale, further exacerbating operational challenges; vendors might implement stricter payment terms or reduce credit lines; and regular customers could begin patronizing competitors amid uncertainty about the business's future. Beyond these practical considerations lies a profound psychological barrier—many franchisees view their business difficulties as personal failures rather than strategic challenges, with their self-identity and community standing intrinsically linked to their business success. This emotional entanglement often delays necessary exit decisions, as franchisees struggle to acknowledge publicly what they perceive as a personal shortcoming, particularly in tight-knit franchise systems where peer recognition carries significant weight.

4.4 Approaching Franchisees with "Tough Love" Discussions

Effective franchisors recognize the necessity of initiating candid conversations about business viability before the situation deteriorates beyond recovery.[10] These "tough

[9] *See also*, Roland W. Baggott III, Kathyrn M. Kotel, Julie Lusthaus, *Buying and Selling A Franchised Business: Guiding a Franchisee Through the Process*, ABA 42ND ANNUAL FORUM ON FRANCHISING, at 2 (2019).
[10] *See also*, Jason B. Binford, Robert F. Salkowski & Andra Terrell, *Structured Workouts: Franchisor Strategies for Dealing with the Financially-Challenged Franchisee*, ABA 38TH ANNUAL FORUM ON FRANCHISING W-20, at 13-14 (2015).
[10] *Id.* at 8-9.

love" discussions require a delicate balance of empathy and directness, ideally occurring during scheduled business reviews where performance data can be objectively presented alongside system benchmarks. Successful approaches typically involve framing the conversation around the franchisee's personal and financial wellbeing rather than system compliance, emphasizing that continuing to operate an underperforming unit often depletes retirement savings and increases personal debt and as discussed previously could lead to default and termination. Franchisors who maintain comprehensive financial benchmarking across their system possess a powerful tool for these discussions, as they can demonstrate objectively when a unit's performance falls significantly below sustainable or target thresholds. The most constructive conversations present multiple potential paths forward—including operational improvements with specific timelines or structured exit strategies—while emphasizing that maintaining the status quo represents the highest-risk option for the franchisee financially and possibly personally.

4.5 Assessing Risks of Holding Onto a Failing Business

Franchisees often underestimate the cumulative risks of persisting with underperforming operations, focusing primarily on short-term cash flow concerns while overlooking more insidious long-term consequences. Beyond the obvious financial drain of covering operational losses from personal finances, struggling franchisees frequently defer essential equipment maintenance or location remodels or updates, creating a cycle of deterioration that further erodes business performance and ultimately decreases the business's resale value.

The psychological toll represents another significant but often unacknowledged risk, with franchisees reporting elevated stress levels, sleep disturbances, strained family relationships, and diminished physical health—factors that impair decision-making capabilities precisely when clear judgment is most critical. From a legal perspective, continuing operations while underperforming increases exposure to multiple risks: potential default under lending agreements; personal liability under lease guarantees; tax liabilities that may pierce corporate protections; and labor law violations as cost-cutting measures become more desperate. Perhaps most critically, franchisees who delay necessary exit decisions typically deplete capital reserves that could otherwise fund a strategic transition, ultimately forcing more distressed and financially disadvantageous exits such as closures or bankruptcy.

In some cases, the situation within the business reaches the point where there is no value to a potential buyer, and the time and cost associated with continuing to market the business for sale is only making the situation worse. Neither party benefits from the franchisee continuing to dig itself into a financial hole it cannot escape, while the territory remains unavailable to new candidates. In these situations, a mutual termination agreement that releases both parties from further obligations under the franchise agreement, except for certain post-termination obligations, like indemnification rights and trademark restrictions, may be the best result.

The franchisor may lose its rights to future royalty fees or liquidated damages, and the franchisee would lose its chance to receive value for the business. But further royalties or fees in this situation would have likely driven the franchisee into bankruptcy anyway and the terminating franchisee could still receive some value by selling its assets, like equipment, preferably to other franchisees in the network. The mutual termination allows both parties to cut their losses and move on and opens up the territory for the franchisor to find a candidate who will have more success.

5. Lease Assignment Considerations

Brand recognition, consistency, and continuous operations are exceedingly valuable elements to any franchise system. As such, franchisors spend considerable resources protecting these interests. This is especially true for franchisors with brick-and-mortar locations, as one of the keys to their success is finding and maintaining great locations. This results in franchisors wanting to retain control of the valuable real estate upon the termination or expiration of the franchise relationship. Thus, a complex relationship often arises between the franchisor, the franchisee, and landlord. It is important that any lease for a valued location contains certain provisions to protect the parties' respective positions.

Certain lease terms are particularly important to franchisors upon the termination or expiration of the franchise relationship and should be negotiated at the outset. In addition to standard lease agreement provisions, franchisors often seek to obtain beneficial rights under the franchisee's lease agreement to protect themselves, their brand, and the location. This type of agreement is frequently referred to as a "lease rider" and commonly found in the franchise agreement itself or in an exhibit thereto. Essentially, a lease rider allows franchisors to effectively control a site without relying on its franchisees and without additional expenditure. The inclusion of a lease rider is especially important in the event of a franchisee default.

In an ideal world, a lease rider will be a tri-party agreement between the franchisor, the franchisee, and the landlord.[11] However, if a tri-party agreement is not feasible, the franchisor should be named as an intended third-party beneficiary under the lease, with an independent right to enforce the terms of the lease.[12] Importantly, the landlord will need to be a party to any agreement that binds it to deliver the premises.

While many provisions are important to include in the lease rider (including, for example, use clauses, notices clauses, and no amendment clauses), arguably the most important provision to include is the "lease assignment" provision. Such a provision is also commonly referred to as a "Collateral Assignment of Lease." A lease assignment provides the franchisor with the option to take an assignment of the franchisee's lease in the event of a default under the lease or franchise agreement. Put another way, in a lease

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[11] Mark D. Shapiro & Anne P. Caiola, *The Intersection of Franchise and Real Estate Law*, ABA 41st Annual Forum on Franchising W-15, at 5 (2018).

[12] *Id.*; *see also Trient Partners I, Ltd. v. Blockbuster Entm't Corp.*, 959 F. Supp. 748 (S.D. Tex. 1996) (even if agreement gave franchisor the right to assume the lease in absence of default by franchisee, franchisor would not have equitable title because there was no privity of contract between franchisor and landlord).

assignment, the franchisee presently assigns its rights under the lease to the franchisor. However, the franchisor's exercise of the assignment rights is conditioned upon specific events occurring, such as the franchisee's default under the lease or the franchise agreement (among other events).

For example, if a franchisee defaults under the terms of the lease, the landlord will typically send a notice of default to the franchisee (and sometimes the franchisor depending on the provisions of the lease), advising the franchisee of the lease default. If the franchisee fails to cure the default within the specific period of time, the lease assignment provision generally provides the franchisor with a period of time within which to accept assignment of the lease by providing notice to the landlord. Most lease assignment provisions give the franchisor the right to elect whether to exercise the lease assignment, but not necessarily the obligation to do so. And notably, courts generally uphold lease assignment provisions.[13]

Moreover, courts have held that a franchisor's failure to include a lease assignment provision in the lease itself was not a waiver of that right when a provision in the franchise agreement stated that the franchisor could take over the lease. In *Pearle Vision, Inc. v. Adler*, the court granted the franchisor's request for preliminary injunctive relief to prevent the former franchisee from assigning his lease for the former franchised business to a third-party.[14] The dispute arose when the franchisee notified the franchisor that he did not intend to renew the franchise agreement for his location. When the franchisor advised the franchisee that it elected to assume the lease pursuant to the parties' franchise agreement, the franchisee refused to assign the lease.

The franchisee argued that the franchisor waived its right to assume the lease by earlier failing to insist upon the franchisee's inclusion of a "franchisor assignment" clause in the lease. Given the absence of the assignment clause, the franchisee claimed that the franchisor had no automatic right to assume his interest in the lease for the continued operation of the franchised business at that location. Ultimately, the court rejected this argument. The court noted that the franchisor intended to exercise, rather than relinquish, its lease assumption right despite the lack of a franchisor assignment clause in the lease. Second, the existence of general and specific contractual anti-waiver provisions in the franchise agreement, the franchisor's prompt notification to the franchisee of its decision to assume the lease, and the clear language of the franchise agreement requiring the franchisee to include a franchisor assignment clause in any lease for the business all weighed heavily against the franchisee's argument that the franchisor waived its right to assume the lease.

[13] *See Snelling & Snelling v. Martin*, Bus. Franchise Guide (CCH) ¶11,384 (N.D. Cal. Jan. 28, 1998) (court upholding lease assignment provision and holding "the lease assignment provision in this case is apparently intended to allow Snelling to retain clients who are familiar with the precise location of the business; if defendants remain in the premises and Snelling is forced to operate elsewhere, it loses the intangible benefit of that location."); *Dunkin' Donuts v. Taseki*, 47 F. Supp. 2d 867 (E.D. Mich. 1999) (granting franchisor's request for an order requiring franchisee to comply with the terms of the lease option agreement); *Dunkin' Donuts, Inc. v. Dowco*, No. CIV 5:98-CV-166, 1998 WL 160823 (N.D.N.Y. Mar. 31, 1998) (ordering specific performance of lease option agreement after termination of franchise); *Dunkin' Donuts of Am. V. Middletown Donut Corp.*, 495 A.2d 66 (N.J. 1985) (upheld enforceability of similar provision and compelled terminated franchisee to turn over leased premises).

[14] No. 1:07CV321, 2008 WL 2704407, at *1 (S.D. Ohio July 3, 2008).

Importantly, the court found that the franchisor risked substantial irreparable injury in the form of "loss of [a] location and the goodwill it has developed through that store" if the franchisee was allowed to freely assign the lease to a third party. In light of these findings, the court granted the franchisor's request for a preliminary injunction and ordered the franchisee, within thirty days of the order, to seek the landlord's approval to assign the lease to the franchisor.

Best practices, however, would be to include the lease assignment provision in the lease or a lease rider in an effort to avoid litigation like in *Pearle Vision, Inc. v. Adler*. Moreover, a lease assignment should be consented to by the landlord at the time the lease assignment is signed, not when the franchisor is exercising its rights under the lease assignment. If not, the landlord may not be obligated to recognize the franchisor's right to the premises under the lease.[15]

Another issue that arises with lease assignments is the franchisor's ability to designate a replacement franchisee and refranchise the unit, without the franchisor directly assuming the lease itself. Franchisors prefer this option to avoid successor liability issues. Landlords, however, often seek to retain the right to approve or disapprove the party taking over the franchisee's position under the lease. As a compromise, the parties may agree that the landlord's consent to the franchisor (or its designee, including a new franchisee) will not be required if the franchisor or the new franchisee meets certain agreed-upon financial and operational criteria. This places the onus on the franchisor to bring in a new franchisee that meets these financial and operational criteria. However, it is recommended that a landlord's approval of an assignment of the lease to the new franchisee be a required condition to the franchisor's consent to transfer or assign the franchise agreement to the new franchisee. Another option would be to limit an assignment to an existing operator in the franchise system who has a minimum number of years of experience.

Once a franchisor decides to exercise its rights under a lease assignment provision, it often must cure the franchisee's defaults under the lease, whether those defaults be monetary or non-monetary defaults. In negotiations with the landlord, a franchisor should attempt to limit their liability in the event it assumes the lease. This might take the form of capping the required cure amount. Whether such language is ultimately included in a lease rider will necessarily depend on the bargaining power of the landlord and franchisor; however, it is expected that the landlord will seek to have the existing defaults completely cured if the franchisor chooses to exercise its assignment rights. Being able to limit your liability as a franchisor who might want to assume a lease from a defaulting franchisee/tenant, disincentivizes the landlord form allowing a franchisee/tenant to remain in breach for extended periods while running up the back-rent.

[15] *See Danbury Mall Assocs. Ltd. P'ship v. Mazel Enterprises, LLC*, No. CV030347873S, 2004 WL 1832904, at *2 (Conn. Super. Ct. July 14, 2004) (landlord permitted to ignore franchisor's rights under collateral assignment of lease with franchisee where there was no evidence that landlord consented or acquiesced to the collateral assignment of lease).

Successor liability issues also arise when franchisors exercise their right to take an assignment of a lease and related operating assets. In addition to curing lease defaults, franchisors may have additional exposure including third-party liabilities such as tax liabilities, utility charges, vendor liens, and other obligations.[16] And these same concerns also exist for the next franchisee. One consideration franchisors face with regard to lease assignments is whether the franchisor wants to place themselves in the chain of title, even for a short period of time. This is because when franchisors place themselves in the chain of title, creditors may see a potential for recovery against the franchisor with deeper pockets, regardless of the merits of the claim.[17]

Thus, it is important for the franchisor to include language in the lease assignment that the franchisor's cure of the franchisee's defaults of the lease will not excuse the franchisee from liability for the amount expended by the franchisor to cure the defaults. As a practice tip, it is important to research state successor liability laws in order to assess the risk of becoming responsible for the prior franchisee's liabilities. In short, the franchisor should preserve the right to recover against the franchisee for its efforts in curing the defaults under the lease.

Additionally, some franchisors will request the right to exercise renewal or extension options that a franchisee/tenant fails to exercise under a lease. This is another way a franchisor might protect the goodwill of the brand generated at that specific location and continue to have a presence in the market. If granted, following notice of the franchisee's failure to exercise its renewal rights, the franchisor would have the right to assume the lease for the option period, and, upon satisfaction of the franchisee's lease obligations, the franchisee would be released.

6. Structuring a Realistic Sale Process Once Decision to Sell Is Reached

Successfully transitioning an underperforming franchise requires a carefully structured sales process that acknowledges the unique challenges these transactions present. Unlike the sale of thriving businesses, underperforming franchise units demand specialized approaches that balance the franchisee's need for an expeditious exit with the practical realities of the marketplace. A well-structured process not only increases the likelihood of completing a transaction but also helps preserve value by maintaining operational continuity and stakeholder relationships throughout the transition period.

6.1 Setting Reasonable Timelines and Expectations

Establishing realistic timelines represents a critical first step in structuring an effective sales process for underperforming franchises. Franchisees must recognize that distressed business sales typically require significantly more time than conventional transactions, with realistic timeframes generally ranging from 6-18 months from initial marketing to closing. This extended timeline reflects several factors unique to

[16] Mark D. Shapiro & Anne P. Caiola, *The Intersection of Franchise and Real Estate Law*, ABA 41st Annual Forum on Franchising W-15, at 6 (2018).
[17] *Id*.

underperforming franchise transfers: the limited pool of qualified buyers willing to consider distressed units; the comprehensive due diligence such buyers typically conduct; and the multi-layered approval process involving both the franchisor and potentially third-party landlords or lenders.

Franchisees should develop a detailed transaction timeline that incorporates these contingencies while establishing clear financial benchmarks to determine how long they can sustain operations during the sales process. Price expectations similarly require careful calibration, with successful sellers typically adjusting initial valuation expectations downward as the process unfolds. These longer timelines can also represent a challenge for the franchisor who may have considered terminating the franchise. How long are they willing to allow a non-compliant franchise to continue to operate? Often, a compromise of 6-12 months is provided to a franchisee to sell the business and if the business is not sold within the defined period, then there is a resulting termination of the franchise. Coupling a timeline to sell within the defined period and a right to terminate that is undisputed by the franchisee provides the franchisor assurance that its issues with the franchise will be resolved one way or the other.

6.2 Franchisor's Role in Assisting the Sale

The franchisor's involvement in the sale of an underperforming unit can range from simply providing consent to transfer to active facilitation, depending on the franchise system's approach and the specific circumstances of the unit. Franchisors with substantial turnover may dedicate resources to resales to assist franchisees who seek to sell their business.[18] Concrete assistance may include providing access to the franchisor's pool of qualified franchise candidates who expressed interest in existing units; brokering the sale of the franchise themselves; expediting the transfer approval process with dedicated staff resources; and occasionally offering financial incentives such as reduced transfer fees or temporarily modified royalty structures to facilitate transactions for units in challenging markets. In providing additional assistance, the franchisor gets the benefit of reducing terminations and the resulting "black eye" in Item 20 of the franchise disclosure document.

6.3 Use of Third-Party Brokers to Validate Effort

Engaging specialized franchise business brokers provides multiple strategic advantages beyond merely identifying potential buyers. First, experienced brokers bring valuable objectivity to the pricing process, helping franchisees establish defensible asking prices based on comparable transactions within the franchise sector. Second, professionally marketed listings create documented evidence of reasonable commercial efforts to sell the business—documentation that may prove crucial should disputes later arise regarding the franchisee's good faith efforts to mitigate damages through sale rather than abandonment. Third, reputable brokers maintain relationships with franchise-specific

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[18] *See also*, Roland W. Baggott III, Kathyrn M. Kotel, Julie Lusthaus, *Buying and Selling A Franchised Business: Guiding a Franchisee Through the Process*, ABA 42ND ANNUAL FORUM ON FRANCHISING, at 6-7 (2019).

lenders who understand the unique aspects of franchise transfers and may offer creative financing solutions for underperforming units.

The challenge is that brokers may not be interested in selling an underperforming location knowing that the buyer pool is limited, and their efforts may go to waste. The use of a broker is more likely in situations where the average franchisee in a system is profitable, but an isolated, underperforming unit is being sold.

7. Franchisor Buyback and Step-In Rights

While there are situations where it is in the franchisor's best interest to simply let the franchise business close and de-identify, in some cases a franchisor may decide that it is in the best interest of the brand and the system for the franchisor itself to operate the business. In that case, the franchisor is faced with a variety of decisions about how best to continue such operations.

7.1 When the Franchisor Should Consider Buying Back the Unit

A buyback refers to a process where a franchisor purchases certain items from a franchisee, whether it be the entire franchise business or certain assets or inventory of the franchisee. For the franchisor, a buyback of the franchised business can help maintain band consistency, quality standards, customer loyalty, and maintain goodwill created, especially in situations where a franchisee is violating the franchise agreement or facing financial difficulties. A buyback of the franchised business can also provide the franchisor with an opportunity to resell the franchised business to a more qualified franchisee, of expand its corporately owned networks. However, a buyback of the franchised business can be costly if the unit has low sales or requires significant renovations or upgrades. For franchisees, a buyback option might affect resale strategies and financial outcome, but it also provides a way to exit the franchise system, avoid litigation, and recover some of its initial investment. Notably, however, a buyback can limit the franchisee's bargaining power and choice of buyer, as the franchisor might have the right of first refusal to buy back the unit in any event (as discussed elsewhere herein).

The terms of the buyback are generally outlined in the franchise agreement, but state relationship laws should also be consulted when dealing with buybacks. Importantly, some state relationship laws require the franchisor to "buyback" or repurchase certain items upon termination of a franchisee, so it is important to be cognizant of these provisions.[19] The state relationship laws differ depending on (1) whether repurchase is required if there is good cause for termination, (2) whether repurchase is required in the case of both termination and nonrenewal, (3) what must be repurchased, and (4) the price that must be paid.[20] For example, in California, upon lawful termination, the franchisor must repurchase items from the franchisee except for in certain defined circumstances.[21]

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[19] The states with these provisions include: Arkansas, California, Connecticut, Hawaii, Maryland, Rhode Island, Washington, and Wisconsin.
[20] Karen Marchiano, Glenn Plattner, & Leonard Vines, *Roadmap for the Default and Termination Process*, 35th Annual ABA Forum on Franchising, W-7, at 19 (2012).
[21] CA Bus & Prof Code § 20022 (2024).

By contrast, in Arkansas, a franchisor is required to repurchase items from franchisees if the franchisee was terminated without good cause.[22] In Wisconsin and Rhode Island, a franchise must repurchase only the inventory items sold by the franchisor to the franchisee for resale that bear the franchisor's name, trademark, label, or other mark identifying the franchisor.[23] And in Washington, franchisors do not have to repurchase items that are not reasonably required in the operation of the franchise business.[24]

Additionally, some states, like California, provide exclusions to buyback requirements, where the repurchase obligation does not apply if the franchisee declines a bona fide offer of renewal from the franchisor or if the franchisor does not prevent the franchisee from retaining control of the principal place of the franchised business.[25] Thus, familiarity with state relationship laws' buyback provisions is an important consideration for both franchisors and franchisees alike.

7.2 Exercising Operational Step-In Rights

Sometimes a franchisor might want to keep a franchised unit open but does not want to purchase the franchised unit itself and cannot find an appropriate buyer.[26] In this circumstance, one of a franchisor's options might be to take over the operations of the franchise business directly or through an affiliate. Some franchise agreements contain provisions granting the franchisor "the right to assume the operation and/or management of a franchisee's business during a certain period of time and under certain circumstances."[27] These are often referred to as step-in rights.

As a general matter, courts generally enforce step-in rights. For example, in *Sunni, LLV v. Edible Arrangements, LLC*,[28] a federal court enforced a franchisor's step-in rights and held that a franchisee failed to establish irreparable harm when seeking an injunction against the franchisor. In *Sunni*, a franchisor did not renew a franchise agreement and terminate another franchise agreement where a co-owner of the franchisee due to the co-owner's "egregious, admitted criminal conduct."[29] The franchisee filed for arbitration, and subsequently, the franchisor notified the franchise that it planned to terminate the franchises' access to the online ordering systems before the arbitrator had decided the matters.[30]

The franchisee then filed an action in New York state court for an order to show cause as to why the franchises should not be allowed to operate during the pendency of

[22] Ark. Stat. Ann. § 4-72-209.
[23] WI Stat. § 135.045 (2024); R.I. Gen. Laws § 6-50-5.
[24] RCW 19.100.180(2)(i).
[25] CA Bus & Prof Code § 20022(c)-(d) (2024).
[26] Michael Einbinder, Benjamin B. Reed, & Stephanie Russ, *It Ain't Over 'Til It's Over: Creating, Enforcing, and Defending Franchisor Remedies Short of Termination*, 46th Annual ABA Forum on Franchising, W-7, at 21 (2023).
[27] Scott McIntosh & Emily Plakon, *Alternatives to Termination: Effective Means of Facilitating Compliance or Merely Delaying the Inevitable*, 43 Franchise L.J., p. 273 (2024).
[28] *Sunni, LLC v. Edible Arrangements, LLC*, No. 14-Civ 461 (KPF), 2014 WL 1226210 (S.D.N.Y. March 25, 2014).
[29] *Id*. at *4.
[30] *Id*. at *5.

the arbitration proceedings.[31] The franchisor ultimately removed the action to federal court, and the franchisee moved again for an injunction to prevent immediate and irreparable harm by virtue of the franchisor's termination of the franchisee's access to the online ordering platform. During a hearing held by the court, the franchisor represented to the court that upon termination of the agreements, it intended to exercise its contractual right to assume management of the three franchises on an interim basis until the franchisee's claims were resolved in arbitration.[32] Thus, if the court denied the franchisee's motion for a preliminary injunction, the franchisor would assume control and operate the three franchises in a manner consistent with their current operation, including maintaining all leases, retaining staff and employees, and maintaining all appropriate records of the franchises.

The court ultimately denied the franchisee's motion for preliminary injunction, holding that among other reasons the franchisee could not show irreparable harm. The court noted that the franchisee's argument regarding "irreparable harm [was] essentially negated by [the franchisor's decision to assume management of the three franchises during the pendency of the arbitration" and effectively validating the franchisor's exercise of its step-in rights.[33]

A franchisor may have various objectives when deciding to exercise step-in rights. Those objectives might include ensuring the continuing operation of its franchises, protecting the brand from reputational harm associated with outright termination and closure of the franchise,[34] or preventing a franchisee's destructive behavior once it finds out termination is imminent. Other times it might be in the franchisor's interest to step in and operate/manage the business itself in order to bring the franchisee back into compliance and avoid termination. Generally, however, a franchisor will only resort to this exercising step-in rights when it has exhausted other forms of assisting a struggling franchisee through mentorship, training programs, or even financial assistance.[35] The following events often trigger a franchisor to exercise step-in rights include:

- Death or disability of the franchisee or franchisee's owner;
- Situations in which there is no one to operate the franchised business;
- Franchisee abandonment or absentee franchisee;
- Situations where a franchisee's action threatens the goodwill of the brand or the system; and
- Defaulted franchisees, among others.[36]

Importantly, step-in rights provide a franchisor with the right but not the obligation to exercise step-in rights. And while a franchise agreement might provide the franchisor with step-in rights, such rights are rarely exercised. One reason is likely that the risk of

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[31] *Id*.
[32] *Id*. at *6.
[33] *Id*. at *9.
[34] *Id*.
[35] Dominic Mochrie, James M. Susag, & Harris J. Chernow, *Ensure Your Good Deed Goes Unpunished – Assisting Struggling Franchisees*, 54th Annual IFA Legal Symposium (2022).
[36] *Id*. at p. 273-274.

potential liability for a franchisor is much higher when it participates in the day-to-day management of the franchised business. Further, taking over management of a franchised business can create logistical problems for the franchisor, as well as administrative and accounting challenges because the franchisor will have to meet the franchisee's ongoing obligations to vendors, suppliers, and landlords.

Additionally, many franchisors do not have the infrastructure to take over a franchised business. This is especially true for industries where employees need certain licenses or qualifications, such as healthcare and education, among many others. Thus, if the franchisor finds itself in a situation where it is not able to operate the franchised business for one of these reasons, it may be more prudent to shut down the business.

In some circumstances, even if the franchise agreement does not include a provision that grants the franchisor the right to assume operation and/or management of the franchise agreement, a defaulted franchisee facing the threat of termination might want to enter into an ancillary agreement with the franchisor to handover operations for a limited period of time rather than lose the franchised business.[37] In such an ancillary agreement, the franchisor might require the franchisee either to sell the business a pre-determined price or turnaround the business in an agreed to period of time.[38]

If the parties decide to enter such an agreement, it should establish a realistic timeline that meet the parties' respective goals and sets forth who will bear the costs of operations. The agreement should also state the consequences of parties not meeting their respective goals, such as returning the franchised unit to the franchisee or ultimately closing the unit. Additionally, the agreement should address the franchisee's obligation to provide insurance coverage and indemnification during the period of time the franchisor is operating the business. This type of management agreement might also be a good solution for a franchisor who does not want to buy back the franchised unit but there is not another franchisee to purchase the franchise. Assuming operations for a specific amount of time can serve as a good solution for the franchisor to preserve the franchised business for a future sale.[39]

7.3 Enforcing Step-In Rights

Because the need to enforce step-in rights and buyback provisions usually occur with a failing or non-compliant franchisee, the franchisee may be unwilling to let the franchisor step in and take over the business. In this circumstance, a franchisor would need to seek injunctive relief and be prepared to establish that it will suffer irreparable harm if not allowed to exercise its step-in rights.[40] For example, in *Interim Healthcare, Inc.*

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[37] Patrick J. Maslyn & Morgan Ben-David, *Enforcement and Risks of Post-Termination Buybacks and In-Term Step-In Rights*, IFA 52nd Annual Legal Symposium (2019).

[38] Michael Einbinder, Benjamin B. Reed, & Stephanie Russ, *It Ain't Over 'Til It's Over: Creating, Enforcing, and Defending Franchisor Remedies Short of Termination*, 46th Annual ABA Forum on Franchising, W-7, at 22 (2023).

[39] *Id*. at 3.

[40] *Interim Healthcare, Inc. v. Interim Healthcare of S.E. Louisiana, Inc.*, No-19-CV-62412, 2020 WL 3078531 (S.D. Fla. June 10, 2020) (franchisor sought and was granted an injunction allowing it to exercise step-in rights and operate the franchise to prevent customer confusion and harm to the franchisor's goodwill and reputation where the franchisee

v. Interim Healthcare of S.E. Louisiana, Inc., a franchisor sought and was granted an injunction allowing it to exercise step-in rights and operate the franchise to prevent customer confusion and harm to the franchisor's goodwill and reputation where the franchisee continued to operate under the franchisor's marks and refused to comply with the step in rights provided in the parties' franchise agreement.[41] The court specifically noted that Further, the requested preliminary injunction was not against the public interest because "[t]he public interest is served by supporting contractual enforcements that fortify the franchise system itself."[42]

Additionally, cases have arisen where a franchisor's exercise of its step-in rights have exposed it to claims for breaches of duties, such as a breach of the duty of good faith and fair dealing or potential duties owed to a franchisees' employees and customers.[43] For example, in *Charter Practices Int'l, LLC v. Robb*, the franchisor delivered a notice of termination to the franchisee for administering half-doses of rabies vaccines, in violation of the Connecticut Unfair Trade Practice Act, and therefore provided good cause for termination.[44] The franchisor exercised its step-in rights and designated an affiliate to operate the business.[45] The franchisee, however, took steps to interfere with the franchisor's operation of the business, and the franchisor filed suit for breach of contract and sought a temporary restraining order and preliminary injunction.[46]

The franchisee counterclaimed against the franchisor claiming breach of the covenant of good faith and fair dealing due to the franchisor's exercising step-in rights during the time of between termination and the sale of the franchise to a third party.[47] Specifically, the franchisee claimed that exercising step-in rights was equivalent to a termination and deprived the franchisee of the 60 days' notice required pursuant to the Connecticut Franchise Act. Ultimately, however, the federal court dismissed the franchisee's counterclaim, reasoning that while the franchise agreement permitted the franchisor to exercise its step-in rights during this period of time, it was also clear that the franchisee still owned the franchise and that any revenue generated would accrue to the franchisee's account until the official date of termination.[48]

Lastly, as explained elsewhere herein, the franchisor must also ensure ancillary contracts, such as lease agreements, do not interfere with its ability to exercise its rights to take over the operations of the franchise business.

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continued to operate under the franchisor's marks and refused to comply with the step in rights provided in the parties' franchise agreement);

[41] No-19-CV-62412, 2020 WL 3078531 (S.D. Fla. June 10, 2020).

[42] *Id*. at *21.

[43] Scott McIntosh & Emily Plakon, *Alternatives to Termination: Effective Means of Facilitating Compliance or Merely Delaying the Inevitable*, 43 Franchise L.J., p. 278 (2024).

[44] 3:12-CV-1768 (RNC), 2017 WL 4366717, at *3 (D. Conn. Sept. 30, 2017).

[45] *Id*.

[46] *Id*.

[47] *Id*.

[48] *Id*. at *4.

8. Valuation Considerations

Despite the inherent challenges of selling an underperforming franchise unit, strategic preparation can significantly enhance valuation outcomes. Franchisees facing this scenario must recognize that conventional business valuation metrics—typically based on multiples of EBITDA—may yield disappointing results when earnings are minimal or negative. In such cases, the focus must shift toward asset-based valuation approaches while simultaneously addressing operational deficiencies that can be remedied in the short term. Comparisons for valuation purposes can also be found in other franchise sales or public listings such as on BizBuySell.com.[49]

8.1 Strategies for Maximizing Valuation

The strategic repositioning of an underperforming franchise for sale requires a systematic approach beginning 6-12 months before the intended transaction. Franchisees should first conduct a thorough operational assessment to identify "quick wins" that can improve performance metrics with minimal investment—such as adjusting operating hours (where allowed) to eliminate consistently unprofitable time periods or implementing targeted marketing initiatives with measurable ROI. Documentation becomes particularly crucial in this context; maintaining detailed records that differentiate between one-time expenses and recurring operational costs enables prospective buyers to recognize opportunities for improved performance under new ownership. Additionally, franchisees should resolve any outstanding litigation or regulatory issues, as these represent significant red flags for potential buyers and franchisors considering buybacks. Perhaps most critically, franchisees must resist the temptation to artificially inflate short-term performance through unsustainable cost-cutting measures like reduced staffing or lower-quality inputs, as sophisticated buyers and experienced franchisees will readily identify these tactics during due diligence, potentially undermining credibility in the transaction process and causing a deal to fall through.

8.2 Determining Fair Market Value in Sales and Buybacks

The determination of fair market value in underperforming franchise transactions requires careful consideration of multiple valuation methodologies, as traditional earnings-based approaches often prove inadequate. Asset-based valuations typically establish the baseline, accounting for tangible assets such as equipment, inventory, and leasehold improvements, while adjusting for accumulated depreciation and deferred maintenance requirements. The franchise agreement itself represents a critical reference point, as many contracts contain specific buyback provisions that prescribe valuation formulas or procedures. These provisions may include predetermined formulas such as valuing the assets at the lesser of the fair market value or depreciated book value,[50] third-

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[49] *See also*, Roland W. Baggott III, Kathyrn M. Kotel, Julie Lusthaus, *Buying and Selling A Franchised Business: Guiding a Franchisee Through the Process*, ABA 42ND ANNUAL FORUM ON FRANCHISING, at 3 (2019).

[50] *See also*, Susan E. Tegt & Carmen Caruso, *Business Valuation Issues in Franchise* Cases, ABA 43RD ANNUAL FORUM ON FRANCHISING, 5-7 (2020).

party appraisal mechanisms, or right of first refusal clauses that allow franchisors to match any bona fide third-party offer.

9. Another Consideration – Right of First Refusal

A right of first refusal is found in many (if not most) franchise agreements and are important considerations for franchisors and franchisees alike. A right of first refusal generally provides the franchisor with the right, but not the obligation, to purchase a franchise unit before a franchisee can sell it to a third-party outside buyer on the same terms and conditions as those offered by the third-party purchaser. In short, when a franchisee receives an offer from a third to purchase or transfer its business, the franchise agreement typically requires the franchisee to notify the franchisor of the terms and conditions of the offer.

The franchise agreement may also require the franchisee to provide a copy of the proposed contract for transfer, as well as information including financing arrangements, accommodations extended to or by the franchisee, and information on the proposed buyer. Upon receiving this notice, the franchisor has a specified period of time to respond and exercise its right of first refusal. The specifics of any rights of first refusal are generally outlined in the franchise agreement, but often a franchisor must match the offer made by the third party. If the franchisor decides not to exercise its right of first refusal, then the franchisee is free to proceed with the transaction to the third-party as outlined by that offer and in compliance with the terms of the franchise agreement.

A third party's offer to purchase the franchised business needs to be a valid, bona fide offer under the terms of the franchise agreement in order for the franchisor to be able to exercise its right of first refusal. For example, in *IJLSF, LLC v. It's Just Lunch International, LLC*, [51] a California court of appeal affirmed trial court ruling that a third party's offer to purchase a franchise was not a valid, bona fide offer under the terms of a franchise agreement because the purchase price was contingent on the franchise's future revenue. In *IJLSF, LLC*, the franchisee sought to tell its business to a third-party buyer who owned and operated several franchises of the same business in other locations, for a certain price, most of which was contingent on future revenues.[52]

When the franchisor received notice of the proposed sale of the franchisee, rather than reject the offer as indefinite on price (as the franchise agreement gave it the right to do), it instead treated the offer as acceptable and asserted its right of first refusal on the same terms and conditions.[53] The franchisee objected and ultimately filed a lawsuit where the parties litigated whether the franchisor had the to purchase the franchise. The trial court ruled that the offer was not a valid, bona fide offer to purchase the franchise—as defined in the franchise agreement—because the offer did not set a fixed purchase price and entered judgment in favor of the franchisee.[54]

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[51] No. E071940, 2021 WL 3012850 (Cal. Ct. App. July 16, 2021).
[52] *Id*. at *1.
[53] *Id*.
[54] *Id*.

Thereafter, the parties appealed, and the appellate court affirmed the ruling of the trial court. The appellate court interpreted the plain language of the franchise agreement—which required that any offer include a "purchase price . . . in a dollar amount"—and concluded that the parties intended any sale to be on more definite terms than those agreed to by the third-party and the franchisee.[55] The court reasoned that the requirement that the offer include a set dollar amount provides the franchisor with information it needs to evaluate whether to approve the sale or exercise its right of first refusal and step in as purchaser.[56] The court further held that the offer was vague because the purchase price would change depending on who acquired the franchise and runs the business.[57] Finally, the appellate court held the trial court erred in holding that the franchisor had waived its right under the franchise agreement to reject the purchase offer and remanded for further proceedings on that issue.[58]

A right of first refusal enables the franchisor to maintain control over the transfer of the franchised business and ensure that a qualified and suitable replacement is found for the outgoing franchisee. This allows the franchisor to protect the franchised business's reputation and maintain consistency across the franchise system. A right of first refusal also gives the franchisee some certainty that it will have a willing buyer for their franchised business, whether it be the franchisor or a third-party buyer. However, some franchisees argue that the inclusion of a right of first refusal in the franchise agreement inhibits the franchisee's ability to sell the franchised business.

Franchisors and franchisees alike should be aware of the specific requirements and notice provisions associated with the right of first refusal, as failing to adhere to these specific requirements can result in potential disputes or even legal actions.[59] Franchisors should also consider the implications (financial, operational, etc.) of exercising its right of first refusal.

The right of first refusal is not without limitations, however, and the franchise agreement typically defines that scope. For example, the right of first refusal may only apply to the sale of the franchised business, but not other parts of a transaction. *Tavarua Restaurants, Inc. v. McDonald's USA, LLC*,[60] is instructive. In *Tavarua*, the plaintiff franchisees sought to sell eight McDonald's franchise locations, along with an office and storage facility to a third party. The proposed transaction was structured as a purchase and sale agreement, which contemplated a third party purchasing the corporate stock to own the eight McDonald's franchises, as well as purchasing the plaintiff franchisees' office and storage facility.

Notably, the franchise agreement required the plaintiff franchisees to obtain McDonald's written consent prior to completing the sale and purchase. The franchise

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[55] *Id*. at *9-10.
[56] *Id*. at *10.
[57] *Id*. at *11.
[58] *Id*. at *15.
[59] *See Paccar Inc. d/b/a Peterbilt Motors Co. v. Elliot Wilson Capitol Trucks LLC,* 2013 U.S. Dist. LEXIS 21004, (D. Md. Feb. 8, 2013) (manufacturer's exercise of its right of first refusal was not timely and therefore ineffective where manufacturer was aware of essential terms of transaction and had sufficient time to obtain other details it needed).
[60] Bus. Franchise Guide (CCH) ¶ 16,487, 2019 WL 3858826 (S.D. Cal. Aug. 16, 2019).

agreement also provided the franchisor with a right of first refusal. McDonald's chose to exercise its right to purchase the eight franchise locations. However, McDonald's refused to purchase any assets of the corporation unrelated to the franchised restaurants, including the office and storage facility. Thus, the plaintiff franchisees rejected McDonald's attempt to acquire the restaurants.

The plaintiff franchisees filed suit seeking a declaratory judgment that McDonald's failed to validly exercise its right of first refusal under the franchise agreement. McDonald's counterclaimed, seeking a declaratory judgment that it did validly exercise its right of first refusal and validly exercised its right to purchase the restaurants for the purchase price set forth in the purchase and sale agreement. The key language in the franchise agreements was "McDonald's shall have the first option to purchase the Restaurant by giving written notice to Franchisee of its intention to purchase on the same terms as the offer within ten (10) days following McDonald's receipt of such notice."

McDonald's argued that the language of the franchise agreement that governs its right of first refusal did not encompass and was not contingent upon the purchase, sale, or transfer of any assets unrelated to the restaurant franchises, specifically the office and storage facility. The plaintiff franchisees argued that the language "on the same terms as the offer" meant that McDonald's had to agree to the terms of the purchase and sale agreement, which included the purchase of the office and storage facility, and McDonald's could not "cherry pick," agreeing to some but not all of the terms of the purchase and sale agreement.

The court ultimately agreed with McDonald's, granting its motion for partial judgment on the pleadings. Citing Illinois law, the court held that McDonald's validly exercised its option to purchase the restaurant franchises at the purchase price set forth in the purchase and sale agreement and was not required to purchase assets unrelated to the restaurants. In responding to the plaintiff franchisees' arguments, the court reasoned that the terms and conditions of the purchase and sale agreement regarding the office and storage facility were outside of the scope of the franchise agreements. Specifically, the court stated, "[t]he franchise agreements set forth the terms of the option, which concern the purchase of the restaurant franchises—nothing more."

In short, the right of first refusal option in the franchise agreement was only related to the restaurant franchises. And while the scope of the purchase and sale agreement went beyond the restaurant franchises, that did not mean that McDonald's had to agree to terms that did not impact the restaurant franchises in its exercise of its right of first refusal.

The key takeaway for a franchisor in this case is that when a right of first refusal is properly drafted, a franchisor can exercise its right of first refusal without having to agree to all of the terms in a potential deal. The franchisor need only to focus on terms that address the franchise. However, from the franchisee's perspective, it is important to carefully structure the transaction to define which assets relate to the franchise business. But both parties must review the right of first refusal in the franchise agreement and the potential transaction in order to identify any pertinent risks.

Lastly, it is always important to review state relationship and franchise laws when discussing a franchisor's ability to impose restrictions on the franchisee's ability to transfer its business, including with regard to rights of first refusal. For example, the Michigan Franchise Investment Law prohibits a requirement in the franchise agreement that the franchisee sell assets of the business back to the franchisor that are not uniquely identified with the franchise, but it does not prohibit a provision that grants a franchisor a right of first refusal to purchase the assets of a franchise on the same terms and conditions as a bona fide, third-party willing and able to purchase those assets. [61]

Regardless of their right to do so, franchisors should expertise caution in taking over a franchise if the franchisor does not have infrastructure dedicated to running company locations. A system that is 100% franchised may have industry experience and know-how on its support team. But if those people are fully tasked with training and support of other franchisees, they are unlikely to have the bandwidth to run a company location. Without the right people fully engaged in turning around the struggling location, the situation could end up worse, not better.

10. Conclusion

Ultimately, there are many things to consider when deciding whether to terminate the franchise relationship from both a business and legal perspective. While this paper is not designed to explain in detail the procedural and legal requirements for defaults and terminations, there are some pitfalls that franchisors and franchisees should avoid when considering termination options. First, franchisees and franchisors alike should review the franchise agreement to determine whether termination is proper, as well as any specific requirements each party must undertake. Additionally, it is critical for the franchisor to review state relationship laws and their applicability to terminations. Many states include mandatory notice and cure periods prior to termination. And other states require good cause to terminate the franchise relationship, and the good cause definition varies by state. Moreover, a review of the jurisdiction's case law is also recommended. There also might be disclosure issues under state laws and the Federal Trade Commission's Franchise Rule that arise based on alternatives to termination, and, ultimately, termination itself.

From a business perspective, a franchisor must consider the impact of terminating the franchised business. This includes: (1) the loss of revenue stream from that franchisee; (2) whether a new location can be opened and when; (3) lack of presence in the market; (4) the disclosure of terminations to prospective franchisees and its impact on the system as a whole. Franchisees, on the other hand, have different considerations, such as resale value of its business, amount of debt, and its relationship with the franchisor on an ongoing basis.

Sometimes, proceeding with termination is the best course of action, particularly where there are health and safety concerns at issue or there have been repeated defaults

[61] Mich. Comp. Laws Ann. § 445.1527(h).

such that the relationship has soured beyond repair.[62] Other times, proceeding with some of the alternatives to termination set forth herein may be the best option for all involved. Regardless of the path chosen, it is important that substantial planning is done at the outset of the parties' relationship and the rights and obligations of all involved are clearly delineated in the parties' agreements.

Ultimately, the right approach will be circumstance specific so the parties can reach a resolution without the need for litigation that is cost effective and also palatable to all involved.

[62] Scott McIntosh & Emily Plakon, *Alternatives to Termination: Effective Means of Facilitating Compliance or Merely Delaying the Inevitable*, 43 Franchise L.J., p. 284 (2024).

Biographies

Elizabeth McIntosh is an associate attorney at Venable, LLP in Miami, Florida. She practices in commercial litigation and franchise litigation. Elizabeth also represents clients in federal receivership actions, handling matters from insolvency to complex business litigation. She represents clients in state and federal courts and in arbitration proceedings. She served as a judicial intern to the Honorable Marcia G. Cooke at the U.S. District Court for the Southern District of Florida and Judge Kerry I. Evander at the Florida Fifth District Court of Appeals. Before law school, Elizabeth was the program director for the Partnership for Appalachian Girls' Education, a nonprofit educational enrichment program for girls in rural Appalachia.

Doug Luther is the founder of and attorney with the law firm of Luther Lanard, PC. His practice focuses on litigating, arbitrating and mediating disputes on behalf of franchisees, helping clients buy and sell franchises and negotiating master franchise and development agreements. Doug has litigated matters in jurisdictions across the country obtaining over $20 million in verdicts, pre-trial judgments, and settlements. Prior to starting the firm, Doug was a general counsel for a franchisor. He uses the knowledge gained in the business side of franchising to help franchisees in negotiations and in resolving disputes. Doug is a Certified Specialist in Franchise and Distribution Law by the State Bar of California's Board of Legal Specialization and past chair of the California Lawyer's Association's Franchise Law Committee. He is a past speaker at the American Bar Association Forum on Franchising, has written for the Franchise Law Journal and was a contributing author to the Franchise Deskbook: Selected State Laws, Commentary and Annotations, Third Edition.

Michael Brodarick, once honored as the "Favourite American of the Year" by PuroClean Canada, offers legal expertise to the PuroSystems business groups, in addition to enforcing and safeguarding PuroSystems' global trademarks and franchise agreements. Michael also has experience in defending insurance carriers and their insureds against construction defect and property damage claims, having served clients such as Zurich Insurance Group, Continental Casualty Company (CNA), and Citizens Property Insurance Corporation. Michael is a member of the Florida, Georgia, Michigan, and Kentucky State Bar Associations.