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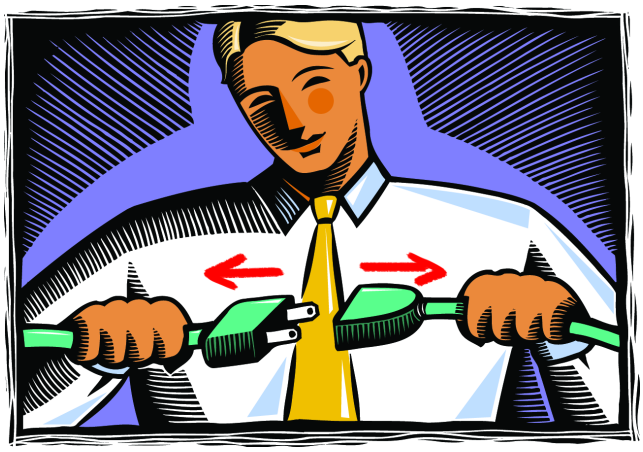
# LITIGATION

## Litigating Over the Termination of Franchises

*Covenant of Good Faith and Fair Dealing Often Raised at Preliminary Injunction Stage*

**BY JAMES M. WICKS**

ON APRIL 29, $16.5 million was awarded to a former McDonald's franchisee who claimed the company pursued a vendetta against her. She claimed McDonald's conspired to defraud her out of the several franchise restaurants she once owned. This verdict confirms that the concept of good faith and fair dealing is alive and well in the franchise setting.



Oftentimes, the propriety of franchise terminations are played out at the preliminary injunction stage, either by the franchisee moving to enjoin a pending termination, or by a franchisor seeking to enforce a termination. Although the courts apply the traditional standard in determining whether to grant preliminary injunctive relief, franchisees often raise claims of breach of the implied covenant of good faith and fair dealing at that stage of the process in an effort to stave off termination. As a result, in the preliminary injunction context, the focus not surprisingly becomes the conduct of the franchisor.

In considering the validity of terminations, courts examine whether the franchisor complied with the termination and, if applicable, cure provisions of the parties' agreement. Next, was the basis for the termination proper? It is in the latter context that the courts will look carefully at a franchisor's conduct in dealing with its franchisee. Defensively, the issue could be raised by the franchisee invoking the doctrine of "unclean hands." Offensively, depending on which state law applies, the franchisee could raise a claim of breach of the implied covenant of good faith and fair dealing.[1] Cases within the U.S. Court of Appeals for the Second Circuit, as well as those outside this circuit, confirm that the courts do essentially analyze the conduct of the franchisor in the termination process, even where, for example, it may appear that likelihood of success on the termination claim would otherwise appear clear.

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### New York Courts

In *Dunkin' Donuts Inc. v. Northern Queens Bakery, Inc.*, the plaintiff filed suit seeking to enjoin defendants from operating their franchise stores.[2] The plaintiff terminated the franchise agreements based upon allegedly failed health, safety and sanitation inspections and re-inspections of the franchisee stores.[3] An argument made by the franchisee in opposition to the motion for an injunction was that plaintiffs breached the franchise agreements and/or covenants of good faith and fair dealing by "terminating the franchises on the eve of substantial renovations organized and partially paid for by the defendants."[4]

Nonetheless, the court in the Eastern

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District of New York dismissed the defendants' argument as unpersuasive and held that defendants violated the terms of the franchise agreement. The court noted that the law is "well settled that 'the Court's function in construing a contract is to give effect to the clear agreement made by the parties and not to fashion a new set of obligations.' "[5]

Similarly, in *Shred-It America, Inc. v. Haley Salve Inc.*, the court in the Western District of New York found for plaintiff franchisor and issued a preliminary injunction.[6] The plaintiff claimed that the franchise agreement was terminated because the defendant did not cooperate with inspections or offsite shredding standards, nor did they pay advertising, promotion and royalty fees. As to the failure to cooperate with inspections, defendant argued that the various requests for inspections were not reasonable under the terms of the franchise agreement. Although not raised by the defendant, the court stated that "[w]hile repeated requests for inspections, may, at some point, become so onerous that [they] violate the covenant of good faith and fair dealing implicit in the franchise agreement," here, this was not the case.[7] Instead, the franchise agreement did not limit the number of inspections and therefore, it was within plaintiff's right to terminate it.

Likewise, in *Adiel v. Coca-Cola Bottling Co. of New York*, the plaintiff franchisees argued that the defendant breached the implied covenant of good faith and fair dealing by terminating the distribution agreements.[8] Plaintiffs argued that the defendant, in order to persuade plaintiffs and other distributors to enter into an agreement which made them assume substantial and long-term personal obligations, made oral promises to them that the defendant would renew their distribution rights indefinitely.[9] However, the court in the Southern District of New York held that, under New York law, a "party's reliance upon express contractual terms insulates it from such claims."[10] Here, the franchise agreements in no manner required the defendant to renew the distribution rights.[11]

In contrast, franchisors have raised the implied covenant of good faith and fair dealing to support their termination of a franchise agreement.[12] For example, in *Southland Corp. v. Froelich*, the franchisor filed a motion for preliminary injunction alleging that it was entitled to terminate the franchise agreement because of the franchisee's material breaches.[13] The franchisor claimed, among other things, that the franchisee used fraudulent lotto "post voids" to divert funds from the store's deposited receipts, which thereby deprived the franchisor of its contractual share of the gross profits.[14]

Furthermore, the franchisor argued that the breaches were so material, that they went to the core of the contract.[15] The Eastern District court agreed, stating that:

> '[i]n every contract there is an implied covenant that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of that contract, which means that in every contract there exists an implied covenant of good faith and fair dealing.'[16]

Hence, the court found for the franchisor and issued a preliminary injunction enjoining the franchisee from using the franchisor's service marks, trade dress, trade name and trademarks.[17]

As noted above, some courts have flat out refused to recognize the implied covenant of good faith and fair dealing.[18] In *Romacorp, Inc. v. TR Acquisition Corp. and Angelo Slabakis*, the plaintiff franchisor sought to terminate and permanently enjoin the defendants from further use of their trademarks.[19] One of the defendant franchisees claimed that the franchisor breached the implied covenant of good faith and fair dealing by failing to deal in good faith.[20] However, the Southern District, applying Texas law, held that the law does not impose a duty to bargain in good faith, by stating that:

> 'others have recognized an implied contractual duty of good faith and fair dealing in franchise agreements arising out of a general duty of good faith and fair dealing implied in all contracts. (citations omitted.) We, however, have specifically rejected the implication of a general duty of good faith and fair dealing in all contracts.[21]

In turn, franchisees have been successful in arguing a franchisor's lack of good faith should preclude termination in a preliminary injunction hearing.

For example, in *Bronx Auto Mall, Inc. v. American Honda Motor Co. Inc.*, the plaintiff franchisee filed a motion for preliminary injunction to enjoin the defendant from terminating its franchise agreement.[22] The plaintiff claimed that the franchisor wanted to extinguish the dealership in the Bronx because it decided that it had established too many dealerships. To that end, the franchisor made unreasonable demands on the franchisee in order to "establish a pretext for terminating its franchise."[23] Among many facts discussed in the case, a critical one to the court was a list of renovations that were required of the plaintiff if it were to obtain renewal of the franchise agreement.[24]

The court in the Southern District held that insisting that the franchisee abide by the entire list of renovations violated the New York Franchised Motor Vehicle Dealer Act (the Act).[25] Furthermore, the court held the Act's requirement of "due cause" for termination or non-renewal was not satisfied unless the franchisor had both good cause and good faith.[26] The court cited several cases holding the franchisor to a good faith standard by virtue of the implied covenant of good faith and fair dealing.[27] In sum, the court concluded

that the franchisor's unfair demands were not made in good faith.[28]

## Other States

The courts in the Second Circuit have not been alone in looking at the conduct of the franchisor in franchise terminations. Courts outside this circuit have also considered similar claims regarding the implied covenant of good faith and fair dealing in the preliminary injunction phase of litigation.

For instance, in *Foreign Motors, Inc. v. Audi of America, Inc. and Volkswagen of America, Inc.*, the franchisee filed a motion for injunctive relief alleging that the defendant manufacturer terminated its franchise arbitrarily and without good cause.[29] In its defense, the franchisors argued that the franchisee never satisfied the requirements of the franchise agreement, and in view of that poor performance, they made a business determination to terminate the agreement. Although the plaintiff raised the issue of the implied covenant of good faith and fair dealing, the Massachusetts district court instead held that it "should not force Audi to continue the franchise where FMI's 'chronically and irremediably [poor performance]' justifiably causes Audi substantial concern."[30]

In *Pappan Enterprises, Inc. v. Hardee's Food Systems, Inc.*, the franchisor sought review of a decision that denied its motion for preliminary injunction.[31] The franchisee, beginning in 1993 (except for one year), stopped making royalty and advertising payments on its five remaining franchises as required by the franchise agreement.[32] In 1997, the franchisor officially sent a termination letter. The franchisee alleged breach of contract and breach of the covenant of good faith and fair dealing. However, the U.S. Court of Appeals for the Third Circuit found that the termination of the franchise agreement was within the franchisor's rights and the plaintiff's continued use of the trademarks must cease.

In *Dunkin' Donuts, Inc. v. Guang Chyi Liu*, defendant franchisee moved for reconsideration of the district court's dismissal of the franchisee's counterclaim for breach of good faith and fair dealing.[33] During the lower court proceeding, the franchisor claimed to have terminated the franchise agreement because the franchisee had violated the agreement by underreporting its sales and committing tax fraud.[34] The franchisee counterclaimed alleging, among other things, that the franchisor breached the implied covenant of good faith and fair dealing.[35] The franchisee alleged that the franchisor did so by manipulating the QRSA, a computer auditing program that it claimed was unreliable, to extort money from its franchisees.[36]

In the present action for reconsideration, the franchisee attempted to revive the implied covenant of good faith and fair dealing counterclaim by setting forth additional new evidence.[37] The franchisee claimed that, in addition to the prior proceedings, the franchisor also breached the implied covenant of good faith and fair dealing by terminating the agreement as a pretext so they could sell the store for a profit.[38] The franchisees argued that the QRSA was an unreliable auditing tool used by the franchisor as an improper motive to terminate the franchise agreement.[39] However, U.S. District Judge James McGirr Kelly found the evidence unconvincing, and upon reconsideration, adhered to his original decision because no genuine issue of material fact was raised.[40]

## Conclusion

It appears that the implied covenant of good faith is an issue seen frequently by the courts in considering terminations. Moreover, the good faith and fair dealing of the franchisor is often played out during the preliminary injunction phase. The focus of the motion then becomes how did the franchisor act toward the franchisee in carrying out the termination?

Courts must analyze and determine whether the franchisor acted in a manner that violated the implied covenant of good faith and fair dealing or whether the implied covenant is in fact relevant to the proceeding. The covenant, if found to have been breached, can have staggering results, as demonstrated in the *McDonald*'s case. As case law continues to develop in this area, query whether the implied covenant of good faith and fair dealing is being raised more in the franchise context than other contractual settings.

(1) Some states, like Texas, do not recognize such claims.
(2) 216 F.Supp.2d 31 (E.D.N.Y. 2001).
(3) Id. at 38.
(4) Id. at 39.
(5) Id. at 42 (quoting *Dunkin' Donuts Inc. v. Priya Enterprises Inc.*, 89 F.Supp.2d 319, 323 (E.D.N.Y. 2000) (citing *Slatt v. Slatt*, 64 N.Y.2d 966, 967 (1985)).
(6) No. 01-CV-0041E(SR), 2001 WL 209906, at *4 (W.D.N.Y. Feb. 26, 2001).
(7) Id. at *3.
(8) No. 95 Civ. 0725 (wk), 1995 U.S. Dist. LEXIS 13141, at *6 (S.D.N.Y. Sept. 11, 1995).
(9) Id. at *3.
(10) Id. at 6.
(11) Id.
(12) See *Southland Corp. v. Froelich*, 41 F.Supp.2d 227 (E.D.N.Y. 1999).
(13) Id. at 229.
(14) Id. at 232.
(15) Id. at 246.
(16) Id. at 247 (citing *Kirke La Shelle Co. v. Paul Armstrong Co.*, 263 N.Y. 79, 87 (1933).
(17) Id. at 249.
(18) See *Romacorp, Inc. v. TR Acquisition Corp. and Angelo Slabakis*, No. 93 Civ. 5394, 1993 U.S. Dist. LEXIS 16923 (S.D.N.Y. Dec. 1, 1993).
(19) Id. at *1.
(20) Id. at *18.
(21) Id. at 19 (citing *English v. Fischer*, 660 S.W.2d 521, 522 (D. Tex. 1983). For this reason, the court found in favor of the franchisors. Id.
(22) 934 F.Supp. 596; Bus. Franchise Guide (CCH) ¶ 11,000 (S.D.N.Y. 1996).
(23) Id. at 597.
(24) Id. at 610.
(25) Id.
(26) Id. at 611.
(27) Id.
(28) Id.
(29) 755 F.Supp. 30 (D. Mass. 1991).
(30) Id. at 35 (citing *Amoco Oil Co. v. Dickson*, 389 N.E.2d 406, 409 (Mass. 1979).
(31) 143 F.3d 800 (3d Cir. 1998).
(32) Id. at 802.
(33) No. 99-3344, 2002 U.S. Dist. LEXIS 12270, *1 (E.D. Pa. June 25, 2002).
(34) Id. at *10.
(35) Id.
(36) Id. at *16.
(37) Id. at *17-18.
(38) Id. at 20.
(39) Id.
(40) Id. at 23.