CASE REPORT

Princeton Review Litigation Puts Renewal Condition to the Test

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The ruling in *Test Services, Inc. v. The Princeton Review, Inc* validates a franchisor's legitimate interest in putting renewing franchisees on the same contractual footing as those entering the franchise system under the franchisor's current form of franchise agreement

It is a routine condition of franchise renewal that the franchisee sign a new contract on the terms and conditions then being offered to new franchisees. In fact, this renewal condition is so common, it is surprising that few reported judicial decisions address it in the U.S. Late last year, however, the United States District Court for the District of Colorado offered some useful guidance in *Test Services, Inc. v. The Princeton Review, Inc.*, No. 05-CV-01674-MSK-CBS, 2005 WL 3211594 (D. Colo. Nov. 29, 2005).

This renewal condition recognizes that a franchisor's business will inevitably change over the ten- or twenty-year term of a franchise agreement as a result of changes in technology, competitive circumstances, regulatory developments, consumer trends, and myriad other factors. More to the point, it recognizes that these changes will be reflected in the terms of the franchise offering. The basic concept is that the renewing franchisee, if it wishes to continue the relationship, must catch up to changed circumstances by signing the same form of agreement that the franchisor is offering to new franchisees.

The provision strikes a fair deal between the parties. The trade-off is this: the franchisee holds the option on whether to renew or not; if the franchisee wishes to continue the franchise relationship, the franchisor cannot refuse to renew if the franchisee meets the conditions. The counterbalance is that the franchisor has the right to update the contract terms to current practice, by requiring the franchisee to sign the current form of franchise agreement if the franchisee chooses to renew. Assuming that the renewal agreement tendered to the franchisee is the form of agreement that the franchisor offers to new franchisees, the franchisee's protection, if it finds the renewal terms unacceptable, is not to renew or to try to negotiate changes.

But just how far does this concept carry? Does a condition that a "renewing" franchisee sign the franchisor's then-current form of agreement mean that the franchise relationship can be dramatically restructured in the new agreement? The *Princeton Review* litigation probed this question.

The facts presented in *Test Services, Inc. v. The Princeton Review, Inc.* were straightforward. The franchisee, Test Services, Inc. ("TSI"), sought to "renew" its franchise relationship under an option contained in its original franchise agreement. Its franchisor, The Princeton Review, Inc. ("TPR"), thereupon presented its current form of franchise agreement to TSI for signature. TSI refused to sign the new form of agreement, saying that it would unreasonably curtail TSI's previous contract rights and exclusivity. When negotiations stalled, both parties sued for declarations of their respective rights and obligations in connection with TSI's desire to renew the franchise relationship.

The Parties' Original Franchise Relationship

TPR is a New York City-based provider of diverse educational services, but its original business, which it franchised, is test preparation for U.S. college and graduate school admissions tests. TPR has company-owned and franchised offices in the U.S.A. and two dozen other countries that prepare students to take standardized examinations such as the SAT, GMAT, and MCAT.

TSI's franchise agreements, which dated from the 1980s, gave TSI an "option to renew the license granted

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herein" provided that TSI signed a renewal agreement "on the terms and conditions then being offered to new franchisees." TSI's original agreements also gave TSI three express assurances with regard to the renewal agreements it would be offered: (1) that they would not require an initial franchise fee, (2) that they would not require periodic payments that were higher or more frequent than those under TSI's original agreements, and (3) that they would not impose more onerous reporting requirements.

The Evolution of TPR's Business and Franchise Agreement

TPR's business has changed dramatically since the 1980s as the result of new technology, consumer trends, and government policies on education. TPR responded to these market forces by developing new delivery mechanisms for its test preparation courses, such as online courses, and by introducing new products and services, such as programs to help local school districts achieve government-mandated goals for elementary and secondary ("K12") students. TPR's 1980s-vintage franchise agreements did not foresee these developments, creating uncertainty as to TPR's right to implement these programs in franchised territories. Choosing to resolve the uncertainty through negotiation rather than litigation, TPR and its franchisees, including TSI, negotiated addenda in the 1990s and early 2000s that provided franchisees with additional rights and certain payments in exchange for a clear path for TPR to introduce new products and services in franchised territories. At the same time, however, TPR repeatedly updated its standard franchise agreement to clarify the rights reserved to TPR. Thus, new franchisees did not obtain the same contract terms that existing franchisees had received through the negotiated addenda.

In addition to updating the terms of its franchise agreement over the years, TPR changed the geographic focus of its franchising efforts. By the time TSI's franchise agreements came up for renewal, TPR had not offered franchises in the U.S.A. for several years, but TPR did maintain an active international franchising program.

TPR's Renewal Procedure

Under its original franchise agreements, TSI was required to give notice of its intention to renew at least 180 days before expiration of the agreement and was required to sign a renewal franchise agreement at least 120 days before the scheduled expiration. The 180-day notice would give TPR time to redevelop TSI's territory if TSI did not wish to renew. If TSI did wish to renew, the 180-day notice gave TPR time to present TSI with TPR's current form of franchise agreement and any necessary disclosure document. The 120-day deadline for the actual signing of the renewal franchise agreement gave TSI two months to review the new form of agreement and seek to negotiate any desirable modifications, while still allowing TPR time to begin orderly redevelopment if no mutually acceptable renewal terms were reached by the deadline.[1]

Six of TSI's franchise agreements were scheduled to expire on December 31, 2005. In January 2005, TSI gave notice of its intention to renew those agreements. TPR prepared a Uniform Franchise Offering Circular based on its most recent form of franchise agreement and delivered the UFOC to TSI in early May 2005. After reviewing the franchise agreement and disclosure document, TSI advised TPR that it wished to negotiate changes in the agreement that had been tendered.

The Run-Up To Litigation

As the negotiations began, TSI took the position that the renewal agreement tendered by TPR breached the terms of TSI's existing contracts. TSI asserted that its "option to renew the license granted herein" meant that the scope and exclusivity of its license could not be changed at the time of renewal. TSI also contended that the renewal agreement did not contain "the terms and conditions then being offered to new franchisees" because the new form had only been offered to international candidates, not to prospective franchisees in the United States.

Over the summer of 2005, the parties exchanged information and negotiated regarding TSI's substantive concerns. As part of those discussions, they agreed that neither party would file suit against the other before August 26, 2005, a week before TSI was required to enter into its renewal agreements. When no resolution was reached by that date, each party filed suit in the federal district court of its respective home state.

This race to the courthouse could have been avoided if TSI's original franchise agreements had contained a forum selection clause, but the 1980s contracts did not designate the venue for litigation between the parties. A forum selection provision would almost certainly have been enforced and may have avoided the duplicative filings in two different courts. As it turned out, however, the court in Colorado, where TSI had filed its action, indicated that it would be able to address the matter more quickly than the New York court overseeing the case filed by TPR. Since a prompt resolution of the issue

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was important to both parties, they focused their efforts in Colorado.

Pre-Trial Activities

At the outset, the Colorado court indicated that the parties' respective renewal rights could likely be resolved on the language of TSI's franchise agreement alone. The court also made clear that it understood the desirability of a ruling before the end of 2005, when TSI's original franchise agreements would expire. Nonetheless, the court took under advisement a motion by TPR to decide the case based on the contract language and allowed limited, expedited discovery.

The court rejected attempts by TSI to obtain documents and depositions reflecting all of TPR's communications with recent franchisees. Instead, the court held that a summary of contact information for those to whom TSI sent disclosure documents over the last several years would suffice. In addition, TPR produced copies of all franchise agreements signed by franchisees over the previous seven years, to confirm the terms that had been offered to new franchisees during that period. The court then consolidated TSI's motion for a preliminary injunction barring expiration of its agreements with trial on the merits and set a bench trial for November 2005, three months after the complaint had been filed.

The Court Enforces The Contract According To Its Terms

The trial to the court included testimony from the president of TSI, the chief executive officer of TSI, and the president of TPR. The franchisee's chief executive officer admitted that he understood that his company's franchise agreement could be changed at the time of renewal, but denied understanding that the changes could reach the scope and nature of his "license." In addition to cross-examination by opposing counsel, the court itself questioned the executives of both companies on what limits on the franchisor's ability to change the agreement, if any, each found in the language of the original franchise agreements. TPR's position throughout was that if the renewal agreement offered to TSI was the same form of agreement TPR offered at the time to new franchisees, then the only limitations on its terms were the three express assurances set out in TSI's original agreement.

Two weeks after the conclusion of the trial, the court issued its decision in a memorandum opinion dismissing all of the franchisee's claims relating to the renewal terms. In short, the court held that the renewal provision in TSI's original agreement required TSI to enter into the renewal agreement that TPR had tendered to it.

Applying New York law, the court held that the language of TSI's franchise agreement unambiguously required TSI to execute TPR's current form of franchise agreement to effectuate renewal of its franchises. That the renewal agreement would arguably curb the "license" originally granted to TSI was held immaterial, the court finding "no provision in the Expiring Agreements that preserves any other terms or conditions for TSI as opposed to new franchisees. Other than the [three express exceptions], the terms and conditions of the Renewal Form are those 'then being offered to new franchisees.'"

As stated by the court, the "renewal provision here does not expressly require the continuation of the contractual relationship on the exact terms and conditions as contained in the original Expiring Agreements. Rather, it provides for a new and different contract with three enumerated exceptions that apply to TSI." TSI's argument to the contrary was held untenable because it would "nullify the condition that TSI enter into renewal agreements containing the 'terms and conditions then being offered to new franchisees.'"

The court also rejected TSI's contention that the renewal form tendered by TPR was not the current form of agreement offered by TPR to new franchisees because it had not been offered to any new domestic franchisee. The court found "[n]o distinction between domestic and foreign franchisees is made in the [franchise agreements]. No express language in the [franchise agreements] supports such a limitation on the term 'new franchisees.'"

Having determined that TSI "was aware that the terms and conditions of the [franchise agreements] could change" and that "TPR had legitimate business reasons for reserving its right to make changes in the terms and conditions," the court concluded that the franchise agreements "expressly permit TPR to renew TSI's franchises on terms and conditions that are different than those granted in the Expiring Agreements, so long as at the time of renewal the terms and conditions offered to TSI are the same terms and conditions that are being offered to new franchisees."

TSI initially announced an intention to appeal the trial court's decision, but within six weeks after the decision the parties had negotiated a full settlement. Under the settlement, TSI signed the new form of franchise agreement for all 10 of its franchise territories

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(not just the six that were expiring as of the end of 2005), with certain negotiated changes.

Implications

The court's ruling in this case was important both for TPR and for franchisors generally. At stake was TPR's ability to control the development of its brand and business in key markets in the United States. In the twenty years that TPR had been franchising, its business plan changed significantly in the face of new opportunities and evolving market conditions. It was thus critical that TPR retain the benefit of its bargain: its ability to adjust contract terms to current conditions at the time of renewal. An adverse decision could have curtailed TPR's online business in the markets of its U.S. franchisees and substantially hampered its ability to compete with other test preparation businesses.

For franchisors generally, the decision stands as authority for an important proposition: when a franchisor and franchisee agree that the renewal contract can differ from the original franchise agreement, that agreement is enforceable, even if tl renewal form would substantially alter the terms of tl franchise. The decision also supports the principle tha unless a contract specifically says otherwise, domestic and international franchise agreements can be treated in the same manner for purposes of determining the terms currently offered by a franchisor.

What Made the Difference for TPR?

1. Drafting

The TPR case demonstrates the importance of good contract language when seeking the enforcement of renewal provisions. The inclusion of explicit exceptions to TPR's right to include different terms in the renewal agreement (e.g., an express assurance that the royalty rate would not increase) demonstrated to the court that the parties had agreed to preserve only certain terms of the expiring agreements. There are also other ways that franchisors can tighten the language of their agreements to eliminate the ambiguities that TSI alleged. For example, a franchisor could explicitly state in its renewal provision that the renewal agreement it will offer may have significantly different terms that may limit or fundamentally change the scope of the license.

2. TPR's ability to show that its conduct was not opportunistic.

It was also important for TPR to be able to show the court that the renewal agreement offered to TSI had been offered to other recent prospective franchisees. TPR had solid records of each occasion that it sent a franchise agreement and franchise disclosure document to a prospective franchisee. As a result, TPR was able to prove that the renewal agreement offered to TSI had not been conjured up just for TSI. Because market forces impose discipline on the contract terms that a franchisor offers, this evidence also gave force to the legitimacy of the renewal agreement. Even better, TPR was able to prove that several international franchisees (and a number of renewing domestic franchisees) had entered into the form of franchise agreement offered to TSI. Thus, this form of franchise agreement had passed the test imposed by the market, and it could not plausibly be argued that TPR had offered TSI an unreasonable franchise agreement as a ploy to push TSI out of the *The Princeton Review* franchise network.

. TPR's advocacy regarding the need to pdate franchise relationships.

TPR also emphasized to the court that there were legitimate business reasons for the changes that had been made in TPR's franchise agreement. The need for a franchisor at some point to modernize its franchise system to take advantage of new opportunities and to meet new competitive forces proved to be a compelling argument.

Conclusion

As this dispute illustrates, even familiar contract provisions cannot be taken for granted. Even familiar provisions must sometimes be fully briefed and litigated before their meaning is finally established.

In light of this decision, franchisors can be more confident that when an initial franchise term ends, they will not be forced to continue "legacy" contract terms written for a world gone by. The ruling validates a franchisor's legitimate interest in putting renewing franchisees on the same contractual footing as those entering the franchise system under the franchisor's current form of franchise agreement, one that makes sense for the franchisor's business today.

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Footnotes

1. The Supreme Court of Alabama recently upheld and strictly enforced a similar structure for renewal of a franchise. In re Keelboat Concepts Inc. v. C.O.W. Inc., No. 1040091, 2005 WL 3506864 (Ala. Dec. 23, 2005).

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