Franchise relationships are premised on the relatively straightforward assumption that a franchisee will use and enjoy the benefits of a franchisor’s system—most importantly, its intellectual property—in exchange for which the franchisee will pay royalties or other fees. Yet a franchisee’s failure to pay royalties is perhaps the most common basis for defaults under, terminations of, and disputes arising out of franchise agreements.

Franchisees often withhold royalties and attempt to justify their failure to pay by arguing that the franchisor’s own breach excused the obligation to pay fees or made it financially impossible for the franchisee to comply. The franchisee’s position in such cases is that it was not realizing any benefit from the relationship because the franchisor failed to provide any support, and therefore the franchisee could not and had no obligation to pay under these circumstances. If, as many courts have held, the franchisee’s position is fundamentally wrong, why is it still the subject of so many disputes and so much litigation?

Black Letter Contract Law
An analysis of this question begins with a return to black letter contract law and the well-settled premise that a material breach by one party to a bilateral contract excuses performance by the other party. Unlike the typical bilateral contract, however, franchise relationships involve a variety of rights and obligations. At the core of this relationship is the franchisee’s right to use, display, and enjoy the opportunity to benefit from the franchisor’s intellectual property, including trademarks, service marks, and the franchisor’s particular franchise system.

It is precisely because the franchise relationship is, indeed, a relationship founded upon a franchisee’s operation as a particular brand that the law excusing performance under a bilateral contract requires a closer look. What constitutes a material breach excusing performance, and what does it mean to excuse performance of a franchisee’s obligations?

What Constitutes a Material Breach?
The first issue, i.e., what constitutes a material breach, warrants only a brief detour from the more pertinent issue of the consequences of such a breach. Like most issues of materiality, whether the franchisor’s alleged breach is material is ordinarily a question of fact; and for purposes of this discussion, the franchisor’s material breach may be assumed, subject to an important point of clarification: the franchisor’s breach does not involve the validity of or the franchisee’s access to the franchisor’s intellectual property. In other words, the material breach at issue in the typical nonpayment case involves a franchisee’s claim that the franchisor has failed to perform some obligation under the parties’ agreement, as distinguished from claims deriving from the franchisee’s inability to use the franchisor’s intellectual property in the first place.

Jiffy Lube: Withholding Royalties Not Justified
Thus, assuming the franchisor’s material breach, we may turn to the more interesting issue of the consequences of the said breach. What are a franchisee’s rights and obligations when confronted with a material breach by the franchisor? This was precisely the issue addressed in the leading case of S&R Corp. v. Jiffy Lube International, Inc., a thorough and well-reasoned decision by the U.S. Court of Appeals for the Third Circuit.

The facts of Jiffy Lube are familiar. Jiffy Lube entered into several franchise agreements authorizing its franchisee to operate automobile service centers under the Jiffy Lube trademark. During the course of the parties’ relationship, the franchisee stopped paying royalties at each of the facilities because the franchisee claimed that Jiffy Lube was breaching its obligations under the franchise agreement. Significantly, however, the franchisee continued to operate each of the centers as a Jiffy Lube. The franchisee then filed a lawsuit claiming that Jiffy Lube had breached the franchise agreements by failing to maintain the quality of other franchised centers in the same geographic area, thereby causing the franchisee to suffer.

Jiffy Lube, on the other hand, terminated the franchise agreements and filed a motion for preliminary injunction seeking to enjoin the franchisee’s continued use of its trademark. Jiffy Lube contended that it had the right to terminate the franchise agreements and enjoin the use of its trademarks due to the franchisee’s failure to pay fees. The district court denied Jiffy Lube’s motion, finding that Jiffy Lube had failed to establish a likelihood of success on the merits due to the termination dispute.

The Third Circuit found that the district court had erred and reversed. Although an issue of first impression in the circuit, the court held “by reference to contract and trademark principles that a franchisor’s right to terminate a franchisee exists independently of any claims the franchisee might have against the franchisor.” Upon a franchisee’s failure to comply with the terms of the franchise relationship, the franchisor had the power to terminate and enjoin the continued use of its trademark. Relying on basic contract principles, the court articulated its reasoning as follows:

[When one party to a contract feels that the other contracting party has breached its agreement, the non-breaching party may either stop performance and assume the contract is avoided, or continue its performance and sue for damages. Under no circumstances may the non-breaching party stop performance and continue to take advantage of the contract’s benefits.]

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The franchisee had done “exactly what contract law forbids,” i.e., it “stopped making royalty payments, but [the franchisee] continued to operate the service centers under the Jiffy Lube name.” The court squarely addressed the franchisee’s allegations of Jiffy Lube’s breach, stating that “[w]here the franchise agreement gives the franchisor the power to unilaterally terminate the agreement under certain conditions, and those conditions exist, pre-termination complaints are not relevant to infringement under the Lanham Act. Rather, pre-termination disputes affect the issue of damages.”

Well-Settled Body of Law Supports Jiffy Lube

The principle that a franchisee cannot justify its nonperformance under a franchise agreement based on the alleged pretermination breaches of a franchisor is by no means limited to the Third Circuit’s decision in Jiffy Lube. Indeed, the Jiffy Lube decision includes a review of cases holding that a franchisee cannot stop paying fees while continuing to use the franchisor’s marks. Nonpayment reflects the franchisee’s decision to deem the franchise relationship terminated, and that decision requires the franchisee to cease use of the franchisor’s trademarks. Nonpayment coupled with ongoing use of trademarks is, in essence, a form of self-help that is precluded by a well-settled body of cases. As stated by one district court, a franchisee may ultimately prevail on a breach-of-contract claim and be excused from paying royalties, but the Court cannot see how this separate cause of action entitles them to continue rights under the franchise agreement. In order to have preserved their right to recover for the alleged breaches and to continue to use the [Plaintiff’s] trademark, Defendants should have continued to pay royalties, advertising expenses and rent.

Franchisee Options

Returning to the facts of Jiffy Lube, what could the franchisee have done? In fact, the franchisee had two options. It could have continued to pay franchise fees and sued for breach, or, alternatively, it could have deemed the franchise agreements to be terminated based on Jiffy Lube’s alleged breach and stopped performing. The franchisee could not terminate its obligations (i.e., stop paying) yet continue to accept the opportunity to benefit from the Jiffy Lube trademarks. In other words, termination means the termination of all of the parties’ respective rights, rather than the selective or unilateral course of termination chosen by the franchisee. The reasoning by the Third Circuit is entirely consistent with black letter law regarding termination of bilateral contracts. Furthermore, if an injured party elects not to terminate based on the alleged breach and continues performance under the agreement, the breach is deemed partial and the contract remains in force. Under no circumstances may a party repudiate a contract as materially breached and at the same time continue to receive the benefits contemplated by the agreement.

Moreover, the Jiffy Lube decision is not unfair to franchisees. The Third Circuit did not hold or suggest that the franchisee was without remedies. To the contrary, a franchisee may stop performing, provided it also stops using the franchisor’s trademarks, or the franchisee can continue to operate as a franchise and sue for damages. The franchisee cannot, however, consider the contract terminated due to alleged breaches by the franchisor while continuing to avail itself of any of the benefits of the contract.

Contradictory Ruling

Despite Jiffy Lube and the cases addressed in the appellate decision, franchise lawyers and courts continue to debate why a franchisee should be required to pay when the franchisor is alleged to have materially breached its obligations. For example, should a hotel franchisee be required to pay royalties despite its allegations (ultimately determined to be untrue) that the franchisor failed to provide reservations?

This was the issue before the district court in the recent case of Travelodge Hotels, Inc. v. Honeysuckle Enterprises, Inc., another failure-to-pay case. In Honeysuckle, the franchisee entered into a license agreement to operate a Travelodge hotel and agreed to pay a flat fee each month. The franchisee made an allegation, unsupported by the parties’ franchise agreement, that it had entered into the agreement for the sole purpose of receiving reservations from Travelodge’s central reservation system. The franchisee was dissatisfied with the number of reservations it received and, therefore, withheld payment while simultaneously operating the hotel as a Travelodge. Indeed, the franchisee never made a single flat fee payment to Travelodge, and the franchisee unilaterally terminated the license agreement less than a year after opening. Travelodge filed suit seeking outstanding fees due at the time of termination and liquidated damages that became due as a result of the franchisee’s termination, and the franchisee filed a counterclaim alleging that it had been fraudulently induced to enter into the franchise agreement or, alternatively, that Travelodge had breached the agreement and thereby excused the franchisee’s performance of its obligations.

Travelodge filed a motion for summary judgment on its breach-of-contract claims because the franchisee’s failure to pay and, therefore, its breach were undisputed. The district court denied Travelodge’s motion, finding that “it is black letter contract law that a material breach by one party to a bilateral contract excuses the other party from rendering any further contractual performance. . . . Whether conduct constitutes a breach of contract and, if it does, whether the breach is material are ordinarily jury questions.”

Notwithstanding the fact that the hotel was operating as a Travelodge by, among other things, using the Travelodge name in association with its operations, the district court found a genuine issue of material fact “as to whether Travelodge failed to place Honeysuckle on its reservation system, and whether such failure was a material breach, such that Honeysuckle should be excused from performing its obligations to pay Recurring Fees to Travelodge.” The district court therefore concluded that the franchisee’s claims for fraudulent inducement and breach of contract “prevent this Court from concluding that Travelodge is entitled to summary judgment” on its affirmative breach-of-contract claims.
Rejecting Jiffy Lube

Interestingly for purposes of this discussion, the district court found that Jiffy Lube was inapposite because that case “was primarily concerned with whether the franchisor was entitled to preliminary injunctive relief on a trademark claim, and from this vantage point, discussed the likelihood that the franchisor’s termination of the franchise agreement was proper.”16 In particular, the district court found that “[u]ltimately, however, S & R Corp. concluded that, where the franchise agreement ‘gives the franchisor the power to unilaterally terminate the agreement under certain conditions, and those conditions exist, pre-termination complaints are not relevant to infringement under the Lanham Act.’”17 The district court therefore concluded that Jiffy Lube was not controlling. Furthermore, the district court noted that, even if Jiffy Lube was applicable, and despite the fact that the franchisee was using the Travelodge trade name and service marks, a jury could conclude that the franchisor had in fact stopped performing based on the franchisee’s allegations that it was not receiving any benefits under the franchise agreement.18

Court Erred in Honeysuckle

Parsing the district court’s decision reveals errors in the interpretation, and thus some of the reasons for ongoing confusion regarding the meaning, of Jiffy Lube. First, Jiffy Lube was not and should not be limited to the context of infringement. Although the decision arose in the context of a motion for preliminary injunction, the analysis was in the context of Jiffy Lube’s ability to demonstrate a likelihood of success on the merits of its termination.19 Jiffy Lube’s right to an injunction hinged on the validity of its termination of the various franchise agreements. Second, the district court’s speculation that the franchisee may not have run afoul of the holding of Jiffy Lube has no basis under that or any other case. In Honeysuckle, there was no dispute that the franchisee had used Travelodge’s intellectual property during the period of nonpayment, thus receiving at least some measure of performance under the parties’ agreement. The law does not permit such selective participation in a contract; a party waives the right to cease its own performance following a material breach if it continues to accept performance from the breaching party.20

Conclusion

The use of a franchisor’s trademarks is a significant consideration under a franchise agreement. An alleged breach of the agreement by the franchisor does not provide a basis for the franchisee to continue using the marks either prior to or after termination of the franchise agreement. Accordingly, when confronted with an alleged breach by a franchisor, a franchisee may continue to pay and sue for breach or it can consider the contract terminated, subject, of course, to the risk that such termination was improper. If a franchisee chooses to terminate, however, the termination must be complete. The franchisee must cease all performance under the parties’ agreement, which necessarily means that the franchisee must stop using the franchisor’s marks in conjunction with all facilities and operations. Absent such a complete termination, the franchisee’s failure to pay will constitute an independent and irrefutable basis for termination by the franchisor.

Endnote

1. See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 237 (“Except as stated in § 240, it is a condition of each party’s remaining duties to render performances to be exchanged under an exchange of promises that there be no uncured material failure by the other party to render any such performance due at an earlier time.”); 14 WILLISTON ON CONTRACTS § 43.15 (4th ed. year) (“Where there has been a material failure by the obligee to perform, the obligor is not bound because a condition precedent to its duty—substantial performance by the obligee of its contractual duty—has not occurred.”).

2. RESTATEMENT (SECOND) OF CONTRACTS § 241 (identifying circumstances that are significant to a determination of whether a failure to perform is material, including “the extent to which the injured party will be deprived of the benefit which he reasonably expected” and “the extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing”).

3. S&R Corp. v. Jiffy Lube Int’l, Inc., 968 F.2d 371 (3d Cir. 1992). This case was decided by a Third Circuit panel that included recently confirmed Supreme Court Justice Samuel Alito.

4. Jiffy Lube’s motion for preliminary injunction was filed after the franchisee’s motion for preliminary injunction enjoining termination had been denied.

5. Jiffy Lube, 968 F.2d at 375.

6. Id. at 376.

7. Id. at 377.

8. Id.

9. See Lewis & Maswep Enters., Inc. v. McDonald’s Corp., No. 94-1351, 1995 U.S. App. LEXIS 37083, at *7–8 (6th Cir. Nov. 27, 1995) (holding that even if franchisor breached the agreement, by continuing to operate the restaurant and use the franchisor’s marks, franchisee was “obligated” to “continue making payments under the franchise agreement” and his nonperformance was not excused); see also Burger King Corp. v. Hall, 770 F. Supp. 633, 638–39 (S.D. Fla. 1991): Having chosen to stop her own performance under the parties’ Franchise Agreement by refusing to pay her monthly royalties and advertising and sales promotion contributions to BKC, Hall herself effectively terminated her Franchise Agreement with BKC. . . . [S]he may not continue to use the BKC Marks in the operation of her restaurant.

Id.; Burger King Corp. v. Lee, 766 F. Supp. 1149, 1154–55 (S.D. Fla. 1991) (franchisee’s failure to make royalty payments resulted in termination; posttermination use of trademark enjoined despite franchisee’s claim of breach); Broschad of Milwaukee, Inc. v. Dion Corp., Bus. Franchise Guide (CCH) ¶ 9566 (E.D. Wis. Jan. 10, 1989) (holding that, where franchisee had failed to pay royalties for years, “[e]ven if [the franchisor] had breached the franchise agreement, plaintiffs were not entitled to continue using the [marks] in accordance with the agreement without performing the reciprocal obligations of the agreement”); see also Dunkin Donuts of Am., Inc. v. Minerva, Inc., 956 F.2d 1566, 1571 (11th Cir. 1992) (a franchisee’s continued performance under the franchise agreement by continuing to use the franchisor’s marks precluded the franchisee from arguing that its breach was excused by the franchisor’s alleged conduct); Ramada Franchise Sys., Inc. v. Eagle Hospitality Group, No. 03-3585, 2005 WL 1490975, at *10 (D.N.J. June 23, 2005) (stating that “[e]ven assuming wrongs were committed by [the franchisor], these do not excuse [franchisees’] non-payment of the required fees”); Murphy Oil USA, Inc. v. Brooks Hauser, 820 F. Supp. 437, 442 (D. Minn. 1993) (franchisee was not permitted to unilaterally cease making payments required by a lease and franchise agreement based on his allegation that the franchisor breached the agreements); Burger King Corp. v. Majeed, 805 F. Supp. 994, 1004 (S.D. Fla. 1992) (finding that there was no support for franchisee’s position that, because it asserted damages claims against franchisor, it may therefore operate royalty- and rent-free for however long their damage action remains pending); McDonald’s Corp. v. Robert A. Makin, Inc., 653 F. Supp. 401, 403 (S.D.N.Y. 1986) (recognizing that a franchisee cannot suspend payments based on the franchisor’s alleged breach and continue to operate the facility using the franchisee’s marks). The analysis is not limited to failure-to-pay cases. See,
e.g., McDonald’s Corp. v. Robertson, 147 F.3d 1301, 1309 (11th Cir. 1998) (franchisee’s failure to comply with quality standards was a breach sufficient to justify termination; therefore, franchisee’s claim that McDonald’s improperly terminated the agreement did not matter to determination of whether a preliminary injunction was appropriate); Green River Bottling Co. v. Green River Corp., 997 F.2d 359, 362 (7th Cir. 1993) (“Unauthorized use of a trademark is an infringement, and we have held that the infringement of a trademark is not a proper self-help remedy for a breach of contract.”).


11. See, e.g., Lovink v. Guilford Mills, Inc., 878 F.2d 584, 586 (2d Cir. 1989) (“A total breach justifies termination of the contract and damages for complete failure of performance; a partial breach does not.”); Pappan Enters., Inc. v. Hardee’s Food Sys., Inc., 143 F.3d 800, 806 (3d Cir. 1998) (“Under no circumstances may the non-breaching party stop performance and continue to take advantage of the contract’s benefits.”); Costandi v. AAMCO Automatic Transmissions, Inc., 456 F.2d 941, 942 (9th Cir. 1972) (“It is an elementary rule of contract law that one cannot repudiate a contract and at the same time retain the consideration or any part thereof received under the contract.”); V.S. Int’l, S.A. v. Boyden World Corp., 862 F. Supp. 1188, 1196 (S.D.N.Y. 1994) (“Plaintiffs cannot elect to continue with the contract, continue to receive the benefits from it, and thereafter bring an action for rescission or total breach.”); Bigda v. Fischbach Corp., 898 F. Supp. 1004, 1011 (S.D.N.Y. 1995) (“Once a party elects to continue the contract, he can never thereafter elect to terminate the contract based on that breach.”); Al Copeland Enters., Inc. v. C.T.V. Sys., Inc., No. 92-2264, 1993 U.S. Dist. LEXIS 7415, at *4–5 (E.D. La. May 21, 1993) (holding that, even where franchisee may have breached agreement, “franchisee cannot enjoy the benefits of the franchise agreement without tendering consideration as provided for in the agreement”); Cities Serv. Helix, Inc. v. U.S. Nat’l Helium Corp., 543 F.2d 1306, 1313 (Cl. Ct. 1976) (recognizing that if party elects to “continue the contract, the obligations of both parties remain in force and the injured party may retain only a claim for damages for partial breach”); Specialties Dev. Corp. v. C.O-Two Fire Equip. Co., 109 F. Supp. 732, 736 (D.N.J. 1953), aff’d, 207 F.2d 753, 756 (3d Cir. 1953) (“We do not find anything . . . to throw doubt upon the general proposition that one against whom a material breach is committed must make up his mind what he is going to do about it, and that if he goes ahead with performance he is not excused from liability under the terms of the contract.”); USA Network, Inc. v. Jones Intercable, Inc., 729 F. Supp. 304, 311–12 (S.D.N.Y. 1990) (“[T]he party who refuses to regard [the contract] as terminated by the breach remains liable to all his obligations and liabilities.”).

12. Restatement (Second) of Contracts § 243 (1981) (if, in spite of a breach, the nonbreaching party wishes to await performance and “to ‘have merely a claim for damages for partial breach, he must perform his obligations in spite of the non-performance by the other party’”); Allan Farnsworth, Farnsworth On Contracts §§ 8.15, 8.16, 8.18 (1998) (“If the injured party does not terminate the contract either because he has no right to or does not choose to, he is said to treat the breach as ‘partial.’” (emphasis in original); ARP Films, Inc. v. Marvel Entm’t Group, Inc., 952 F.2d 643, 649 (2d Cir. 1991) (stating that the “decision to continue receiving benefits pursuant to the . . . Agreement was tantamount to an election to affirm the contract”); Tyger Constr. Co. v. Beer Precast Concrete Ltd., No. 89-2934, 1990 WL 15658, at *3 (4th Cir. Feb. 13, 1990) (holding that the “material breach did not end the contract; instead, it merely gave [defendant] the option either to end the contract or to continue the contract on its original terms and sue for damages for partial breach”); Burger King Corp. v. Hall, 770 F. Supp. 633, 638 (S.D. Fla. 1991) (stating that a terminated franchisee may seek money damages for any injuries resulting from the franchisor’s alleged wrongful conduct, but it may not continue to use the franchisor’s trademarks without authority).


15. 357 F. Supp. 2d at 797.

16. Id. at 798.


This Court finds that the [franchisee’s] alleged material breach, even if proved, would not excuse payment by the [franchisees], as long as [the franchisees] continued to use the Travelodge marks . . . . Because of the [franchisees’] failure to make their required payments pursuant to the License Agreement and Guaranty, while continuing to use the Travelodge marks, the [franchisor] is entitled to summary judgment on the issue of liability.

Id. The author represented THI in that action.

19. 968 F.2d at 376 (“It is also apparent that [the franchisee’s] continued use of the trademark was unauthorized, in violation of § 32” of the Lanham Act due to the termination of the franchise agreements.)