Breaking Up

Preliminary Injunctions in Contested Termination Lawsuits

by Sheila Raftery Wiggins, Susan V. Metcalfe and Allison S. Khaskelis

In any long-term relationship, breaking up is hard to do—even when there is a detailed termination clause in the franchise agreement.[1] Yet, it can be especially difficult when a franchisee contests whether the franchisor properly terminated the franchise agreement. In such a case, the facts will often be contested. The outcome will depend on the language of the franchise agreement, the requirements of complex statutory regimes, and a court's inherent sense of fairness.

Good Cause: The Standard for Terminating

The fundamental rule is that the termination of a franchise agreement can only occur for good cause and, of course, not merely at the whim of a franchisor. Section 10-5 of the New Jersey Franchise Practices Act defines good cause as a franchisee's failure "to substantially comply with those requirements imposed upon him by the franchise."[2] A franchisor must demonstrate a franchisee failed to comply with the material requirements of the franchise agreement.

The act was enacted by the Legislature to address a perceived disparity in bargaining power between the franchisor and the franchisee. The act is designed to prohibit the franchisor from imposing "unconscionable" terms in its franchise agreement. Yet, the act recognizes the franchisor's business need to protect the trade name and goodwill of its franchise system. New Jersey courts take a restrictive view of what constitutes good cause for termination of a franchise agreement.

The good cause standard has limits. New Jersey case law states that the act does not protect franchisees from their own deliberate misconduct. The New Jersey Supreme Court stated, in *Dunkin' Donuts of America, Inc. v. Middletown Donut Corp.*,[3] that the act "is not designed to protect those franchisees who willfully violate the terms of their franchise agreements," and that the act "does not compensate those franchisees who have lost their franchises as a result of their own neglect or misconduct."[4] Likewise, the district of New Jersey determined in *Dunkin' Donuts Franchised Restaurants LLC v. Strategic Venture Group, Inc.*[5] that a franchisee's repeated non-compliance also constitutes good cause. In that case, the Court found the franchisee's failure to honor payroll tax law requirements was not an isolated mistake, and constituted good cause for the termination of the franchisee.

Franchisor's Goal: Protecting Its Property and the Franchise System

The franchise system thrives by ensuring consistent, high-quality customer experiences among the many franchise locations. The franchisor permits the franchisees' use of the brand logo, brand standards, brand services, and marketing in order to achieve a thriving system. A franchisee may fail to uphold the brand standard by, for example, failing to maintain cleanliness of the location (*e.g.*, a franchise hotel location fails to meet quality assurance requirements), offering products outside the franchise system (*e.g.*, a restaurant sells a competitor's product), or misusing brand logos (*e.g.*, a fitness gym refuses to display the franchise slogan or signage). When a franchisee fails to cure these deficiencies, the franchisor has the goal of accountability—holding the franchisee accountable for maintaining the franchise's brand standard as required by the franchise agreement.

The franchisor's property interest in the franchise brand is protected by federal law. The Lanham Act provides for damages and/or injunctive relief to the owner for the unlawful use of a trademark by another.[6] The term 'trademark' includes any word, name, symbol, or device that distinguishes goods or the source of goods. The term 'service mark' means any word, name, symbol, or device that distinguishes a service or the source of the service.[7] When the franchisee contests the termination, a franchisor can seek a preliminary injunction to prevent the franchisee from damaging its trademark by continuing to operate in a manner at odds with the brand standards specified in the franchise agreement while the underlying termination suit against the franchisee is pending.

An injunction is an order by the court requiring a party to stop certain activities. For a preliminary injunction to be properly issued, the court must state the reasons why it was issued, state its terms specifically, and describe in reasonable detail the acts restrained or required.[8] Thus, the party seeking to obtain a preliminary injunctive order must demonstrate to the court the existence of the following four factors: 1) a substantial likelihood of prevailing on the merits of the lawsuit; 2) a substantial threat that it will suffer irreparable injury if the injunction is not granted; 3) the threatened injury outweighs the threatened harm if the injunction is not issued; and 4) granting the preliminary injunction is in the public interest.[9]

Franchisee's Goal: Protecting the Individual Business

The franchise system also thrives by ensuring the franchisee invests capital, time, and effort to promote the franchisor's products or services. The franchisee's goal is to protect the value of the going business at its specific location. Franchisees often view themselves as protecting their livelihood and the jobs and services they provide to the neighborhood.[10]

Like the franchisor, the franchisee may also seek a temporary restraining order or a preliminary injunction to maintain the *status quo* pending the resolution of the lawsuit in which the franchisee disputes whether the franchisor properly terminated the franchise agreement. The franchisee typically seeks to continue operating the franchise location and obtaining access to the franchise products while the termination lawsuit is pending. It is not uncommon to have both the franchisor and franchisee seek competing injunctions at the outset of a termination dispute.

The franchisee's primary argument is that an injunction is necessary to prevent irreparable harm that may otherwise occur if the franchisor is permitted to withhold franchise brand support and merchandise during the pendency of the termination lawsuit. The franchisee typically argues that either: 1) the breach of the franchise agreement did not occur, or 2) the breach was *de minimis* and not worthy of the drastic step of terminating a franchise. A franchisee's secondary argument is that, during the lawsuit, the franchisor will benefit via the money earned from fees paid by the franchisee.

Convincing the Court of a Likely Win

To establish likelihood of success on the merits of the case, a franchisor's best bets are often to demonstrate: 1) repeated, deliberate, and/or substantial breaches of contract by the franchisee; and 2) the strong prospect that its trademark will be infringed by the franchisee's continued operations.

To prevail on a breach of contract claim under New Jersey law, a franchisor must demonstrate that: 1) a valid contract existed; 2) a franchisee breached the contract; 3) the franchisor performed its obligations under the contract; and 4) the franchisor was damaged as a result of the franchisor's breach.[11] When a franchisor dutifully maintained its contractual obligations prior to discovering evidence of the franchisee's breaches, the franchisor should be able to demonstrate the franchisee breached the franchise agreement.[12]

To prevail on a trademark infringement claim, a franchisor must demonstrate that: 1) it has a valid and legally protectable mark; 2) it owns the mark; and 3) the franchisee's use of the mark to identify goods or services causes a likelihood of confusion.[13] A trademark holder is entitled to unfettered control over its trademarks, a right that is effectively nullified when a franchisee continues to use those trademarks after the agreement has been terminated.

Case law from the Third Circuit establishes that the unauthorized use of a trademark causes inevitable customer confusion because a customer assumes he or she is purchasing a product from its authorized retailer.[14] A franchisor is likely to succeed on a Lanham Act claim if it can demonstrate a properly terminated franchisee continues to: 1) market and sell trademarked products; 2) utilize trademarked work apparel; or 3) otherwise operate by relying on or exploiting the franchisor's trademarks.

The franchisee will seek to present evidence to raise doubts regarding the franchisor's ability to establish the merits of its claims. In particular, the franchisee is likely to argue the continued use of the trademark by the franchisee presents no real danger of confusion concerning the mark. If the franchisor has allowed nonconforming trademark use by the franchisee (or others), delayed enforcing its rights, or tacitly encouraged or caused the breach of the franchise agreement for the purpose of creating grounds to terminate, the franchisee may also assert defenses such as the doctrine of waiver, laches, and/or unclean hands.[15]

Convincing the Court There Will be Irreparable Harm

The harm the franchisor suffers if the offending franchisee retains control of the store must go beyond recompense by money damages. A franchisor often asserts a 'quality control' argument, specifically that the inability to oversee and control the use of the mark during the pendency of the litigation will irretrievably dilute the value of the mark. The Third Circuit stated, in *S&R Corp. v. Jiffy Lube International, Inc.,* that in a trademark infringement case the "grounds for irreparable injury include loss of control of reputation, loss of trade, and loss of goodwill."[16] Likewise, the Third Circuit also stated, in *Opticians Association of America v. Independent Opticians of America,* that the key in trademark infringement cases "is lack of control which potentially might result in a damaged reputation."[17] Thus, the franchisor argues, this inability to protect its trademarks results in irreparable harm that cannot be compensated by an award of money in the future.

The loss of control of a trademark is compelling because the trademark is a unique property. Monetary damages are insufficient to compensate for the loss of control of a trademark. Moreover, a franchisor asserts that when its "interests involving real property [such as physical stores] are at stake, preliminary injunctive relief can be particularly appropriate...."[18]

On the other hand, the franchisee will argue the risk of irreparable harm is not to the franchisor but one the franchisee bears. The franchisee will attempt to show the award of money damages at the end of the case is an insufficient remedy. Typically, the franchisee will urge it stands to lose a going business as a result of the failure of the franchisor to honor brand and merchandise obligations during what could be a long and protracted lawsuit. Inevitably, the persuasiveness of this argument is impacted by the strength of the franchisor's case on the merits. If the court finds the franchisee's harm is 'self-inflicted' because the franchisee chose to stop performing under the parties' agreement, the court will likely find any risk of irreparable harm to the franchisee is outweighed by "the immeasurable damage done to the franchisor."[19]

Convincing the Court That Helping is Fair

A franchisor must show the benefits outweigh the harm a franchisee will suffer if a court issues the injunction. This is accomplished by showing the injunction will protect the franchisor while the harm to the franchisee flows entirely from the franchisee's breaches: "[A violator can] hardly claim to be harmed, since it brought any and all difficulties occasioned by the issuance of an injunction upon itself."[20] Deliberate offending behavior of a franchisee is the best evidence that fairness favors the franchisor.

A franchisor should assure the court that, if the court grants injunctive relief allowing the franchisor to operate the stores, it will maintain meticulous records to ensure that any and all income that may be due to the franchisee, should it ultimately prevail, will be properly accounted for during the operation of the injunction. This will establish that the injunction sought by the franchisor is fair, because even if the franchisee prevails in the termination dispute the franchisee will not lose any income as a result of the injunction having been granted.

Conversely, the franchisee will argue the injunction sought by the franchisor is not fair because removing the franchisee from control of the business will damage or deprive the franchisee of its livelihood and customer and employee relationships during the pendency of the lawsuit. The franchisee will claim that replacing management of the business is a step that will cause more problems than it will solve. Finally, even if the franchisor accounts for the income while it controls the business, the franchisee may assert depriving the franchisee of that income may impede the franchisee's ability to prosecute or defend the lawsuit.

Convincing the Court of the Public Interest

This final factor is often regarded as the least significant in a court's preliminary injunction calculus. As the district of New Jersey declared, "[w]here a party demonstrates both the likelihood of success on the merits and irreparable injury, it almost always will be the case that the public interest will favor the issuance of an injunction."[21] Nonetheless, this factor should not be ignored by the parties.

A franchisor may argue the public interest is better served if consumers have access to franchises that are run properly, efficiently and with integrity. The enforcement of contractual obligations and compliance with state and federal law and trademark protection are clear public values.[22] In the trademark context, courts often define the public interest at stake as the right of the public not to be deceived or confused.[23] Conversely, the franchisee will claim the disruption to employees occasioned by the takeover sought by the franchisor is contrary to public interest.

Discovery and Hearing

The court rules governing the issuance of a preliminary injunction require notice be given to the other party so it may oppose the preliminary injunction. The district court, generally, will then hear oral testimony—rather than merely relying on affidavits and other proofs—to determine whether to issue a preliminary injunction. The court may afford the parties an opportunity to conduct limited, expedited, discovery before the hearing on a preliminary injunction, often seeking the parties' cooperation in stipulating to the scope and timing. For example, when a franchisor terminates the franchise agreement because of the franchisee's failure to maintain accurate financial records—and this issue is disputed—the court may permit discovery regarding the franchisee's record keeping or permit an audit of the franchisee's financial records.

The benefit to seeking injunctive relief is to obtain a *preliminary* decision on the merits of the ultimate issue in dispute. For example, when a franchisor terminates the franchise agreement because of the franchisee's failure to maintain accurate financial records, the court may expedite a trial on the merits when the franchisor is able to demonstrate the likelihood of success on the merits of the claim. This preliminary decision can be useful in promoting settlement discussions as well.

Conclusion

A franchisor seeking a preliminary injunction to gain control of the stores of a franchisee who has disregarded its contractual obligations would be well served to remember two salient points. First, the franchisor must terminate the offending franchisee properly in compliance with the act.

Second, the crux of the franchisor's argument should focus on the immeasurable ways in which the franchisor will be harmed if the court denies the preliminary injunction. Quantifiable financial harm simply won't do because it is inherently reparable through an award of money damages. By contrast, damage to the franchisor's reputation and goodwill cannot be measured, and, therefore, adequately repaid. Such irreparable damage to reputation and goodwill will only worsen, in ways that cannot be predicted and checked, if speedy relief—in the form of a preliminary injunction—is not granted. ⚖

Sheila Raftery Wiggins *and* ***Susan V. Metcalfe*** *are partners at Duane Morris LLP and members of the firm's franchise and distribution litigation practice.* ***Allison S. Khaskelis*** *is an associate with the firm.*

ENDNOTES

1. This article addresses requests for preliminary injunctive relief within the context of the Federal Rules of Civil Procedure. Prior to the application for a preliminary injunction, a party may seek a temporary restraining order (TRO), which is typically issued without notice or with limited notice to the adverse party. The purpose of a preliminary injunction is to preserve the 'status quo' and to protect a party from irreparable harm pending a final decision on the merits of the lawsuit. Unlike a TRO, a preliminary injunction may only be issued on notice to the adverse party. Fed. R. Civ. P. 65(a). An order granting, continuing, or modifying a preliminary injunction is immediately appealable. 28 U.S.C. § 1292(a)(1).
2. N.J.S.A. 56:10-5.
3. 100 N.J. 166, 495 A.2d 66 (1985).
4. *Id.*, 100 N.J. at 178, 495 A.2d at 72.
5. No. 07-1923 (SRC), 2010 WL 4687838 (D.N.J. Nov. 10, 2010).
6. 15 U.S.C. § 1127.
7. *Id.*
8. Fed. R. Civ. P. 65(d)(1).
9. *Opticians Ass'n of Am. v. Independent Opticians of Am.*, 920 F.2d 187, 191-92 (3d Cir. 1990).
10. A court may require a bond or other security when issuing a preliminary injunction or TRO to pay the costs and damages sustained by a party found to have been wrongfully enjoined or restrained. Fed. R. Civ. P. 65(c).
11. *See, e.g.*, *Video Pipeline, Inc. v. Buena Vista Home Entm't, Inc.*, 275 F. Supp. 2d 543, 556 (D.N.J. 2003).
12. One nuance to keep in mind is that the Third Circuit and its sister jurisdictions make a distinction between preliminary and mandatory injunctions, finding that the former typically maintain the *status quo* and prohibit actions, while the latter alter the *status quo* through affirmative steps. *Edge v. Pierce*, 540 F. Supp. 1300, 1303 (D.N.J. 1982); *Acierno v. New Castle Cty*, 40 F. 3d 645, 653 (3d Cir. 1994); *Tom Doherty Assocs., Inc. v. Saban Entm't, Inc.*, 60 F.3d 27, 34 (2d Cir. 1995). A franchisee's ouster is a change to the *status quo*. In situations seeking a change to the *status quo*, parties "bear a particularly heavy burden in demonstrating its necessity." *Acierno*, 40 F. 3d at 653. Courts will apply a heightened analysis of the merits of the claims, requiring the moving party to demonstrate a greater likelihood of success by a clear or substantial showing. *Tom Doherty Assocs*., 60 F.3d at 34. Franchisors should keep this heightened standard in mind as they prepare their injunction requests.
13. *A & H Sportswear, Inc. v. Victoria's Secret Stores*, 237 F.3d 198, 210-11 (3d Cir. 2000); *see also* 15 U.S.C. § 1114.
14. *See, e.g.*, *S&R Corp. v. Jiffy Lube Int'l, Inc.*, 968 F.2d 371, 375 (3d Cir. 1992); *Opticians*, 920 F.2d at 191-92.
15. *S&R Corp.*, 968 F.2d at 377.
16. *Id.* 378.
17. *Opticians*, 920 F.2d at 195.
18. *RoDa Drilling Co. v. Siegal*, 552 F.3d 1203, 1210 (10th Cir. 2009). *See also Equilon Entm't LLC v. Shahbazi*, No. 06-05818 (JF), 2006 WL 3507928, *5 (N.D. Cal. Dec. 5, 2006).
19. *Pappan Enter., Inc. v. Hardee's Food Sys., Inc.*, 143 F.3d 800, 806 (3d Cir. 1998).
20. *Opticians*, 920 F.2d at 197.
21. *Marsellis-Warner Corp. v. Rabens*, 51 F. Supp. 2d 508, 532-33 (D.N.J. 1999).
22. *See, e.g.*, *Certified Restoration Dry Cleaning Network, LLC v. Tenke Corp.*, 511 F.3d 535, 551 (6th Cir. 2007); *Marblelife, Inc. v. Stone Res., Inc.*, 759 F. Supp. 2d 552, 563-64 (E.D. Pa. 2010).
23. *Wetzel's Pretzels, LLC v. Johnson*, 797 F. Supp. 2d 1020, 1029 (C.D. Cal. 2011).