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Lawrence I. Fox

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LEGAL STRATEGY AND TRIAL PROCEDURE

*LAWRENCE I. FOX**

I. INTRODUCTION

Imagine that you are sitting in your office sipping your morning coffee. Your secretary buzzes your intercom and you are told that there is a Mr. Apollo in the reception area waiting to see you. Mr. Apollo, you are informed, is the president and majority shareholder of Venus Beauty Products—a manufacturer of beauty products distributed nationwide through contract couriers—and that he needs to speak with you immediately because he is having a problem with his product distribution system.

He is ushered into your office, whereupon he informs you that he has recently been to see Messrs. Joslyn, Lifland, Kobak & Perry, and that he has now come to you searching for a one-handed litigator to help him with his problem.

As you slyly slide one hand to your side and place the other on the desk, you inquire as to what he means by a one-handed litigator. Whereupon he expresses that when receiving advice from these attorneys concerning whether he is a franchisor or not, or if he had any antitrust problems, or if there were common law issues to be concerned about, he has always been told on the one hand this, yet on the other hand that.

My topic today addresses the litigation issues that should be considered when representing a supplier or dealer in a termination context. By providing an analytical framework to apply to the myriad of considerations that affect a litigation judgment, each of you will be more able to include yourselves among that elite group known as one-handed litigators.

A. Typical Rendition of Facts from the Franchisor's Perspective

Typically, the story you would hear from someone in Mr. Apollo's position is as follows:

Forty years ago my father, an innovative chemist working in his basement, developed a beauty product that became successful as a result of his vision and hard work. The success and growth of the com-

* Lawrence I. Fox, B.S. 1970, Boston University; J.D. 1973, Georgetown University. Member, Berger, Steingut, Weiner, Fox & Stern.

pany was, in addition to being a function of a great product, also a result of the innovative and creative marketing approach that the company developed. Specifically, they sold their products door-to-door through individuals who signed contracts with Venus and were assigned exclusive territories. A franchise system was never set up; it was just a normal contract distribution system where a supplier furnished a dealer with goods for resale. The company was generous in working with these dealers by providing them with national advertising, training, and financing. Moreover, these couriers were given extensive leeway in developing their own creative marketing approaches so long as they were consistent with the overall aims of the company.

Then, because of changing demographics and the reduction in the number of women at home during the day, revenues began to decline. Rather than working hard in their market to penetrate it further and garner new customers by continuing the active promotion of Venus' sales on a door-to-door basis, the couriers got greedy. They began selling products of other manufacturers—products such as home cleaning items, garbage bags, and magazines. Such sales denigrated Venus' products and injured the valued image and trademark of Venus. In essence, these couriers were "free riding" on Venus' national ad campaign using Venus' image and advertising to enable them to gain access to customers so that they could sell other manufacturers' products.

Not only did they begin to sell other lines, thereby diluting their effort on behalf of Venus, but these couriers also fundamentally changed the nature of Venus' tried and true distribution pattern of *private sales* by engaging in *public sales* at places such as county fairs, shopping malls, and flea markets. Finally, not satisfied with the marketing leeway with which we had provided them, the couriers began substituting Venus' products with other manufacturers' products in Venus' wrapping, thus creating health and safety problems, products liability exposure, and trademark problems. In our effort to stop these practices, we sent a notice to our couriers that they immediately stop selling other manufacturers' products or be terminated. We hoped it would work. We hoped no one would be terminated. The policy, however, was difficult to police, and although we caught some, others continued these practices. We decided to no longer tolerate the denigration of our products and the erosion of the good will which our company had built up over forty years. In July, we gave notice of termination to all of our couriers, stating they would be terminated in four weeks, consistent with their contracts. Of course, in an effort to be fair and equitable, we offered them each an opportunity to apply for a job with us in our newly designed sales and marketing effort. After a brief testing period, we concluded that this new sales and marketing idea was the most appropriate one for us to pursue in light of the changing market conditions and in connection with a newly formed

method of distributing our products. Specifically, we began selling to retailers, which enabled us to predict and control our manufacturing needs and to avoid the total erosion of the important image and good will we had established over forty years. Thus, we decided that in the future we would distribute our products through our sales agents at select retail outlets. Obviously, it was a reasonable business response to the economic exigencies of the new marketplace.

Well, we just learned at a meeting of the Couriers' Association that the couriers have discussed suing Venus for wrongful termination. I wanted to check with you to confirm that everything we had done was correct. They don't have a prayer—do they?

B. The Franchisees' Story

Returning to the opening scene of this dialogue, you're sitting at your desk—your intercom buzzes—your secretary announces that there is a man and a woman wearing vermillion tee shirts emblazoned across the front with the words "VENUS FOREVER" and they need to see you right away.

Your curiosity piqued, you ask that they be brought in. Sitting in your office, sipping herbal tea, they recount the following version of the facts:

Twelve years ago we bought the franchise from another courier with Venus' assent and approval. There had been a forty-year history of non-termination which certainly gave us the expectation of a right to continuing business as long as Venus was in business and we met our contract obligations.

We invested all our savings to purchase the franchise area and the van Venus required. Moreover, we went each year to two training sessions, at our own expense. We bought large inventories of their products, some of the products were introductory products that we didn't even need or want, but had to take. Also we had to keep a checking account without receiving interest.

More important, we spent the last twelve years of our time, effort, and money to develop this business. We have "sweat equity" invested in this business.

To ensure that we met the growing performance demands of Venus, we worked longer hours; we engaged subdistributors to help us in penetrating the market in a more efficient manner; and we explored new and innovative ways to improve and expand sales. In part, the demographics were changing and the women were not staying at home as much, so we had to use our creativity to ensure continued viability of the Venus product distribution system.

In order to attract more patrons to the Venus line, we realized that customers would be more attracted if we had a broader supply of ancil-

lary products to show them. So we took on products that didn't compete with or detract from our support for Venus' lines. Moreover, we realized that we could maximize the efficiency of selling Venus' products by speaking and meeting with groups of people rather than on a one-to-one basis, as had been the case in our door-to-door efforts. In this regard, we began selling at social functions, county fairs, shopping malls, and churches with great success as shown through increased sales.

How does Venus reward us for our effort, creativity and enormous investment of time and dollars? I'll tell you how they reward us. They terminated us so that they can seize the opportunity that *we* created. Seeing that our innovative sales techniques were successful in improving sales, they cut back our supplies and placed their own sales agents in retail outlets in direct competition with us. The distribution to these agents and retail outlets in our distribution area is a clear violation of their grant to us of exclusive distribution rights and could only have been designed for one purpose—to drive us out of business, take over the asset we created and not pay us for it. Venus' actions are nothing more than an effort to steal our business, and they must be stopped.

Although the contract contains a termination clause which provides that a termination may occur on thirty days notice, Venus' conduct over the years clearly indicated to us that such a termination clause merely was part of a form contract and would never be exercised. In fact, we were never subject to that clause. Even Venus didn't believe the clause was effective, for when they found out some of the couriers were selling other products and subsequently announced those couriers would be terminated, they actually entered into agreements with the couriers who were caught to prohibit future sales of non-Venus products, but never terminated them. Moreover, that was merely a form that was never subject to negotiation.

No one in his right mind would purchase anything for such a large sum believing that his right to work and to keep and continue to profit from the product could be terminated on thirty days notice. It is obvious that, by purchasing the routes and devoting our lives and fortunes to building this business, we relied on the company's explicit and implicit representations and acts which assured us that our contractual relationship was a lasting one and not subject to unilateral termination without cause.

Finally, it is clear that the company's real purpose was anti-competitive, because there was no good cause for the terminations. This is demonstrated by the fact that, at the very instant Venus was planning to terminate all its couriers and sell direct through their own agents located in retail outlets, the president was telling couriers the future of door-to-door selling by couriers was rosy and bright. Venus even continued to accept applications for van financing and approved new as-

sistants for training programs. Essentially, they would do anything that benefited them and did nothing to assist the franchisees who built their business.

As Willy Lohman said in *Death of a Salesman,* you just can't eat the orange and throw away the peel.

Venus is nothing but a money hungry franchisor who has wrongfully taken our life's work without any compensation. Their actions are clearly wrong, and through a lawsuit we should be able to receive millions of dollars in damages—that's right, isn't it?

II. Pre-Litigation Analysis—Preparing for Termination and Non-Renewal—Some Counseling Advice

Now that we've heard the likely characterizations of the facts contained in our hypothetical situation, let's analyze how you, as an attorney, should approach a discussion with your client, be it franchisor or franchisee, in order to better determine the course of action that should be pursued.

A. The Franchisor's Perspective

1. What are the supplier's underlying motivations for terminating the dealer? Is it an overall change in the franchisor's marketing plan which affects *all* franchisees, some franchisees, or just a particular dealer? If it is a particular dealer, what is the nature of the problem with the particular dealer that has resulted in the decision to terminate; e.g., is it a credit problem? If it is, the supplier should be aware that upon termination, if he follows the termination with a collection lawsuit, he is likely to draw an antitrust counterclaim. However, the franchisor/supplier should be aware that he will likely be obligated to fill the dealer's orders up until the time the agreement expires or is terminated. By requiring cash payments and filling the dealers "normal" requirements, the supplier can protect himself.

2. Review the contract between the parties to identify their respective obligations. If, as is likely, the supplier is held to a good cause termination standard, a key question may be whether the contract defines good cause to include the supplier's desire to restructure distribution so as to avoid losses, or whether good cause relates exclusively to dealers' non-compliance with their obligations. In the former case, it may be possible to establish good cause even if a state franchise definition applies. *See Lee Beverage Co. v. I.S.C. Wines of Cal., Inc.,* 623 F. Supp. 867, 870 (E.D. Wis. 1985) (good cause for dealership termination can be based on supplier's business motives, irre-

spective of dealer's performance, but a mere shift in product distribution from one dealer to another may not constitute good cause for termination); *see also Bimel-Walroth Co. v. Raytheon Co.*, 796 F.2d 840, 843 (6th Cir. 1986). *But see Medina & Medina v. Country Pride Foods, Ltd.*, 631 F. Supp. 293, 297 (D.P.R. 1986) (franchise statute limits just cause for termination to a dealers' acts or omissions; a supplier's economic reasons do not constitute just cause).

Also, the contract may specifically provide indications of the nature of the relationship as being a franchise or not, i.e. marketing plan or community interest.

a. With regard to the "marketing plan" type of franchise definition, the recent case of *Grand Light & Supply Co. v. Honeywell, Inc.*, 771 F.2d 672, 677 (2d Cir. 1985), appears to import something resembling a community-of-interest test into the marketing-plan analysis. The district court in *Grand Light* found that a marketing plan existed and awarded substantial damages to the wrongfully terminated dealer. *Id.* at 676. The court of appeals, in reversing, did not limit its analysis to factors showing lack of requisite control by the supplier or a lesser amount of damages. Rather, it expounded on the lack of dealer's general dependence on the supplier, a factor more relevant to community-of-interest considerations. *Id.* at 677.

In attempting to determine the existence of a prescribed marketing plan, counsel should examine the supplier's control over the following aspects of a dealer's business:

- marketing territory
- dealer's choice and volume of inventory
- dealer training
- dealer advertising
- dealer hiring and training of subordinates
- dealer's manner of dress and image
- dealer's facilities and equipment
- dealer's credit practices
- dealer's financing of inventory and equipment
- dealer's ability to take new marketing initiatives.

b. In addition to a shared financial interest, community-of-interest statutes require the use of supplier's trade name, trademark, and in most states, payment of a franchise fee. Recent cases have continued to interpret the trademark nexus to include any authorized use which

would convey to the public an assurance that the named supplier stands behind its product as distributed by the dealer. *See American Business Interiors v. Haworth, Inc.*, 798 F.2d 1135, 1140 (8th Cir. 1986). Recent cases have not developed further criteria delineating what may indirectly constitute a franchise fee (e.g., inventory costs above bona fide wholesale price), a training fee, mandatory purchases of more or different merchandise than desired by dealers, equipment costs, or payments to third parties.

3. Determine what documentation, if any, exists that may demonstrate that the franchisee has not met its obligations—e.g., correspondence, inspection reports, customer complaints, past-due accounts. In assessing what dealer conduct may constitute good cause for termination, and whether such conduct has occurred, counsel should also review the areas covered by any inspection program carried out by the supplier regarding dealer's sales performance, promotional, and general business practices. Further, counsel should review specific documentation of late payments, operating deficiencies, customer complaints and corrective actions taken, as well as examine the franchisor's files and interview its sales and management personnel. Essentially, to support a claim of good cause, a franchisor wants to show that the franchisee has had poor sales, poor performance, poor business practices, and operational deficiencies.

In the course of analyzing a termination situation, it may be helpful to bear in mind the following arguments pursued by suppliers and dealers in some recent cases:

a. Recent Franchisor Arguments

- refusal to move
- failure to pay accounts
- refusal to operate 24 hours
- unprofitable dealership
- failure to personally supervise
- division and sale of territory without franchisor's consent
- sale of franchisor's stock to franchisee's competitor
- lack of station cleanliness.

b. Recent Franchisee Arguments

- racial bias
- inadequate rate of return is not good cause for termination

- tying
- sex and age discrimination.

c. The franchisee should retain copies of inspection reports, notes of discussions with franchisor representatives, evidence of corrective action taken, and all other documentation relevant to asserted defaults and other possible motives for termination.

The importance of creating and maintaining a record is exemplified in *Wesley v. Mobile Oil Corp.*, 513 F. Supp. 227 (E.D. Pa. 1981). In violation of an express provision of his dealership agreement, a gasoline dealer closed his station for a period of more than seven days. Both sides admitted that the conduct had occurred, that it was material to the agreement, and that the agreement specifically prohibited it. However, good cause was found to be lacking because, upon hearing of the dealer's plan to close the station, the oil company representative said, "Do what you want. What can I say?" *Id.* at 229. Furthermore, just before the closing, the representative said, "Have a good vacation." *Id.* Thus, the oil company was held to have misled the dealer into believing it would waive its right to terminate. *Id.* at 230.

4. Determine which, if any, statutes apply to the termination in question, e.g., state unfair competition statutes, state franchise statutes, federal franchise statutes, specific state or federal industry regulation. The question of whether a statute applies will involve an inquiry focusing on whether the definition of franchise has been met. If this burden has been met, the impact of such statute must be assessed. For example, is good cause for termination a requirement? This question is critical, as it has an impact on the burden of proof and who shall bear this burden in any litigation.

5. Counsel should assess whether the franchisor can prove that good cause exists to justify termination. ALWAYS ASSUME THAT THE FRANCHISOR MUST PROVE GOOD CAUSE AND THAT IT WILL BE THE FRANCHISOR'S BURDEN TO DEMONSTRATE GOOD CAUSE FOR THE TERMINATION. EITHER THE FRANCHISEE WAS BAD OR A DISTRIBUTION CHANGE WAS NECESSARY TO INCREASE EFFICIENCY. *See Kealey Pharmacy and Home Care Services Inc. v. Walgreen Co.*, 761 F.2d 345, 350 (7th Cir. 1985).

Good cause based on dealer breaches must be evaluated in

light of a supplier's past dealing with its dealer. Thus, under the Puerto Rican franchise statute, a dealer's untimely payments to his supplier might not constitute nonperformance of an "essential obligation of the dealer's contract," given an established pattern of untimely payment. *Biomedical Instrument & Equip. Corp. v. Cordis Corp.*, 797 F.2d 16, 17 (1st Cir. 1986). On the other hand, secondary issues, such as a failure to meet prescribed standards of appearance, may constitute good cause for termination. *See Azcuy v. Amoco Oil Co.*, 50 Antitrust & Trade Reg. Rep. (BNA) No. 1250, at 209 (Jan. 30, 1986). These considerations would appear equally applicable to non- franchise contract claims.

6. Important is whether the franchisee has evidence supporting a claim of bad faith on the part of the franchisor.

a. Counsel should scrutinize all aspects of the supplier's conduct with its dealers which may not have comported with its statutory or common law/U.C.C. obligations of good faith. Areas of concern include the following:

- dual distribution impinging on dealers' exclusive distribution rights
- discriminatory service to dealers, as compared to direct purchasers of supplier employees;
- threats of termination
- misrepresentation of supplier's intentions and plans vis-a-vis continuation of existing relationships
- requirement of dealer payments to third parties, e.g. opening interest-free bank accounts
- unduly restrictive noncompetition requirements.

b. Counsel must address whether the motivation for termination is anti-competitive? Is the franchisor terminating the franchisee as a result of conspiracy among other franchisees to eliminate price competition—and is therefore part of a horizontal *per se* price-fixing agreement—or is the termination an attempt by the franchisor to vertically integrate and take over the retail distribution of its products and monopolize the market? In evaluating whether such a program exists, inquiry should be made as to what evidence does the franchisee have that the motivation is anti-competitive, i.e., any tape recordings or other correspondence from the unfortunate franchisor to the franchisees which indicates that it would withhold supplies or take over the franchisee's territory if the franchisee did not

"stay in line."

c. Another crucial element is whether similarly situated franchisees have been treated the same, or is this termination discriminatory and selective? The more selective the termination, the more likely it is that absent a clear demonstration that the franchisee was deficient in its operation, the termination was not in good faith.

Where the supplier is terminating all of its dealers, discrepancies in the supplier's treatment of individual dealers, e.g. preferable rates of severance compensation, including post-termination employment offers, should be scrutinized for evidence of the supplier's conspiracy with certain dealers or prior improper pricing demands. Uniformity may deter allegations of such conduct. However, uniform terminations of all dealers, regardless of any differences in their compliance with contractual obligations clearly indicates the relative unimportance of dealer breaches and thus defaults as a "good cause" motive for the supplier's action.

d. Counsel must also determine whether the franchisor has made any threats concerning the pricing of the franchisee or its sales of competing products. Such conduct may show termination is part of an overall anti-competitive program.

e. Lastly, counsel should examine the contract itself for unduly restrictive non-competitive clauses.

7. What is the franchisor's liability in the event of a successful wrongful termination claim?

a. Damages—compensatory and punitive.

b. Equitable relief—recission, injunction, constructive trust for the money that the franchisor receives from the franchisee's former customers.

8. How competitive is the marketplace, i.e., does the dealer/franchisor have monopoly power or near monopoly power over the product in question? If a non-price vertical restraint such as a territorial or customer restraint is involved, then needed is an analysis of the effect of that restraint on inter-brand and intra-brand competition to determine the restraint's reasonableness. If the supplier's market share is small and the restraint arguably creates distributional efficiencies, then the restraint is likely to be upheld. However, if the supplier has a

large market share and very little inter-brand competition exists, it is possible that the restraint will be found unreasonable.

9. What are the dealer's potential counterclaims?

a. For the termination itself;

b. For antecedent matters such as for: antitrust violations; breach of contract; tort; unfair competition; common-law; U.C.C.

10. Evaluate the overall equities in the relationship between the parties: What is the degree of the dependence of the franchisee on the franchisor; what was the time and financial commitment made by the franchisee; how can the prior conduct of the franchisor be characterized; what written or oral statements has the franchisor made that could be relied upon by the franchisee. Whether considered as a matter of qualifying for statutory franchisee status, or as a matter of the common law of contracts with good faith obligations, the degree of dealer dependence on the continuation of its dealership will likely influence judicial decisions substantially. *See Grand Light & Supply Co. v. Honeywell, Inc.*, 771 F.2d 672, 677 (2d Cir. 1985) (literal interpretation of statute inappropriate to find franchisee relationship absent requisite dependence). Indeed, the main impetus behind franchise statutes is the attempt to alleviate hardship which may befall highly dependent dealers when terminated. Where such statutes do not exist, courts have resorted to common law doctrines of good faith and fair dealing to ameliorate the problem. *See Misco, Inc. v. United States Steel Corp.* 784 F.2d 198, 203 (6th Cir. 1986) (termination of exclusive dealer under a contract terminable at will requires "reasonable notice" in accordance with good faith and fair dealing determined on specific facts, e.g., length of relationship, reliance, particular industry customs and practices). The factors to be considered in determining the equities of termination may be divided into four categories:

a. The magnitude of a dealer's investment in the dealership, including purchase of the dealership, inventory, equipment and training, and the development of good will. The absence of real investment is often the crucial missing component in cases alleging franchise status. *See Representaciones EBI, Inc. v. Gator Indus.*, 629 F. Supp. 662 (D.P.R.), *aff'd*, 807 F.2d 1 (1st Cir. 1986) (representative for sneaker manufacturer deemed not a dealer because of lack of investment in advertisement, inventories of

items, and lack of assumption of credit risks); *Agee Agric. Equip. Sales v. Trail King Indus.*, 800 F.2d 789 (8th Cir. 1986) (remanded due to inadequate findings of whether the agreement constituted a franchise). In determining the degree of investment in inventory, the question is not whether a dealer takes title but whether he is in fact financially at risk. *Moore v. Tandy*, 819 F.2d 820 (7th Cir. 1987) (dealer's substantial "security deposit" on inventory did not constitute investment where generally subject to refund on dealers' fulfillment of management obligations). Investment in good will alone, "produced merely by the duration of representative's relationship with customers" is not sufficient to meet the franchise statute standard. *Aida Eng'g, Inc. v. Red Stag, Inc.*, 629 F. Supp. 1121, 1126 (E.D. Wis. 1986).

b. The length of time of the relationship and justifiable reliance on its continuation. *See Misco v. United States Steel Corp.*, 784 F.2d 198, 203 (6th Cir. 1986).

c. The portion of the dealer's business represented by his work for supplier. In *Kusel Equip. Co. v. Eclipse Packaging Equip. Ltd.*, 647 F. Supp. 80 (E.D. Wis. 1986), dealer and supplier were not deemed to share a "community of interest" where less than two percent of the dealer's sales were attributable to the supplier's products. *See also Foerster, Inc. v. Atlas Metal Parts Co.*, 105 Wis. 2d 17, 313 N.W.2d 60 (1981) (representatives of manufacturer found not to be a dealership when only calling cards and advertising brochures were supplied by manufacturer and representative handled at least four other companies); *Grand Light & Supply Co. v. Honeywell, Inc.*, 771 F.2d 672, 677-79 (three percent of business does not amount to franchise status or application of U.C.C. good faith obligations to supplement contract terms).

d. The dealer's ability to pursue alternative lines of business. Exploration of these issues will assist counsel in determining the nature and extent of damages incurred by dealers, as well as whether dealers meet the community-of-interest requirement of many franchise statutes.

11. What procedures must be followed for the termination?

a. What is sufficient notice: under the agreement; statutes; good faith and equitable fairness doctrines? Counsel must remember that notice of termination requirements,

whether contractual or statutory, may involve more than merely giving dealers notice (and, in some cases, an opportunity to cure defaults). A supplier must take care to continue to meet all of his obligations to the dealer during the time between giving notice and the date of actual termination. In *American Bus. Interiors v. Haworth, Inc.*, 798 F.2d 1135 (8th Cir. 1986), the supplier failed to provide necessary pricing information to its dealer in the post-notice, pre-termination period. The court held that this failure "violated duties independent of contract. . . . [and that a] jury could find . . . [it] constituted a termination," thus breaching the contract and tortiously interfering with the dealer's business relationships. *Id.* at 1145. The latter claim supported an award of $250,000 in punitive damages, although the dealer did not allege lack of justification for the supplier's decision to terminate. *Id.* at 1147; *see also Aida Eng'g Inc. v. Red Stag, Inc.*, 629 F. Supp. 1121, 1127 (E.D. Wis. 1986) (supplier's alleged reduced interaction with dealer prior to termination, hindering dealer's ability to solicit sales, and supplier's portrayal of dealer to third parties as "lame duck" stated cause of action for breach of contractural right to exclusive representation).

b. What is the form of notice required—oral, written, telex, certified mail?

c. What are the parties' respective rights during the post-notice, but pre-termination period regarding continued supply and participation in franchisor's advertising? Is the franchisee entitled to a period of time to liquidate its inventory, a phase-out period? Is the franchisee entitled to one last purchase opportunity? Is the franchisor required to repurchase from the franchisee its remaining inventory?

d. Must the franchisee have an opportunity to cure any defect which is the basis for termination?

12. Are there any alternatives to termination, for instance:

a. Let the agreement expire and not renew it.

b. Buy out the franchisee.

c. Where a franchisee has made a substantial investment in the franchise, it may be advisable to allow the franchisee an opportunity to sell the business to an acceptable successor franchisee, thereby affording the new franchisee to realize the unamortized value, and any appreciation, of the as-

sets and any residual good will of the business.

d. Is it likely that the franchisee may ask to terminate the agreement?

B. Pre-Litigation Counselling
from the Franchisee's Perspective

The approach is a simple one. Counsel for the franchisee wants to evaluate whether its client has fulfilled all of its obligations under its contract terms, whether his client is in fact a franchisee governed by its state's franchise statute, and whether the franchisor has met the criteria for a termination with "good cause." COUNSEL SHOULD ALWAYS ASSUME IT MUST PROVE THAT ITS CLIENT HAS MET ITS CONTRACT OBLIGATIONS AND HAS ACTED REASONABLY AND IN A MANNER DESIGNED TO AGGRESSIVELY AND PROPERLY PROMOTE THE FRANCHISOR'S TRADEMARK PRODUCTS. In this connection counsel will want to obtain discovery that:

1. The franchisee actively promoted the franchised products.

2. That it met its sales quotas.

3. It paid its bills in a timely manner. A dealers' untimely payments to his supplier may not, however, be deemed "essential obligations of the dealer's contract," given an established pattern of untimely payment. *Biomedical Instrument & Equip. Corp. v. Cordis Corp.*, 797 F.2d 16, 17 (1st Cir. 1986).

4. That no complaints were lodged against it by the franchisor or by its customers.

5. That it made substantial financial, as well as time commitments to the franchisor's products.

6. That it was dependent upon the franchisors for its business livelihood and that it could not readily use any equipment or facilities in connection with another line of work, nor could it obtain another distributorship readily. Moreover, a strong claim of dependence is made when the franchisee can demonstrate that a large proportion of the franchise business was represented by its sale of the franchisor's products and that the relationship was a long-term one with few, if any, problems.

a. The portion of dealer's business represented by his work for supplier. In *Kusel Equip. Co. v. Eclipse Packaging Equip. Ltd.*, 647 F. Supp. 80 (E.D. Wis. 1986), dealer and supplier were not deemed to share a "community of interest" where less than two percent of dealer's sales were

attributable to the supplier's product. *See also Foerster, Inc. v. Atlas Metal Parts Co.*, 105 Wis. 2d 17, 313 N.W.2d 60 (1981) (representative "which maintained no inventory of manufacturer's products, which had no responsibility for completing sales . . . , and which used the manufacturer's trade name only on some business cards and brochures supplied to it by the manufacturer was not a dealer for purposes of the Fair Dealership Law.") and *Grand Light & Supply Co. v. Honeywell, Inc.*, 771 F.2d 672, 677-79 (three percent of business does not justify franchise statute application of U.C.C. good faith to supplement contract terms).

7. Finally, demonstrate that the reason for termination was an anti-competitive one, for example:

a. The true reason for termination was that it was, in reality, a consequence of a horizontal price-fixing, market allocation, or customer allocation conspiracy between and among the other franchisees;

b. The termination was part of an overall vertical price-fixing agreement;

c. The termination was a result of the franchisee's failure to adhere to unreasonable non-price verticle restraints imposed by the franchisor, such as prohibitions against carrying non-competing products;

d. The termination was a result of an unlawful tying and the franchisee's unwillingness to continue to purchase the unwanted products.

e. Always seek to demonstrate that the purported rationale of franchisor's conduct, although ostensibly pro-competitive, was in fact anti-competitive because it did not result in increased efficiencies or enhanced product quality. Evidence of this may exist in varying forms, such as showing that the termination would result in increased prices to consumers and decreased quality, output, and innovation, as well as ultimately decreasing distributional efficiency.

III. Litigation Strategy and Issues

Returning to the scene in your office where you are discussing the rights and obligations of your franchisee clients, you must now assess what course of action they should pursue in light of the fact that they have received the termination notice.

Generally speaking, if the termination is of the specific franchisee

only, and is not part of a system-wide distribution change involving the termination of most, if not all, franchisees, one would be well advised to contact the franchisor to immediately discuss the reasons for the termination in an attempt to gain some informal discovery as to the underlying basis for the decision. During these discussions, you may well discover the identity of the parties possessing other relevant information as well as any existing relevant documents. Moreover, you may elicit some other information that your client has not disclosed.

In our current situation, we have a system-wide distribution change and a notice of termination to all franchisees. Whether a single franchisee or all were terminated, the analysis of litigation strategy can be segmented into four broad categories: A) Who should be a plaintiff? B) What causes of action are available and which of them should be pursued? C) Where should the action be commenced? D) What relief should be sought?

A. Who are the potential plaintiffs?

1. Only the terminated dealers that are your clients?

2. Should the assistants be joined as plaintiffs and, if so, does sufficient privity of relationship exist?

3. Other suppliers of products to the franchisees who were deprived of outlets because of supplier's exclusive dealing requirement? They may have had an action during the period that the franchisees were precluded from selling their products, but the termination in fact makes their case less viable because they would now have access to the terminated couriers.

4. Should you seek a group of dealers as plaintiffs?

a. Advantages:

(i) Financial—costs and burdens shared.
(ii) Equities—ability to show impact of defendant's conduct.

b. Disadvantages:

(i) May have conflicts.
(ii) Increases plaintiff's usual discovery burdens.
(iii) Complicates case, which may decrease chances of settlement.

5. Should a class action on behalf of all terminated franchisees be instituted? Members of a class action benefit from a number of economies of scale which may be crucial to maintaining an action where individual damages are relatively slight. However, the party opposed to a class may prefer to be

in a position to deal with all its adversaries at once. Indeed, it is possible that this party may employ the device defensively by, for example, suing the class for a declaratory judgment. This approach may not succeed, however, if most or all of the plaintiff class members opt out of the class. FED. R. CIV. P. 23(c)(2) (providing that in certain class actions, the court shall direct to the members of the class the best notice practicable under the circumstances; this notice is intended to advise each class member that it may opt out of the action if that member so requests by a prescribed date).

a. Advantages of Class Action:

(i) Ability to jointly bear litigation expenses.
(ii) Ability to pool useful information to enhance the evidentiary foundation of a claim.
(iii) Availability of broader discovery powers.
(iv) Tolling of statute of limitations for class members.
(v) Settlement of all claims on behalf of class, rather than individual settlements. If the claims are at all amenable to settlement, i.e., if the controversy is not a life or death matter for the class's opponent, a dauntingly united front of class members is likely to motivate the opponent to come early to the bargaining table.
(vi) Adverse publicity attended to class actions may encourage defendant to settle.
(vii) The combined resources of a class will better assure counsel of remuneration, permitting counsel's best efforts.

b. Disadvantages of Class Action:

(i) Administrative burdens.
(ii) Discovery and litigation of class certification can be time consuming and expensive.
(iii) Class actions generally result in more protracted litigation.
(iv) Individual class member's ability to settle is limited unless it opts out.
(v) Counsel carries administrative burden of maintaining adequate contact with class members, and must be careful to discharge a heightened set of fiduciary responsibilities in protecting the interests of each class member.
(vi) Difficulty in selecting adequate class representatives.
(vii) Questions of law or fact may not be common to the class.

(viii) Claims or defenses may differ.

(ix) Difficulty of one litigation forum means that the court may have to apply various state laws. In cases involving the application of the statutes or common law of many different states, a court may rule that proceeding on a class action basis would create an unmanageable level of complication, and thus may deny certification to the class. *See Coca-Cola Bottling Co. of Elizabethtown v. Coca-Cola Co.*, 95 F.R.D. 168, 177-78 (D. Del. 1982) (although proposed class members sought to enforce contracts which were identical in their material parts and derived from a common source, certification was denied because the court would have had to apply the contract law from as many as thirty-two different states; bottlers failed to demonstrate common issues of law or fact necessary under FED. R. CIV. P. 23(a), which states the prerequisites of establishing a class action). Of course, this problem would not pertain to actions under state class action rules, or to class actions based on federal, antitrust or other laws.

(x) Certain class members, while not opting out, may nonetheless be uncomfortable with maintaining an action in a distant forum and being represented by counsel whom they did not personally choose.

(xi) The class opponent will have the benefit of broader discovery rights.

(xii) It is possible that a class action posture will provoke an opponent to file counterclaims against absent class members who otherwise would not be pursued.

(xiii) Some courts have manifested antipathy to class actions, which may prejudice the position of class members.

(xiv) Settlement must be approved by the court. It is inherently difficult with a nation-wide class to demonstrate that common issues of law or fact predominate pursuant to FED. R. CIV. P. 23(a) where the distributor has not terminated all franchisees at one time.

(xv) In the event of failure of the class's action, litigation expenses will probably far exceed those involved in an individual lawsuit.

6. Is an action by the trade association viable or worthwhile? *See* FED. R. CIV. P. 23.2 (right of an unincorporated association to bring action).

a. Usually trade associations are limited to seeking declaratory judgments or injunctions and cannot seek damages. FED. R. CIV. P. 56 allows a party, when seeking to obtain a declaratory judgment, to move with or without supporting affidavits for a summary judgment.

b. The rule for an association's representative standing is that suit may be brought on behalf of members when:

(i) members could sue in their own right;
(ii) the interests sought to be protected are germane to the organization's purpose; and
(iii) neither the claims nor the requested relief require the participation of the individual members in the suit. *See International Union, United Auto., Aerospace and Agric. Implement Workers of Am. v. Brock,* 477 U.S. 274 (1986) (the above three-part standard would appear to preclude a dealer association from suing in a representative capacity for actual damages; however, an action for injunctive or declaratory relief is not so likely to be barred). *See also Peick v. Pension Benefit Guar. Corp.,* 724 F.2d 1247, 1259 (7th Cir. 1983) (associational standing is particularly appropriate when the association is seeking to represent interests central to the purpose of the organization and where the relief sought is some form of prospective remedy, such as declaratory judgment), *cert. denied,* 467 U.S. 1259 (1984); *Committee for Auto Responsibility v. Solomon,* 603 F.2d 992 (D.C. Cir. 1979) (the prerequisites to associational standing were satisfied by a hearing before the district court concerning the organization's motion for injunctive relief), *cert. denied,* 445 U.S. 915 (1980).

7. Can the courier's sub-distributors be named as plaintiffs and should they be? Although the sub-distributors of the couriers are not in contractual privity with the supplier, they may be able to sue the supplier for a breach or for interference with contractual relations. However, it is not advisable that they be joined in the action, as it would seem to unnecessarily complicate the litigation.

8. Should the franchisor be the plaintiff and seek declaratory judgment that the termination was lawful?

B. What Causes of Action are Available and Which are Worth Pursuing?

1. Statutory Causes of Action

a. Applicable Federal Statutes

(i) Lanham Act, 15 U.S.C. §§ 1051-72, 1091-96, 1111-21, 1123- 27 (1982 & Supp. IV 1986) (in order to ensure the integrity of a trademark, it is the duty of the licensor to supervise the use of the trademark).

(ii) Antitrust statutes, *e.g.*, 15 U.S.C. §§ 1-7 (1982) (contracts, combinations in the form of trusts or otherwise, or conspiracies in restraint of trade; or, monopolization or attempt or conspiracy to monopolize any part of trade among the several states is illegal).

(iii) F.T.C. Act, 15 U.S.C. §§ 41-58 (1982 & Supp. III 1985) (unfair competition and deceptive trade practices).

(iv) F.T.C. Franchise Rule.

(v) Automobile Dealer Franchise Act, 15 U.S.C. §§ 1221-25 (1982) (Automobile Dealers Day in Court Act provides for automobile dealers to bring action against automobile manufacturer for failure of manufacturer to act in good faith in complying with terms of the franchise, or in terminating or failing to renew the franchise).

(vi) Petroleum Marketing Practices Act, 15 U.S.C. § 2801 (1982) (general prohibition against termination or non-renewal of franchise except for cause, and then not for the purpose of converting the premises to operation by employees or agents of the franchisor).

(vii) RICO, 18 U.S.C. §§ 1961-68 (1982 & Supp. IV 1986) (Racketeer Influenced and Corrupt Organizations allows for a finding of a pattern of racketeering activity when there are at least two incidents of racketeering conduct within ten years of each other). *See Virden v. Graphics One, Inc.*, No. 83-2420, 49 Antitrust & Trade Reg. Rep. (BNA) No. 1239, at 771 (Oct. 25, 1985) (franchisee's RICO claim held to survive summary judgment motion).

b. Applicable State Statutes

(i) General franchise termination and non-renewal statutes.

(ii) Disclosure statutes.

(iii) Special industry statutes (alcoholic beverages, automobiles, etc.).

(iv) Baby F.T.C. acts, *e.g.*, N.Y. Gen. Bus. Law § 349 (McKinney Supp. 1988) (Consumer Protection From Deceptive Acts and Practices).

(v) State antitrust statutes, *e.g.*, N.Y. Gen. Bus. Law §§ 340-47 (McKinney 1968 & Supp. 1988).

(vi) State unfair competition statutes (prohibiting acts contrary to equity and good conscience). *See Bostick Oil Co. v. Michelin Tire Co.*, 702 F.2d 1207, 1218-20 (4th Cir.) (South Carolina statute prohibited conduct which did not violate the Sherman or F.T.C. Acts, but were contrary to equity and conscience), *cert. denied,* 465 U.S. 759 (1983).

c. U.C.C. Good Faith Requirement

(i) Objective good faith requirement has been adopted by the Uniform Distribution Practices Act § 203, comment 1, i.e., covenant of good faith and fair dealing. *See Corenswet, Inc. v. Amana Refrigeration,* 594 F.2d 129 (5th Cir.), *cert. denied,* 444 U.S. 938 (1979).

(ii) U.C.C. § 2-309(2) (1978). "Where the contract provides for successive performances but is indefinite in duration it is valid for a reasonable time but unless otherwise agreed may be terminated at any time by either party."

(iii) U.C.C. § 1-203 (1978). "Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement."

(iv) Contract Limitations.

(a) Applies only to the sale of goods. *See* U.C.C. § 2-102 (1978).

(b) U.C.C. § 2-719 permits U.C.C. rights to be limited by contract. "[P]arties are left free to shape their remedies to their particular requirements and reasonable agreements limiting or modifying remedies are to be given effect." U.C.C. § 2-719 (1978) "Purposes" comment.

(v) The Uniform Act makes covenant of good faith and fair dealing not waivable by conduct or agreeement.

2. *Common Law Theories*

a. Equitable Estoppel; Promissory Estoppel; Waiver

(i) Party seeking to enforce the contract is precluded when its conduct is inconsistent with the rights or position of opposing party. Justice forbids a person from denying his own conduct when others relied upon him and acted based upon that reliance.

(a) Acts or statements inconsistent with claim asserted and sued upon.

(b) Action and reliance by other party.
(c) Injury to alleging party if first party allowed to repudiate act.

(ii) *Miskimen v. Kansas City Star Co.*, 684 S.W.2d 394 (Mo. Ct. App. 1984). Publisher estopped from terminating 250 contract carriers because publisher had, over ninety-year period, led carriers to believe they had proprietary rights, not just contract rights. Therefore, despite contract right to cancel on four-days' notice, and despite the fact that the publisher gave sixty-days' notice, the court estopped publisher from relying on contract clause after ninety years of contrary behavior. The court noted:

(a) "The forms of contracts were never the subject of negotiations." *Id.* at 396.
(b) "To permit the company to change its delivery system without compensating the carriers for the loss of their business would be manifestly unfair." *Id.* at 402.
(c) "No one in his right mind would purchase anything for such a large sum believing that his right to keep and work and continue to profit from the property could be terminated upon four days' notice. Nothing could be more obvious than the carriers in purchasing the routes and in devoting their lives and fortunes to build their businesses acted in reliance on the company's previous owners' and managers' explicit and implicit representations and acts giving assurance that the contractual relationship was a lasting one and not subject to unilateral termination without cause." *Id.* at 401.
(d) "The unfairness of the situation is further emphasized by the fact that the termination provision was never the subject of bargaining or negotiation. The Star's conduct created a reasonable expectation in the carriers that the relationship was not merely one of a contract terminable at will. It created a reasonable expectation that each carrier owned a business that could be conveyed and sold in the knowledge based upon over ninety years of history that the carrier's business would continue so long as the company's business continued and so long as the individual carrier performed his part of the bargain." *Id.* at 402.

b. Fraud and Breach of Fiduciary Duty

(i) Most courts have refused to apply fiduciary duty construction in franchise relationships.

(ii) *Arnott v. American Oil Co.,* 609 F.2d 873 (8th Cir. 1979) (where franchisor Amoco Oil made material misrepresentations to franchisee Arnott, and franchisee relied on such misrepresentations to his detriment, the court held that franchisor had "breached its 'fiduciary' duty of good faith and fair dealing . . . in terminating its . . . agreement with [franchisee] without good cause."). *Id.* at 884. Franchisor's duty of good faith and fair dealing was limited later in *Bain v. Champlin Petroleum,* 692 F.2d 43 (8th Cir. 1982), in which the court held that:

> In *every* contract there is an implied covenant of good faith and fair dealing on the part of *both* parties . . . . However, although the existence of trust and confidence in another is inherent in all fiduciary relationships, its mere presence does not suffice to automatically make either party to a business relationship such as here present a fiduciary in every aspect of that relationship.

Id. at 47 (emphasis in original).

The court further held that "Arnott does not stand for the proposition that the grant of a franchise of itself in all instances imposes on the franchisor all of the duties and responsibilities which traditionally pertain to a true fiduciary." *Id.* at 48.

(iii) A federal court in Wisconsin, rejected the notion that a fiduciary duty automatically arises from a franchise relationship. *See Amoco Oil Co. v. Cardinal Oil,* 535 F. Supp. 661 (E.D. Wis. 1982).

> [The court rejects] the contention that [a franchisor/franchisee] relationship, in itself, gives rise to fiduciary obligations. It is the law of this state that every contract imposes upon the parties thereto duties of good faith and fair dealing . . . . That this duty also inheres as a matter of statutory law in a franchisor/franchisee relationship does not . . . make that relationship a fiduciary one.

Id. at 666.

(iv) *Walker v. U-Haul Co. of Miss.*, 747 F.2d 1011 (5th Cir. 1984), upheld grant of summary judgment dismissing plaintiff's antitrust and franchise claims, but remanded for trial on fraud and breach of fiduciary duty claims. The franchise was located on company-owned property; franchisee understood that rental would increase only commensurate with increase in his sales. U-Haul increased rent six-fold; plaintiff refused to pay and U-Haul ordered him to vacate. The antitrust case was dismissed for lack of market impact.

(a) Elimination of agent is not an antitrust violation; no anticompetitive effect on marketing.

(b) Franchise statute applicable; proper termination notice given. *See also Walker v. U-Haul Co. of Miss.*, 734 F.2d 1068, 1076 (5th Cir. 1984) (court held a fiduciary duty between a franchisor and franchisee is a question of fact for the jury, and Walker had "offered ample evidence to warrant submitting the question to a jury"), *aff'd on reh'g*, 747 F.2d 1011 (5th Cir. 1984).

3. Breach of Contract/Contract Causes of Action

a. Breach of Express or Implied Terms

b. Implied Covenant of Good Faith Dealing

(i) Courts have adopted notion of implied covenant of good faith.

(a) Uniform Franchise and Business Opportunities Act, § 201, 7A U.L.A. 101 (1987) (duty of good faith accompanies every franchise relationship).

(b) In, *Ciampi v. Red Carpet Corp.*, 167 Cal. App. 3d 336; 213 Cal. Rptr. 388 (1985) the California Court of Appeals found that franchisor's breach of the implied covenant could subject the franchisor to tort, as well as contract liability.

(ii) However, the courts, by recognizing a good faith requirement, were not willing to override explicit contractual terms. In *Grand Light & Supply Inc. v. Honeywell*, 771 F.2d 672 (2d Cir. 1985), the Second Circuit refused to permit good faith provisions of U.C.C. § 1-203 to override a 30-day termination provision. "[W]here the contract expressly provides for termination on thirty days notice, no good faith requirement should be implied to override the contractual provi-

sions. Therefore, the termination was proper within the terms of the contract." *Id.* at 679.

c. Implied prohibition against terminations without reasonable cause if contract is silent: Where the contract is silent on whether cause is required, courts will imply a duty to terminate only upon good cause, relying on public policy which favors voiding grossly unfair contractual provision especially where there is disproportionate bargaining power. *See Shell Oil v. Marinello*, 63 N.J. 402, 307 A.2d 598 (1973) (oil company couldn't unilaterally terminate except for good cause), *cert. denied*, 415 U.S. 920 (1974). But note: Most courts have refused to imply good cause if contract specifies that termination can occur *without* cause.

d. Unconscionability of Contract of Adhesion

e. Breach of Duty of Good Faith

f. Misrepresentation

(i) Fraud or Misrepresentation. Under common law principles, damages may be recoverable for fraud or misrepresentation. Fraud is present when:

(a) a party falsely represents a past or present material fact or actively conceals such a fact;
(b) the misrepresenting party either knew the statement was false or disregarded its truth or falsity;
(c) the misrepresenting party intended that the misrepresentation be relied upon;
(d) that misrepresentation caused the party relying on it to act;
(e) such reliance was justified;
(f) the party relying was damaged as a result of that reliance.

(ii) Although fraud is typically claimed as an inducement to execute the agreement, fraudulent claims may arise during the course of the performance of the agreement, such as representations that the supplier will buy back the franchisee's inventory if the franchisee is terminated or that it will refund the franchisee's investment when in fact it has no intention of doing either.

(iii) Fraud may also be present in promissory statements relating to future events if the conditions listed above are present, and

(a) the party making the statement had an actual

fraudulent intent to deceive the other party, and
(b) there was reasonable reliance on the promise.

(iv) Negligent Misrepresentation

A cause of action for negligent misrepresentation exists if the elements of general negligence are established, i.e. that the franchisor grossly breached his duty of care to the franchisee in making the statement and reasonably could assume that these statements would be relied upon.

g. Equitable Theories, e.g., Reformation, Rescission, Return of Investment

4. Tort Claims

a. Negligent Misrepresentation as a Result of a Gross Breach of Duty of Care

- duty of care
- breach
- causation
- damage

b. Tortious Interference with Advantageous Business Relations

5. Federal and State Securities Laws

a. Franchise agreements may be regarded as investment contracts and consequently be subject to securities laws. An investment contract is an agreement which one invests money in a common enterprise with the profits to come solely from the efforts of others. *See SEC v. W.J. Howey Co.*, 328 U.S. 293, 298 (1946). Some courts have expanded "solely" to include those enterprises whose profits come predominantly, but not exclusively from the efforts of others. *See SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974).

(i) Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1982).
(ii) Section 2(1) of the 1933 Act, 15 U.S.C. § 77b(1) (1982).
(iii) Securities Exchange Act of 1934, 15 U.S.C. § 78a-78kk (1982).
(iv) Section 3(a)(10) of the 1934 Acts, 15 U.S.C. § 78c(a)(10) (1982).
(v) State Securities Acts

(a) N.Y. Gen. Bus. Law §§ 352-359h (McKinney 1968).

b. There are two theories under which the franchisor/franchisee relationship may come into the purview of security regulation.

(i) *Passive Investment Theory.* Franchisor exercises a substantial degree of control over franchisees, whereby the franchisees are mere passive investors expecting profits to be derived solely from the efforts of the franchisor. Thus, the franchise may be deemed an "investment contract" or "security." *Contra Mr. Steak, Inc. v. River City Steak, Inc.*, 324 F. Supp. 640, 644-45 (D. Colo. 1970), (franchisee is an informed investor whose skill and ingenuity will play a significant role in the success or failure of the venture, the contracts by which the relationship was created will not be deemed a security) *modified*, 460 F.2d 666 (10th Cir. 1972); Williamson v. Tucker, 632 F.2d 579, 594 (7th Cir. 1985) (recognizing the existence of the passive investment theory but noting the uniform rejection of this theory by a number of courts).

(ii) *Risk Capital Theory.* If a franchise is undercapitalized, "exceptionally high risk" and speculative, it may be deemed a "security" under the securities laws. *See id.* at 646-47.

6. Trade Laws

a. Section 1 of the Sherman Act, 15 U.S.C. § 1 (1982).

(i) a franchise agreement that unreasonably restrains trade may give rise to liability under this section. *See, e.g., Monsanto Co. v. Spray-Rite Service Corp.*, 465 U.S. 752 (1984).

b. Section 3 of the Clayton Act, 15 U.S.C. § 14 (1982)

(i) Tying, exclusive dealing arrangements, total-requirement. Obligations all may be violative of this section. *See, e.g., Siegel v. Chicken Delight Inc.*, 448 F.2d 43 (9th Cir. 1971), *cert. denied*, 405 U.S. 955 (1972).

c. Federal Trade Commission Act, 15 U.S.C. § 45 (1982)

(i) prohibits anti-competitive conduct by franchisors.

C. Choice of Forum

1. The question of forum encompasses not only where the litigation can occur but also where you want it to occur. Issues that should be considered include:

a. Convenience of parties, witnesses, and documents;

b. Rules of Discovery:

(i) Federal Court:

(a) In federal court, it is easier to take non-party discovery of out-of-state witnesses;
(b) FED. R. CIV. P. 37 makes sanctions for discovery abuses more readily available. *See* FED. R. CIV. P. 37(a) (4), which states that the court shall make the party against whom the motion to compel is made pay reasonable expenses incurred in obtaining the order compelling discovery, including attorney's fees;

(ii) State Court:

(a) In state court, discovery demands must be much more specific but may
(b) permit interlocutory appeal of discovery rulings which will cause delay and
(c) motions to dismiss and for summary judgment stays all discovery.

c. Evidence Rules:

(i) Federal court is more apt to actually follow the federal rules.
(ii) State court anomalies—Brooklyn rule.

d. Judges' expertise, experience, and independence

(i) Local partiality, home court advantage,
(ii) potential for favorable or unfavorable bias toward certain claims or parties should also be considered.

e. When considering speed of adjudication,

(i) case docket,
(ii) individual assignment versus master calendar system and
(iii) pretrial conferences, scheduling and management must be taken into account. *See* FED. R. CIV. P. 16, which states:

> In any action, the court may in its discretion direct the attorneys . . . to appear before it for a conference or conferences before trial for such purpose as (1) expediting the disposition of the action; (2) establishing early and continuing control so that the case will not be pro-

tracted because of lack of management; (3) discouraging wasteful pretrial activities; (4) improving the quality of the trial through more thorough preparation; and, (5) facilitating the settlement of the case.

f. Availability of a desired remedy

(i) In state court, parties can obtain an ex parte injunction more easily than in federal court where a Temporary Restraining Order or a Preliminary Injunction requires notice and a hearing.
(ii) In federal court, federal antitrust claims have exclusive jurisdiction.

g. Cost of adjudication is not a strategic consideration but should be determined.

(i) Court v. arbitration

h. Whether the trial will be heard by a jury is a strategic consideration.

(i) Composition of the jury
(ii) Size of the jury
(iii) Unanimity rules

(a) State—6 jurors; 6-1 verdict
(b) Federal—usually 12 jurors; unanimous—but FED. R. CIV. P. 48 allows stipulation to fewer than 12 and less than unanimous

i. Trial Procedure
(i) Voir Dire

(a) State court—counsel conducts
(b) Federal court—judge conducts

(ii) Closing Arguments

(a) State court—defendant, then plaintiff
(b) Federal court—plaintiff, then defendant, then plaintiff

(iii) *See* FED. R. CIV. P. 52: "In all actions tried upon the facts without a jury or with an advisory jury, the court shall find the facts specially and state separately its conclusions of law thereon . . . . "
(iv) Special verdicts in federal court. *See* FED. R. CIV. P. 49(a): "The court may require a jury to return only a special verdict in the form of a special written finding upon each issue of fact."

(v) General verdict and written interrogatories

j. Availability of FED R. CIV. P. 11, which allows sanctions to help prevent frivolous pleadings and defenses:The signature of an attorney or party constitutes a certificate by the signer that the signer has read the pleading, motion, or other paper; that to the best of the signer's knowledge, information, and belief formed after reasonable inquiry it is well grounded in fact and is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law, and that it is not interposed for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation.

k. Search for the forum with the most favorable interpretation of substantive law.

l. Absent exceptional circumstances, contractual forum selection clauses are likely to be enforced. In the recent case of *Stewart Org., Inc. v. Ricoh Corp.*, 810 F.2d 1066, 1067 (11th Cir.), *cert. granted*, 108 S. Ct. 225 (1987), the court considered the specific issue of whether "a freely negotiated contractual 'choice of forum clause' is enforceable in diversity actions in federal court when the forum state considers such clauses to be violative of state public policy" and upheld the forum selection clause which it found to be fairly bargained for, not seriously inconvenient, and not contrary to public policy.

m. Points to bear in mind in seeking federal diversity jurisdiction include:

(i) The frequency of dual citizenship or corporate parties as citizens of their state of incorporation and of the state of their "*principal* place of business." *See* 28 U.S.C. § 1132(c) (1982) (emphasis added).
(ii) In diversity class actions the court looks only to the citizenship of the named representative parties in determining the citizenship of the class.
(iii) In a class action, class members cannot aggregate their claims to satisfy the jurisdictional amount requirements; rather, each and every class member must be able to satisfy the requirement independently.

n. Arbitration

A termination claim may be subject to arbitration pur-

suant to a contractual arbitration clause. *See Sea-Land Service, Inc. v. Sea-Land of Puerto Rico, Inc.*, 636 F. Supp. 750 (D.P.R. 1986) (parties must submit to out-of-state arbitration despite a state franchise act provision nullifying agreements for out-of-state arbitration—the state provision was preempted by the Federal Arbitration Act).

Alternatively, the parties may consent to arbitration absent such a clause. In either eventuality, the arbitrator will have injunction authority unless this is specifically precluded.

The Supreme Court mandated the enforcement of arbitration agreements in *Southland Corp. v. Keating*, 465 U.S. 1 (1984) ("[i]n enacting § 2 of the federal Act, [United States Arbitration Act] Congress declared a national policy favoring arbitration and withdrew the power of the states to require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitration"). The Court held that the United States Arbtitration Act preempted a state franchise law which made franchise issues subject to judicial resolution. The Court noted the *national policy favoring arbitration* and consequently invalidated the state law attempt to preclude compulsory arbitration.

(i) Pro Arbitration:

- Faster resolution
- Informal and inflexible proceedings
- Private
- Little or no motion practice
- No rules of evidence
- Fact rather than law oriented
- Technical expertise of arbitrator

(ii) Con Arbitration:

- Too informal—complaint usually vague and lacks sufficient detail to frame issues; conduct of hearing lacks formal objections
- Lack of discovery without consent
- Power of arbitrator limited—arbitrator cannot impose punitive damages or sanctions for abuse
- Finding impartial arbitrators is difficult
- The case is less likely to be settled
- Ad hoc disregard for legal precedent

- Arbitrators are not always lawyers
- Enforcement of the award is cumbersome, since the findings are vague
- Overturning arbitrators' awards is difficult because they find both fact and law and mere error is not enough; one needs to show misconduct or that the arbitrator exceeded authority

D. Choice of Law Issues

1. In seeking to enforce a choice of law clause in a franchise agreement, counsel should determine whether the franchise statute of the chosen jurisdiction will apply to dealers outside that jurisdiction.

a. In *Bimel-Walroth Co. v. Raytheon Co.*, 796 F.2d 840 (6th Cir. 1986), the plaintiff sued under the Wisconsin Fair Dealership Law (WFDL) which mandated a ninety-day notice of termination as opposed to the ten-day notice provision present in the franchise agreement. The Court held the law of Wisconsin, the chosen jurisdiction, applied in general to the litigation, but that WFDL only applied to dealers geographically situated in Wisconsin, and thus, the ninety-day notice provision did not extend to out-of-state dealers.

b. In *Winer Motors, Inc. v. Jaguar, Rover, Triumph, Inc.*, 208 N.J. Super. 666, 506 A.2d 817 (App. Div. 1986), the parties' contractual choice of New Jersey law was applied generally, but the court held the New Jersey Franchise Practices Act did not govern the transaction, since plaintiff's business was in Connecticut. This was necessary "to preserve the fundamental public policy of the franchisee's home state where its statutes afford greater protection." *Id.* at 672, 506 A.2d at 821.

2. Counsel should bear in mind that choice of law determinations may vary depending on the nature of the legal action. Thus in *Glaesner v. Beck/Arnley Corp.*, 790 F.2d 384, 386 & n.1 (4th Cir. 1986), a contractual choice of law provision specifying New York law was held inapplicable to the terminated dealer's tort claim for wrongful termination. The federal court, in following the law of the forum state of South Carolina, decided that since the plaintiff alleged liability in tort rather than contract for injuries sustained in South Carolina, that state's law applied because a tort action arises where the injury or wrongdoing occurs.

E. What Remedies Are Available?

1. Injunctive relief is governed by FED. R. CIV. P. 65.

a. FED. R. CIV. P. 65(b) establishes the requirements for granting of temporary restraining order (TRO). Notice is not required if there is a stringent affidavit showing why notice could not be given, and an affidavit showing why irreparable harm will occur if the TRO is not issued. The order lasts ten days. Furthermore, a security bond in amount set by court must be posted.

b. FED. R. CIV. P. 65(a) governs the issuance of a preliminary injunction.

(i) Notice must be given

(ii) Consolidation of hearing with trial.
Note: Evidence at preliminary injunction, even if not consolidated, treated as if at trial and will not be repeated.

(iii) Probability of success on the merits:
Standard—irreparable harm and either (a) likelihood of success on merits or (b) sufficiently serious questions going to the merits to make them a fair ground for litigation and balance of hardships tips decidedly in plaintiff's favor. *See Sadowsky v. City of New York* 578 F. Supp. 1577 (S.D.N.Y. 1984), *aff'd,* 732 F.2d 312 (2nd Cir. 1984) (motion for preliminary injunction against application of local law restricting conversion of single room occupancy dwelling to more profitable residential uses denied to property owner. Local law was a valid exercise of police power and did not effect an unconstitutional taking).

(iv) Security Bond:
Dealers will often seek to enjoin a termination. Often the equities relevant to issuance of a preliminary injunction will favor the dealer. Thus, the trial court's grant of a preliminary injunction pending trial on the merits was upheld by the Minnesota Court of Appeals in *Lano Equip., Inc. v. Clark Equip. Co., Inc.,* 399 N.W.2d 694 (Minn. Ct. App. 1987) (held proper for manufacturer to be temporarily enjoined from interfering with, altering, or terminating dealership after dealer refused to sign annual dealer sales agreement that imposed, for the first time, restrictions on dealer's sales territory). The court cited the long satisfactory duration of the dealership prior to the supplier's attempted

termination; the imbalance of potential harm to the parties; and a likelihood of dealer's success on the merits.

2. *Declaratory Judgment*—FED. R. CIV. P. 57 (procedure for obtaining a declaratory judgment pursuant to 28 U.S.C. § 2201). Uniform Declaratory Judgment Act, 28 U.S.C. § 2201, states that in case of actual controversy within its jurisdiction, except in specified situations, any U.S. court may render a declaratory judgment, regardless of whether further relief will be sought.

a. Appropriate under Uniform Declaratory Judgment Act when proceeding will "terminate the controversy." Cannot be an advisory opinion—must be a real justiciable controversy. While the court will broadly construe the availability of declaratory relief, a pre-termination action may be considered too hypothetical to be justiciable. The supplier may request a determination of the rights and duties of the parties on termination.

(i) In *Aida Eng'g, Inc. v. Red Stag, Inc.*, 629 F. Supp. 1121 (E.D. Wisc. 1986), the supplier requested a declaratory ruling to determine whether the defendant dealer was a "dealer" within the meaning of the Wisconsin Fair Dealership Law, a franchise statute, and whether the supplier could terminate the relationship without first complying with the law. The court ruled in favor of the supplier on both requests without discussing any possible issues of prematurity.

(ii) In *McDonald's Corp. v. Robert A. Makin, Inc.*, 653 F. Supp. 401 (W.D.N.Y. 1986), 1986-2 Trade Cas. (CCH) ¶ 67,373, the court awarded summary declaratory judgment to a supplier, ruling that the dealer's section 1 counterclaims were not relevant to the dealer's liability for termination on grounds of non-payment of fees. Absent an affirmative defense excusing a franchisee's failure to pay, a franchisor had a contractual right to terminate the franchise agreement and recover damages if franchisee refused to meet its contractual obligations while enjoying all of the agreement's benefits.

b. Matter usually involves discrete issue of law or undisputed facts

c. Summary proceeding of justiciable controversy

d. Expedited trial and jury available

e. Tactics:

(i) Excellent vehicle for summary proceeding on expedited basis to get quick declaration of rights
(ii) No bond need be posted
(iii) Avoid lengthy litigation with time consuming and expensive discovery
(iv) Association can bring on behalf of members

3. Damages

a. Compensatory damage awards are based on numerous factors, including:

(i) Lost profits;
(ii) Loss of goodwill;
(iii) Reduction in business receipts;
(iv) Loss of nationally advertised franchise;
(v) Destruction of business;
(vi) Impairment or loss of capital investment;
(vii) Loss of advertising or circulation revenues; and
(viii) Decline in sales volume and market share.

Counsel should consider what effect the loss of the supplier's line may have on other aspects of the dealer's business. The dealer's ability to obtain substitutable product lines after termination is an important consideration. Finally, counsel should determine the dealer's investment in assets which cannot be used in the marketing of other products.

b. Punitive damages are available where conduct engaged in is fraudulent or unconscionable. *See Contractor Util. Sales Co. v. Certain-Teed Corp.*, 748 F.2d 1151 (7th Cir. 1984), Bus. Franchise Guide (CCH) ¶ 8302 (agent was entitled to $3,000,000 in punitive damages where evidence sustained finding of fraud in the execution of contract between the parties), *cert. denied,* 470 U.S. 1029 (1985).

c. Recission—If recission is granted, the franchisee may be entitled to:
(i) value of initial fees
(ii) royalties paid
(iii) cost of removing signs displaying franchisor's name
(iv) return of money paid to franchisor for goods and services returned
(v) disbursements
(vi) attorney's fees

(vii) pre-judgment interest

F. Litigation and Trial Tactical Considerations

1. Complaint: Avoid the tendency to throw in every conceivable claim—as a plaintiff, be more surgical and target defendant's weakest point.

a. Is there an antitrust claim? If there is no real basis for alleging antitrust conspiracy *or* if defendant has insignificant market share in a competitive industry, do not plead the antitrust claim—it opens you up to a motion to dismiss, potential discovery problems and expensive economic analysis. If there is serious question concerning the anticompetitive nature of defendant's conduct,

(i) your complaint should allege the specific geographic and product markets adversely affected by the supplier's conduct;

(ii) that the franchisor's conduct has no efficiency-enhancing characteristics and in fact results in:

- increased price
- decreased quality
- decreased output
- decreased innovation
- decreased production efficiency
- increased transaction costs
- decreased distributor efficiency
- a negative impact on both intrabrand and interbrand competition.

b. Allege that the franchisee is covered by statute and cannot be terminated without cause—burden of proof on franchisor to show cause.

c. Allege the full range of common law rights:

- estoppel
- fraud
- breach of fiduciary duty
- implied convenant of good faith.

This will give a court the hooks on which to hang a judgment for plaintiff based on the equities.

2. Injunction or not?

a. Pro

- fast hearing

- expedited discovery
- less expensive

.b. Con

- may require discovery to develop case
- standard of irreparability is tough
- must post a bond
- if you are not granted the injunction, you give the other side confidence and have telegraphed your best case

3. Investigate whether any cases against defendant exist and get discovery from plaintiff's counsel. Possible offensive collateral estoppel if identical issues litigated and determined finally.

4. Declaratory Judgment

a. good approach.

b. quick-defendant doesn't have time to create elaborate efficiency-enhancing arguments.

c. focuses on key issue of whether the plaintiff is a franchise and whether good cause exists for termination.

d. may prevent the plaintiff from being subject to potentially troubling activities—especially where the purported reason for termination is supplier's desire to change total distribution system.

5. Jury or Not

a. Pro:

- more compassionate and likely to award punitive damages
- judge will preclude defendant from introducing extraneous material about plaintiff
- has interim effect on franchisor and may stimulate settlement

b. Con:

- client many *not* be a good witness and/or has engaged in questionable conduct
- if plaintiff's evidence will have problem getting admitted may have better chance if no jury

IV. Guidance Concerning Conduct

Counsel should, whenever possible, provide the client with detailed guidance concerning the appropriate manner in which to conduct itself in the dealer relationship and in its termination so as to minimize potential legal exposure. The points outlined below should be addressed.

A. Franchisor's Perspective

1. Franchisor should formulate and adhere to standards for inspecting franchises, completing inspection reports, communicating (in writing) deficiencies to a franchisee, giving assistance to the franchisee, and conducting follow-up inspections.

2. All events of default by a franchisee should be properly documented.

3. Even if not required by the franchise agreement, sufficient prior notice of termination is advisable to comply with implied good faith standards.

4. Ensure that termination policy is uniformly enforced. This will help negate franchisee's argument that termination was a consequence of its failure to adhere to franchisor's pricing demands or was a result of conspiracy between the franchisor and the terminated dealers' competitors.

5. Where a franchisee has made a substantial investment in the franchise, it may be advisable to afford a reasonable opportunity to sell the business to an acceptable successor franchisee, thereby allowing the new franchisee to realize the unamortized value (and any appreciation) of the assets and any residual good will of the business.

6. Do not make a policy of soliciting franchisees' views regarding the performance of other franchisees.

7. Consider seeking a declaratory judgment in a friendly forum regarding the lawfulness of a proposed course of action, *e.g.* forward integration.

8. Always give at least 60-days' notice of termination.

9. Offer to purchase franchisee's current inventory.

10. The franchisor should not solicit views of other franchisees as to propriety of appointing new franchise or of terminating an existing franchisee.

11. Specify in distribution agreement that it is not a franchise

and not covered by state statutes.

12. Specify all money paid is for goods and services rendered and not for a franchise fee.

13. Always state that termination may occur *without cause.*

14. Include in the agreement:

   a. an arbitration clause;

   b. venue; and

   c. choice of law.

15. Strictly enforce contracts.

16. Terminate if grounds exist. If you continue franchisee, get written statement that grounds do exist but continuation of franchise is pursuant to settlement.

17. Do not expressly or impliedly permit franchisee to create property interest in franchise.

18. Always prepare memo outlining efficiency-enhancing effects of proposed change in distribution system (have independent economic experts involved), i.e. lower prices, greater efficiency, innovation, and more responsive service.

19. In any litigation get a protective order precluding use of discovery for any purposes or disclosure to anyone not a party to the litigation.

B. Franchisee's Perspective

1. The franchisee should maintain thorough documentation to demonstrate compliance with agreement and to show its damages in the event of termination. Retention of documents should include:

   a. copies of inspection reports

   b. notes of discussion with franchisor representatives

   c. evidence of corrective action taken

   d. all other documentation relevant to asserted defaults and other possible motives for termination.

The importance of creating a record is shown by *Wesley v. Mobil Oil Corp.*, 513 F. Supp. 227 (E.D.P.A. 1981). In violation of an express provision of his dealership agreement, a gasoline dealer closed his station for a period of more than seven days to take a vacation. Both sides admitted that the conduct had

occurred, that it was material to the agreement, and that the agreement specifically prohibited closing the station for more than sixty consecutive hours. Good cause, however, was found lacking because upon hearing of the dealer's plan to close the station, the oil company representative said, "Do what you want. What can I say?" *Id.* at 229. Also, just before the closing, the representative said, "Have a good vacation." *Id.* at 229. Thus, the oil company was said to have affirmatively misled the dealer into believing it would waive its rights to terminate and the dealer was entitled to a preliminary injunction to temporarily preserve the status quo.

2. If a franchisee believes that termination or non-renewal is imminent and that such action by the franchisor is lawful, the franchisee might affirmatively seek the franchisor's permission to sell the franchise to an acceptable successor franchisee.

3. Create estoppel or waiver arguments.

   a. During initial startup when relationship is good and mutual need exists, ask to secure loan from bank with franchise as collateral and other things to create proprietary and not just contractual right.

4. Create *Franchisees Definition Arguments,* i.e. dependence and control.

5. Pay $500 to claim *franchise fee.* Pay in form of a check, specifically identified, or increase payment above bona fide wholesale price.

V. Conclusion

In large measure the growing reliance upon state franchise statutes by terminated dealers has been a response to the inhospitable treatment dealers' antitrust claims have received from the federal judiciary after the onset of the antitrust revolution, which began in the mid-1970s and continues today.

This revolution, many argue, has improperly elevated an antitrust philosophy almost entirely concerned with promoting economic efficiency to a preeminent position without due regard to the injury and dislocations which may be caused to individual terminated dealers.

However, history teaches us that the period of excess created by any revolution is corrected and reduced by the inevitable backlash movement that the revolution spawns. All signs currently point to the growing existence of a powerful backlash movement designed to offset the perceived advances of the efficiency-directed Antitrust Division of the Department of Justice, the Federal Trade Commission, and federal

judiciary. The Congress' repudiation of the Department of Justice's vertical guidelines and the National Association of Attorney Generals' creation of their counter-guidelines all suggest that the upcoming year will be one filled with continuing antitrust skirmishes.

Only time will tell which side, if any, will ultimately prevail, but one thing is certain: the upcoming year will be filled with potential danger for those who conduct themselves believing antitrust enforcement is dead—for if anything is clear, it is that businesses adversely affected by the actions of their suppliers will adapt to the new "efficiency-directed" environment by making the appropriate economic arguments and by relying more on the availability of state franchise statutes and common law theories of liability.