

# Constraints Against Termination of Dealers and Franchisees

## Matthew Moloshok

Relations between dealers and franchisees and suppliers and franchisors have long been a matter of interest to antitrust law.<sup>1</sup> How dealers get appointed, located, or terminated can have profound effects on the prices of goods and services as well as overall efficiency. When those effects result from or are enforced by horizontal arrangements, we are near the core of antitrust concerns,<sup>2</sup> even if the restraint is purely within a single brand.<sup>3</sup> Short of resale price maintenance agreements, however,<sup>4</sup> unilateral terminations by a supplier or franchisor<sup>5</sup> have usually withstood antitrust scrutiny, on the basis that parties should be free to choose with whom they will deal.<sup>6</sup> Standing and “antitrust injury” requirements also serve to impede antitrust challenges to terminations.<sup>7</sup> For the most part, therefore, termination disputes, whatever their potential effects on prices and efficiency, get resolved under bodies of law other than antitrust law, and those bodies of law often restrict the suppliers or franchisors’ ability to terminate its dealer or franchisee.<sup>8</sup>

*The Franchise and Dealership Termination Handbook* released by the ABA Section of Antitrust Law in 2004<sup>9</sup> provides a roadmap through the process of terminating distribution relationships. It addresses at length the many issues that can arise in connection with termination, including legal constraints against termination of franchise and dealerships. Those constraints derive from a variety of sources—contractual limitations, implied contractual obligations, equitable principles, and state and federal relationship statutes.

<sup>1</sup> See, e.g., *United States v. Trans-Missouri Freight Ass’n*, 166 U.S. 290, 323 (1897) (antitrust law exists to protect “small dealers and worthy men”); see also *Brown Shoe Co. v. United States*, 370 U.S. 294, 344 (1962) (although antitrust law protects competition not competitors, “we cannot fail to recognize Congress’ desire to promote competition through the protection of viable, small, locally owned business”); *Klor’s, Inc. v. Broadway-Hale Stores, Inc.*, 359 U.S. 207, 213 (1959) (the law will not tolerate a group boycott disadvantaging a discounter, “merely because the victim is just one merchant whose business is so small that his destruction makes little difference to the economy.”)

<sup>2</sup> *Toys “R” Us, Inc. v. FTC*, 221 F.3d 928, 930 (7th Cir. 2000).

<sup>3</sup> E.g., *United States v. General Motors Corp.*, 384 U.S. 127 (1966).

<sup>4</sup> *Business Elecs. Corp. v. Sharp Elecs., Inc.*, 485 U.S. 717 (1988); *United States v. Parke, Davis & Co.*, 362 U.S. 29 (1960); *Dr. Miles Med. Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911).

<sup>5</sup> See *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 588 (1986) (citing *Monsanto v. Spray-Rite Service Corp.*, 465 U.S. 752, 764 (1984)).

<sup>6</sup> *United States v. Colgate & Co.*, 250 U.S. 300 (1919). This principle is sometimes called the *Colgate* doctrine.

<sup>7</sup> Joseph P. Bauer, *The Stealth Assault on Antitrust Enforcement: Raising the Barriers for Antitrust Injury and Standing*, 62 U. PITT. L. REV. 437 (2001).

<sup>8</sup> *Bronx Auto Mall, Inc. v. Am. Honda Motor Co., Inc.*, 934 F. Supp. 596, 608 (S.D.N.Y. 1996), *aff’d per curiam*, 113 F.3d 329 (2d Cir. 1997).

<sup>9</sup> ABA SECTION OF ANTITRUST LAW, *FRANCHISE AND DEALERSHIP TERMINATION HANDBOOK* (2004) [HANDBOOK].

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The wisdom of imposing noncontractual restraints must be left to others.<sup>10</sup> Awareness of constraints on termination of distribution relationships is, however, critical to avoiding significant costs and liability. “More often than one might expect,”<sup>11</sup> parties ignore those constraints and suffer harsh consequences as a result.

### Reasons the Parties Might Want to Part Ways

Before turning to the constraints, it should be recalled that franchise and dealership arrangements are commercial arrangements and, thus, largely creatures of contract. Parties choose with whom they will deal and the terms on which they will deal. As in any relationship, however, some arrangements work out better or are more durable than others. Not all parties meet their contractual obligations, perform as expected or desired, or meet even the most minimum reasonable standards of performance. A franchisor or supplier will be fed up with a lazy, incompetent, undercapitalized, or otherwise poorly performing franchisee or dealer; the same can be said of a franchisee or dealer having to deal with a lazy, incompetent, undercapitalized, or otherwise poorly performing supplier or franchisor.

*The lore of franchise and dealership protection seems to turn on a model of a small, family business that is about to be shunted aside for arbitrary, inconsequential reasons.*

Even if each side is meeting its contractual duties, there are many reasons why parties would be better off ending a relationship. What is mutually desirable and profitable today may not be workable a year from now (to say nothing of five, ten, or twenty years from now). It may often be efficient or desirable for a supplier and its dealers (individually or collectively) or a franchisor and its franchisees (individually or collectively) to part ways. Each side might naturally and reasonably seek as much flexibility as it can to adapt to changes in technology (such as the advent of the World Wide Web) or to be able to end the existing relationship and take up with a more efficient or better financed business partner even if the existing partner has fully met its contractual obligations. The *Colgate* doctrine certainly suggests a “hands off” approach so as not to second-guess these kinds of business decisions, which could also impede business adaptability. It is precisely because it is so difficult to predict the kinds of circumstances in which change might be desired that suppliers and franchisors might prefer to provide that they could terminate for any reason or no reason.

Nevertheless, it would be naïve to think that all terminations are high-minded, efficient, or appropriate. There are the anecdotal reports that Dealer A gets replaced by Dealer B because Dealer B paid a kickback to the supplier’s agent or Dealer B is a relative of the supplier. There are the occasions when the supplier, having ridden the back of the dealer, now wants to “eliminate the middleman” and appropriate the dealer’s good will. (Going the other way, there are the franchisees who want to misappropriate trade secret information or are simply opportunistic.) There are equitable considerations when one side sinks large amounts into performance only to have the other side destroy that investment by unexpectedly ending the relationship.

Overall, then, Congress, state legislatures, and courts have chosen to fashion protections against termination for certain groups of franchisees and dealers. Where and how, however, should lines be drawn? The lore of franchise and dealership protection seems to turn on a model

<sup>10</sup> See FRANCHISE PROTECTION: LAWS AGAINST TERMINATION AND ESTABLISHMENT OF ADDITIONAL FRANCHISES, ABA SECTION OF ANTITRUST LAW MONOGRAPH No. 17 (1990); Thomas J. Collin, *State Franchise Laws and the Small Business Franchise Act of 1999: Barriers to Efficient Distribution*, 55 BUS. LAW. 1699 (2000).

<sup>11</sup> HANDBOOK, *supra* note 9, at 35, 58–59; REPORT [TO CONGRESS] OF THE AMERICAN BAR ASSOCIATION SECTION OF ANTITRUST LAW ON PROPOSED SMALL BUSINESS FRANCHISE ACT, (1999), available at <http://www.abanet.org/antitrust/comments/1999/final.doc>.

of a small, family business that is about to be shunted aside for arbitrary, inconsequential reasons. Whether that model works when some distributors (think, as examples, of Wal-Mart, or even Toys “R” Us) are bigger or more powerful than their suppliers seems questionable. Yet many small, family-owned enterprises that invest their life-savings into their businesses still remain and, rationally, want protection against arbitrary or bad faith terminations. Even when a termination is “efficient,” it does not mean that it should take place without fair recompense for whatever loss, cost, or disruption it may cause to a franchisor or dealer who had invested relationship-specific costs in reliance on a long-term relationship.

### Terminations and Inadvertent Terminations

If one party (say the supplier) decides to part ways, you might expect it will make a forthright statement to its dealer, “I’m ending the relationship effective today,” or after a period of notice. Not all terminations, however, are that straightforward. The supplier might engage in a creeping, silent withdrawal from or undermining of the relationship.<sup>12</sup> The supplier might inadvertently make profitability too difficult for the dealer by appointing what the dealer asserts is an encroaching dealer and thereby constructively terminate the relationship.<sup>13</sup> Withdrawals of one line of products among several the supplier was furnishing could be deemed a constructive termination as well.<sup>14</sup>

Non-renewal of relationships is even more complex. State and federal statutes protecting franchises or certain dealerships, discussed below, equate termination and the failure to renew a relationship at the end of its contractual term. Franchisors’ and suppliers’ actions can potentially be considered a failure to renew if renewal is conditioned upon impermissible changes in terms of the relationship.<sup>15</sup> (What constitutes “termination” does not involve antitrust issues specifically. Antitrust policy may be concerned, however, if parties are forced to remain in inefficient arrangements. And if we assume, in the long run, parties’ contracts will produce the optimum efficiency, antitrust policy would view “surprise” restrictions skeptically.)

### What Limits Terminations and Non-Renewals?

The common law of contracts and the *Colgate* doctrine of antitrust law teach that parties are free to determine with whom they will do business. Included is the ability to walk away from an existing business relationship without cause, and even without prior notice, unless the contract says otherwise. Whatever the *laissez-faire* appeal of these principles, however, they have limited application.

**Contractual Limits.** As a practical matter, distribution relationships often require large investments by dealers and franchisees—sometimes large in absolute terms, and almost certainly very large as a percentage of the dealer’s or franchisee’s net worth. To encourage those investments, the parties usually reach an express agreement that requires, at a minimum, some period of notice

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<sup>12</sup> See, e.g., *Sons of Thunder v. Borden*, 148 N.J. 396, 690 A.2d 575 (1997); *R.J. Gaydos Ins. Agency v. Nat’l Consumer Ins. Co.*, 168 N.J. 255, 773 A.2d 1132 (2001).

<sup>13</sup> See, e.g., *Petereit v. S.B. Thomas, Inc.*, 63 F.2d 1169 (2d Cir. 1995).

<sup>14</sup> *Compare Central GMC, Inc. v. General Motors Corp.*, 946 F.2d 327 (4th Cir. 1991) (product line withdrawal authorized by contract did not terminate a “franchise” under statute), with *Arthur Glick Truck Sales, Inc. v. General Motors Corp.*, 865 F.2d 494 (2d Cir. 1989) (“heavy duty truck” line could be separate “franchise” for purposes of statute even though only one of several truck lines provided under dealer’s contract).

<sup>15</sup> HANDBOOK, *supra* note 9, at 12–14.

prior to termination. Where huge absolute investments, such as those found with automobile dealerships, exist or where the contract requires development of a new territory, the contracts may be of many years' duration. Some contracts may even require mediation or arbitration before a termination can take effect, requiring the parties to work together while the arbitration process is underway in order to avoid injury to the investment.<sup>16</sup>

Often, a contract will require that the supplier have specified "cause" to end the relationship before its stated term expires. Frequent "cause" grounds for termination include any failure to make payments that are due, failures to meet operating standards, and other uncured breaches of the contract, violations of law, or various types of fraud or misleading business practices.<sup>17</sup> The definition of "cause" itself may require a period of notice and opportunity to cure before "cause" even comes into existence. As a result, some courts even hold that dealers who mislabel products be afforded notice and opportunity to cure because the contract provision was intended to give the dealer the chance to clean up his act.<sup>18</sup> Similarly, a dealer who starts to cure will sometimes receive protection against termination until the cure can be completed.<sup>19</sup>

An "implied covenant of good faith and fair dealing," applicable to contracts, prevents termination that denies the other side the reasonably anticipated fruits of the distribution agreement.

**Equitable Principles and Implied Obligations.** Even if a contract allows termination, implied obligations and equitable principles may impose further restraints. It has occasionally been held that, as a matter of equity, dealers cannot be subject to termination (absent cause) until they have had a reasonable and adequate opportunity to recoup their investment or if the supplier had so much power in the transaction as to make the exercise of termination "unconscionable."<sup>20</sup> An "implied covenant of good faith and fair dealing," applicable to contracts, prevents termination that denies the other side the reasonably anticipated fruits of the distribution agreement. Courts divide over whether the implied duty "trumps" express provisions of the contract.<sup>21</sup>

**Statutes.** Another set of constraints is statutory: forty-eight states have statutes barring termination of or failure to renew a motor vehicle dealer absent "good cause" criteria established by the statute.<sup>22</sup> Usually, a showing of "good cause" requires proof that the dealer materially breached a reasonable term of the contract and the breach remains uncured after an adequate period of notice and chance to cure, or that the dealer is guilty of a crime or a fraud. Some states specifically authorize terminations incident to a complete, nondiscriminatory market withdrawal or for other approved business reasons. Also, states sometimes have statutes similar to the motor vehicle dealer laws to protect dealers in specific industries—commonly beer and wine wholesalers, and farm or heavy equipment dealers.<sup>23</sup>

<sup>16</sup> Long duration contracts may be traps for unwary franchisees, especially in the hotel industry. Franchisees developing hotels may have 15 year contracts—yet will face liquidated damages if there is a premature termination.

<sup>17</sup> Sometimes courts have refused to accept contractual definitions of default: a court refused to enforce a dealership agreement that made it an event of default for dealers to have "below average" sales; applied literally, at all times, half of the distribution network would be in default and subject to termination and the standard gave no consideration to individual competitive circumstances. *Marquis v. Chrysler Corp.*, 577 F.2d 624 (9th Cir. 1978).

<sup>18</sup> *See, e.g., Lippo v. Mobil Oil Corp.*, 776 F.2d 706 (7th Cir. 1985) (majority holds notice and opportunity to cure misbranding required; Posner, J., in dissent, asserts that misbranding is an incurable breach).

<sup>19</sup> *H.C. Blackwell Co., Inc. v. Kenworth Truck Co.*, 620 F.2d 104 (5th Cir. 1980).

<sup>20</sup> HANDBOOK, *supra* note 9, at 39–41.

<sup>21</sup> *See* cases cited *id.* at 15 n.15 and accompanying text.

<sup>22</sup> *Id.* App. C.

<sup>23</sup> *Id.* App. B.

On top of these, two federal statutes are noteworthy. The Petroleum Marketing Practices Act prohibits terminations or non-renewals of petroleum distributors unless (1) it is mutual and voluntary, (2) the franchisee violated a “reasonable provision of the franchise agreement” that is “material” or does not “exert good faith efforts,” or (3) an event “makes termination reasonable.”<sup>24</sup> (Those events are dealer dishonesty or events outside the control of either party.) The Automobile Dealers Day in Court Act<sup>25</sup> requires a manufacturer to act in “good faith” when performing, terminating, or renewing a motor vehicle franchise. In practice, this bars “intimidation” or “coercion” by the manufacturer and, thus, has proven of limited help when manufacturers terminate or decide not to renew.<sup>26</sup>

Last, but certainly not least, roughly twenty states have “franchise protection” or “relationship” laws that provide “good cause” or similar protections to all “franchises” or business relationships that have certain statutorily defined characteristics.<sup>27</sup> This requires that the parties ascertain early in the process whether the termination could involve a protected “franchise” or “relationship” under the statutory definition. Even if the parties disclaim that the relationship is a “franchise,” it could nonetheless be considered a “franchise” under the statute.<sup>28</sup>

In the interests of simplicity, statutory definitions of protected “franchises” usually follow one of two models. “Marketing plan” statutes, found in California, Connecticut, Illinois, Indiana, Iowa, Virginia, and Washington define a protected franchise as involving, in essence, three elements: (1) the franchisee pays a franchise fee, either directly or indirectly through its purchase obligations; (2) the franchisee operates under the franchisor’s trademark or service mark; and (3) the franchisee is required to follow a marketing plan prescribed by the franchisor.<sup>29</sup> The other major type, found in Missouri, Nebraska, New Jersey, and Wisconsin, is a “community of interest” statute. These usually involve two main elements: (1) the dealer has to actually derive, or be intended to derive, a substantial portion of its sales under the trademark of the supplier or franchisor and (2) the dealer and the supplier will have a “community of interest.”<sup>30</sup> A “community of interest” usually arises when the franchisee makes franchise-specific investments or is otherwise highly dependent on the franchisor.<sup>31</sup> Thus, “marketing plan” definitions cover what everyone usually thinks of as a franchise, while “community of interest” definitions capture a range of relationships and can create, in effect, “inadvertent” franchise relationships.<sup>32</sup> Much of the litigation under the relationship statutes turns on fact-and-circumstances inquiries as to whether the statutory criteria have been met.<sup>33</sup>

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<sup>24</sup> 15 U.S.C. §§ 2801–2806.

<sup>25</sup> 15 U.S.C. §§ 1221–1226.

<sup>26</sup> HANDBOOK, *supra* note 9, at 47–48.

<sup>27</sup> *Id.* at 49ff and App. A.

<sup>28</sup> *See, e.g.*, *Contractors Home Appliance, Inc. v. Clarke Distrib. Corp.*, 196 F. Supp. 2d 177 (D. Conn. 2002).

<sup>29</sup> HANDBOOK, *supra* note 9, at 49.

<sup>30</sup> *Id.*

<sup>31</sup> *See, e.g.*, *Cooper Distrib. Co. v. Amana Refrigeration, Inc.*, 63 F.3d 262 (3d Cir. 1995); *Instructional Sys. Inc. v. Computer Curriculum Corp.*, 130 N.J. 324, 328, 614 A.2d 124 (1992).

<sup>32</sup> *See, e.g.*, as a cautionary tale, *Gentis v. Safeguard Business Systems, Inc.*, 60 Cal. App.4th 1294, 71 Cal. Rptr. 2d 122 (1998).

<sup>33</sup> *See* HANDBOOK, *supra* note 9, at 51–52.

### Adjunct Claims

Collateral or adjunct claims, including claims of various types of antitrust violations, often are critical to how the parties resolve their relationship. Such claims may provide grounds to defend against termination or create a risk of large damages unless the parties can settle.<sup>34</sup> In addition, it is often true that these claims would have lain dormant but for the provocation of, or the need to respond to, a termination.

Some adjunct claims one might expect to encounter include:

- Allegations that the dealer was terminated because it would not go along with a price-fixing or resale price maintenance scheme in violation of Section 1 of the Sherman Act;<sup>35</sup>
- Allegations that the dealer was terminated as the result of a group boycott;<sup>36</sup>
- Allegations that the dealer was terminated as the result of the effects of price discrimination or as the result of complaining about discriminatory pricing in violation of the Robinson-Patman Act;<sup>37</sup>
- Allegations that the dealer was terminated because it would not pay kickbacks to the supplier or allegations that the termination came about at the behest of its competitor who paid such kickbacks;<sup>38</sup>
- Allegations that a franchisee was misled into investing in the first place by the franchisor's misrepresentations;<sup>39</sup>
- Allegations that a franchisor failed to support the franchise system, or even undermined it for its own benefit;<sup>40</sup>
- Allegations that a supplier priced the products it required its dealers to purchase at levels it knew would preclude the dealers' profitable operations;<sup>41</sup>
- Allegations that the supplier impermissibly tied the opportunity to purchase certain desired products to a requirement to purchase unwanted products (again in violation of antitrust law).<sup>42</sup>

### Consequences of Termination in Violation of the Constraints

A supplier's attempt to end franchises or protected relationships without establishing requisite "good cause" and satisfying whatever notice and cure requirements are found in the statutes can

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<sup>34</sup> Thus, the fact that a party could have terminated or exercised a right consistently with the contract will not protect it from antitrust liability if it exercised the right in furtherance of an anticompetitive purpose. *See Poller v. CBS*, 368 U.S. 464 (1962); *Lee-Moore Oil Co. v. Union Oil Co.*, 599 F.2d 1299 (4th Cir. 1979).

<sup>35</sup> *Monsanto Co. v. Spray-Rite Serv. Corp.*, 465 U.S. 752, 765 (1984); *McCabe's Furniture v. La-Z-Boy Chair Co.*, 798 F.2d 323 (1986); HANDBOOK, *supra* note 9, at 156–62.

<sup>36</sup> *Klor's, Inc. v. Broadway-Hale Stores, Inc.*, 359 U.S. 207 (1959); *Rossi v. Standard Roofing, Inc.*, 156 F.3d 452 (3d Cir. 1998); HANDBOOK, *supra* note 9, at 166–70.

<sup>37</sup> *George Haug Co. v. Rolls-Royce Motor Cars Inc.*, 148 F.3d 136 (2d Cir. 1998); *Stelwagon Mfg. Inc. v. Tarmac Roofing Sys., Inc.*, 63 F.3d 1267 (3d Cir. 1995).

<sup>38</sup> *Cf. United States v. Joselyn*, 206 F.3d 1444 (1st Cir. 2000) (widespread kickback scheme as condition of allocations of vehicles).

<sup>39</sup> HANDBOOK, *supra* note 9, at 132–37.

<sup>40</sup> *E.g., Sherman v. Master Protection Corp.*, 2002 WL 318-54905 (Cal. Ct. App. Dec. 18, 2002).

<sup>41</sup> *Wilson v. Amerada Hess Corp.*, 168 N.J. 236, 773 A.2d 1121 (2001).

<sup>42</sup> *Eastman Kodak Co. v. Image Technical Servs. Inc.*, 504 U.S. 451 (1992). *Compare Queen City Pizza Inc. v. Domino's Pizza Inc.*, 124 F.3d 430 (3d Cir. 1997) (required purchases did not create an impermissible tie-in), *with Collins v. Int'l Dairy Queen*, 939 F. Supp. 875 (M.D. Ga. 1996) (required purchases were an impermissible tie-in). *See generally* HANDBOOK, *supra* note 9, at 170–75.

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buy big trouble for franchisors and suppliers. To start, even if a contract is terminable at will, failure to give notice may preclude termination altogether or, worse, constitute a material breach of the agreement by the terminating party. Then, too, there can be steep costs associated with litigation—including extensive discovery, expert witnesses, motion practice, and possible trial—or arbitration.<sup>43</sup> Moreover, statutes often provide fee-shifting to the franchisor or supplier, vastly increasing the costs. Some statutes provide liberalized availability for preliminary injunctions, provide multiple damages or civil penalties, or impose requirements that the franchisor repurchase inventory, supplies, or special equipment. There are even five states whose statutes make willful violation of the relationship laws a crime.

Terminations in furtherance of antitrust violations will incur treble damages and/or injunctive relief<sup>44</sup> and conceivably could result in criminal liability.

### **Negotiating the Termination Process**

Termination is a process, which, in some unfortunate circumstances, lasts longer than the parties' actual business relationship. It is a process in which negotiation and the leverage each side brings to bear (whether at the bargaining table or in the courtroom) may be more important than the niceties of whether there was sufficient notice or sufficient cause.

Parties considering whether to terminate or how to respond to a threat of termination need to think of many issues, including:

- Who are the parties? Would termination destroy a family business? Has the dealer made large, recent investments?
- What is the parties' relationship? Is it a franchise or something else?
- What governs the relationship? Is it just the contract or will a statute or implied obligation have to be considered?
- What is the basis to end the relationship—and will it be deemed adequate under the contract, the implied obligations, and any applicable statute?
- What notice and opportunity for cure was required and has it been given?
- What can (or should) be done to preserve the relationship?
- What adjunct claims or counterattacks are likely to be mounted?
- Watch out—is there a release, waiver, statute of limitations, or estoppel defense that will have an effect on either the ability to terminate or the ability to pursue adjunct claims?

### **Conclusion**

Do the many constraints on termination level the distribution playing field or tilt the field in favor of the dealers and franchisees in their relations with suppliers and franchisors? From an antitrust perspective, these constraints in the aggregate could be viewed as a desirable encouragement to investment by the dealers and franchisees who are the flesh and blood of real competition in real markets or as an undesirable barrier that entrenches incumbents and invites inefficiency.

Congress, as much as state legislatures and common-law courts, have chosen to protect automobile dealers (through the Automobile Dealers Day in Court Act), petroleum dealers (through the

<sup>43</sup> Many agreements require arbitration instead, but arbitration is not necessarily less expensive. Also, automobile dealers are beneficiaries of a relatively new federal amendment to the Dealers Day in Court Act that allows many, perhaps most, automobile dealers to opt out of arbitration. 15 U.S.C. § 1226.

<sup>44</sup> See, e.g., *Monsanto*, 452 U.S. 752 (1984); *Toys "R" Us*, 221 F.3d 928 (7th Cir. 2000).

Petroleum Marketing Practices Act), and small dealers (generally, through the Robinson-Patman Act) from impositions by automakers, oil companies, and chain stores, respectively. This may indicate a belief that such protections are consistent with (or at least deserve to be reconciled with and balanced against) the efficiency concerns of antitrust law. Under all circumstances, do not forget the many constraints against termination and failure to renew franchise and dealership arrangements and the significant adverse consequences that can flow from ignoring those constraints. ●