Battle over the Franchisor Business Judgment Rule and the Path to Peace

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I. Introduction

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In successful franchise systems, both the franchisor and the franchisees obsess over the franchisees' bottom line. Healthy franchise systems also see the franchisor properly balancing its own interests with the interests of the franchisees and the system as a whole. The franchisor's role in growing, evolving, and protecting the brand and system is key to this balancing act. If the franchisor fulfills its role, the franchise system is better able to compete effectively against competition, including other franchise systems and non-franchise businesses. But when courts are forced to evaluate the decisions the franchisor makes in attempting this balance, the question becomes by what standard should a franchisor's decisions be judged?

In many instances, the implied covenant of good faith and fair dealing is used as the yardstick, particularly in cases where the dispute involves a franchisor's discretionary decision. However, in recent years, many franchisors have started incorporating the business judgment rule into their franchise agreements. From the franchisee's perspective, franchisors are using the business judgment rule as a "substitute" for the implied covenant. From the franchisor's perspective, the business judgment rule is a standard for resolving whether a franchisor has acted reasonably and in good faith. This article sets out to explore whether the implied covenant, the business judgment rule, or some other standard is appropriate when the issue of franchisor discretion arises. The reader will find that while our analysis and preliminary conclusions, written from the

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point of view of both experienced franchisor and franchisee counsel, are polar opposites, our final conclusions are remarkably similar.

The franchise agreement is the key document that outlines the roles and responsibilities of the franchisor and franchisee. It also shapes how the franchise system responds to changes in the business environment and other competitive threats. No franchise system will be sustainable without effectively responding to customers' ever-changing demands. In order to effectively implement change and maintain sustainability in the hearts, minds, and pocketbooks of customers, a franchisor must (1) focus on customer-centric initiatives and the bottom line of its franchisees; (2) instill in its franchisees an undying devotion to the brand so they have the same customer-centric focus; (3) empower its franchisees through collaboration on key strategic and customer-centric initiatives; and (4) create a strong franchise agreement that allows it to fulfill its role and responsibility to grow, protect, and evolve the franchise system and brand.

An important check on the misuse of authority in the franchise relationship has typically been the covenant of good faith and fair dealing. More specifically, within this context of system change or any other decision a franchisor makes, when a franchisee disagrees with the franchisor, the franchisee often raises a good faith and fair dealing claim. Good faith and fair dealing generally require that when a contract grants discretion to one party, that party is required to exercise that discretion in a fair and reasonable manner, consistent with the reasonable expectations of the parties.[1]

In recent years, however, franchisors have sought to replace or frame the good faith and fair dealing discretionary standard with a corporate law doctrine: the business judgment rule.[2] By contractually replacing or defining good faith and fair dealing with the business judgment rule, a franchisor may exercise its discretion on the basis of its "reasonable business judgment." Often, "reasonable business judgment" provisions also explicitly state that the franchisor meets the standard, even if other reasonable or arguably preferable alternatives are available, if the decision or action is intended to promote or benefit the system generally, even if it also promotes the franchisor's financial or other individual interests.

Here is a typical business judgment rule provision that may be incorporated into a franchise agreement:

> *Our Reasonable Business Judgment*. Whenever we reserve discretion in a particular area or where we agree to exercise our rights reasonably or in good faith, we will satisfy our obligations whenever we exercise reasonable business judgment in making our decision or exercising our rights. Our decisions or actions will be deemed to be the result of reasonable business

1. Restatement (Second) of Contracts § 205 (1981).
2. The authors note that within the last few years a significant majority of the franchise agreements drafted by franchisor counsel or reviewed by franchisee counsel include some form of the business judgment rule.

judgment, even if other reasonable or even arguably preferable alternatives are available, if our decision or action is intended, in whole or significant part, to promote or benefit the franchise system generally, even if the decision or action also promotes our financial or other individual interest. Examples of items that will promote or benefit the franchise system include, without limitation, enhancing the value of the trademarks, improving customer service and satisfaction, improving product quality, improving uniformity, enhancing or encouraging modernization, and improving the competitive position of the franchise system.

The introduction of the "reasonable business judgment" standard of discretion into the franchise arena significantly impacts the franchisor/franchisee relationship. While franchisors have already introduced the "reasonable business judgment" standard into franchise agreements and discussion on the subject began over a decade ago,[3] there is a notable dearth of case law discussing this particular standard of discretion in the franchise context.[4]

In light of the lack of case law on the subject and the seemingly increased use of the business judgment rule in franchise agreements, this article will provide perspective, from the standpoints of both franchisor and franchisee, on the appropriateness of the business judgment rule as a discretionary standard for franchisors as compared to the application of the covenant of good faith and fair dealing. This article begins with a discussion of the development of the business judgment rule and proceeds to discuss the franchisor and the franchisee's perspective as to its application in the franchise context. Finally, this article concludes with the authors' shared conclusions that aim to benefit franchisors and franchisees alike.

II. History of the Business Judgment Rule

"Business judgment" is a legal term of art in corporate law, describing the standard of review used in analyzing the decisions of corporate directors; it has been the subject of the influential Delaware Supreme Court's more notable decisions.[5] Although the business judgment rule dates back to the

3. *See, e.g.*, Jeffrey C. Selman, *Applying the Business Judgment Rule to the Franchise Relationship*, 19 Franchise L.J. 111 (2000).

4. The lack of case law is likely attributable, at least in part, to the prevalence and uniform enforcement of private arbitration agreements and settlements. To date, *In re Sizzler Restaurants International, Inc.*, 225 B.R. 466, 474 (Bankr. C.D. Cal. 1998), is the most notable decision discussing the business judgment rule in the franchise context. *See infra* notes 50–53 and accompanying text for further discussion of the *Sizzler* decision.

5. *See, e.g.*, Smith v. Van Gorkum, 488 A.2d 858 (Del. 1985); Unocal v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

nineteenth century in American courts,[6] numerous commentators have criticized it as one of the least understood concepts in corporate law.[7]

The business judgment rule developed concurrently with the corporate director's duty of care, and, as such, the two are commonly discussed in concert.[8] The Legal Information Institute defines the corporate director's fiduciary duty of care as "the principle that directors and officers of a corporation, in making all decisions in their capacities as corporate fiduciaries, must act in the same manner as a reasonably prudent person in their position would."[9] The business judgment rule is a judicially created standard of review designed to protect the conduct of corporate directors. When facing personal liability for alleged violations of their duty of care, corporate directors assert the immunizing business judgment rule. Most commonly, courts cite three primary rationales for the business judgment rule: (1) limiting personal liability so as to encourage qualified directors to serve; (2) encouraging necessary risk in business decisions; and (3) recognizing that courts are ill-equipped to make business decisions.[10] The key distinction between the duty of care and the business judgment rule is that the duty of care defines conduct directors must aspire to, while the business judgment rule is an *ex ante* standard of review applied to director conduct.[11]

The business judgment rule and the fiduciary duty of care can be traced as far back as the eighteenth century. The 1742 English case of *Charitable Corp. v. Sutton* is frequently credited with the modern formulation of the duty of care and the business judgment rule.[12] In *Sutton*, the court recognized that while corporate directors are obligated to execute their duties with "fidelity and rea-

6. In his 1994 scholarly article, former Delaware Supreme Court Justice Henry R. Horsey aptly detailed early American jurisprudence of a director's duty of care and the business judgment rule. The information contained in this section is largely attributable to Justice Horsey's research and article. *See* Henry R. Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971, 973–76 (1994) (discussing the evolution of the duty of care as a common law principle of corporate law).

7. *See id.* at 995 (the business judgment rule "must be the least understood corporate law concept"); Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 270 (1967) (noting that the business judgment rule is "one of the least understood concepts in the entire corporate field").

8. MODEL BUS. CORP. ACT § 8.30 cmt. at 8-163 (3d ed. 2005 Supp.) ("The elements of the business judgment rule and the circumstances for its application are continuing to be developed by the courts.").

9. *Duty of Care*, Legal Info. Inst., Cornell Univ. (last visited Feb. 16, 2015).

10. Douglas M. Branson, *The Rule That Isn't a Rule—The Business Judgment Rule*, 36 VAL. U. L. REV. 631, 634–35 (2002).

11. Fred W. Triem, *Judicial Schizophrenia in Corporate Law: Confusing the Standard of Care with the Business Judgment Rule*, 24 ALASKA L. REV. 23, 29 (distinguishing the director's standard of care and the business judgment rule).

12. *See* Fisher v. Parr, 48 A. 621, 623 (Md. 1901) (stating that *Charitable Corp. v. Sutton* announced the general principles of the duty of care and noting a previous decision of the court that stated *Sutton* was the "first fully and accurately defined" description of the "liability of directors to corporations for breaches of duty amounting to breaches of trust"); Horsey, *supra* note 6, at 973–75 (noting that *Sutton* has been characterized as a "remarkably modern formulation" of the duty of care and that it may also be the "father" of the business judgment rule in American jurisprudence).

sonable diligence," they must not be punished for mere errors in judgment.[13] By the nineteenth century, both doctrines made their way to the United States.[14] While these doctrines were initially limited to directors of banks and financial institutions, the Supreme Court eventually expanded the fiduciary duty of care to all corporate directors by analogy.[15]

The 1968 decision in *Shlensky v. Wrigley* illustrates the deferential business judgment rule in practice.[16] The shareholders of the Chicago National Ball Club, Inc. (owner of Major League Baseball's Chicago Cubs) brought a stockholder derivative action against the directors of the corporation.[17] The shareholders sought an order to cause the installation of lights, consistent with all other Major League Baseball fields, at Wrigley Field, home to the Cubs, so that it could host evening baseball games, as well as damages for decreased revenue for its failure to host evening baseball games.[18] The shareholders alleged that the defendants' decision to not host evening baseball games was arbitrary, not motivated by good faith, or in the best interest of the corporation, but rather due to 80 percent owner and member of the board Philip K. Wrigley's personal belief that "baseball is a daytime sport."[19] Despite seemingly convincing evidence in favor of the plaintiffs as to the financial benefits of hosting evening games and admitting that the board's decision may have been incorrect, the court refused to second-guess the board's reasoning—that evening games could lead to the deterioration of the neighborhood surrounding Wrigley Field.[20] The court was extremely deferential, noting that the decision was not "beyond [the Board's] jurisdiction and ability" and that the motives alleged in the complaint showed no "fraud, illegality, or conflict of interest in making that decision."[21]

By the 1980s, the business judgment rule had all but swallowed up the duty of care, protecting corporate decisions in almost every instance.[22] That is, until *Smith v. Van Gorkum*, in which the Delaware Supreme Court breathed some life back into the duty of care by scrutinizing the board's deliberative process while making business decisions.[23] In *Van Gorkum*, the court was called upon to review a board of director's decision

13. *See* Horsey, *supra* note 6, at 974.
14. One of the first articulations of the fiduciary duty of care and the business judgment rule arose out of the Supreme Court of Louisiana. Percy v. Millaudon, 8 Mart. (n.s.) 68, 77 (1829). *See also* Hodges v. New England Screw Co., 1 R.I. 312 (1850); Hun v. Cary, 82 N.Y. 65, 71 (1880).
15. Briggs v. Spaulding, 141 U.S. 132 (1891).
16. Shlensky v. Wrigley, 95 Ill. App. 2d 173 (1968).
17. *Id.* at 174.
18. *Id.* at 175.
19. *Id.* at 175–77.
20. *Id.* at 180–81.
21. *Id.* at 181.
22. Horsey, *supra* note 6, at 977 (discussing previous commentators' research and noting that "the business judgment rule had been applied in such a manner as to constitute an almost per se bar to shareholder claims of directors' breach of their fiduciary duty of care").
23. Smith v. Van Gorkum, 488 A.2d 858 (Del. 1985).

to merge with another company.[24] In making its decision, the court reaffirmed that beyond the "mere absence of bad faith and fraud . . . [the fiduciary duty of care] imposes on a director an affirmative duty . . . to proceed with a critical eye in assessing information. . . ."[25] In ruling that the business judgment rule required informed and deliberative decision making, the court borrowed from tort law and stated that the concept of gross negligence is the appropriate standard to determine whether a board's business judgment was an "informed" one.[26]

Incorporating *Van Gorkum*'s informed and deliberative process requirement, courts have articulated two similar versions of the business judgment rule. First, the American Law Institute promulgated this definition:

> A director or officer who makes a business judgment in good faith fulfills the [duty of care] if the director or officer:
>
> (1) is not interested in the subject of his business judgment;
>
> (2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and
>
> (3) rationally believes that the business judgment is in the best interests of the corporation.[27]

With just a slight variation, the Delaware Supreme Court has defined the business judgment rule as "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[28]

In theory, the fiduciary duty of care provides a meaningful standard of conduct for corporate directors. However, in practice, the business judgment rule has, for the most part, rendered the duty of care ineffectual.[29] Plaintiffs challenging the actions of the corporate board of directors bear the burden of proving that directors breached their fiduciary duties. Absent a showing that the director's decision was the product of improper motive, arbitrary, outright fraudulent, or constituted waste, the business judgment rule immunizes decisions that can be tied to any rational business purpose.[30]

Given this backdrop and the acknowledged reality that franchisors need some level of ability to adapt to a changing market over the course of time, the question presented, and reiterated from the introduction, is simple:

24. *Id.* at 866.
25. *Id.* at 872.
26. *Id.* at 873.
27. *Principles of Corporate Governance* § 401, Am. Law Inst. The American Law Institute definition has been adopted by multiple state supreme courts. *See, e.g.*, Seidman v. Clifton Sav. Bank, S.L.A., 14 A.3d 36, 53 (N.J. 2011); Omnibank of Mantee v. United S. Bank, 607 So. 2d 76, 85 (Miss. 1992).
28. *Van Gorkum*, 488 A.2d at 872 (citing Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984)).
29. Horsey, supra note 6, at 977.
30. *See* Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 STAN. L. REV. 927, 982 (1990).

by what standard should franchisor decisions be judged? Is the business judgment rule, the implied covenant of good faith and fair dealing, or some other standard, best suited for this task? Here, we attempt to answer these questions based on the divergent views of experienced franchisor and franchisee counsel.

III. The Franchisor's Perspective on the Business Judgment Rule in the Franchise Relationship

A. *A Franchisor's Effective Use of the Business Judgment Rule Enhances the Sustainability of the Franchise System*

As noted in the introduction, no franchise system will be sustainable if it does not effectively respond to the ever-changing demands of customers. In today's competitive business environment, change is constant and necessary and the failure to embrace it can easily lead to the demise of a franchise system. No franchisor or franchisee should believe otherwise.

Within this context of system change or any other decision a franchisor makes, when a franchisee disagrees with the franchisor it often raises a good faith and fair dealing claim that the franchisor has not acted reasonably or in good faith. The fundamental "real world" problem with good faith and fair dealing is that it means different things to different people, resulting in ambiguity and unpredictability as a franchisor and its franchisees make key decisions regarding their roles, interests, and opportunities as part of the franchise system.

While lawyers might tend to believe that due to the long-standing principle of the implied covenant of good faith and fair dealing, franchisors and franchisees should have a clear understanding of what the covenant means and how it applies in the franchise relationship, nothing could be further from the reality of how the dynamics play out in the real world. Far too often a franchisor makes a decision that it believes is in the best interests of the franchise system and fulfills its role, for example, in taking steps to respond to a competitive change in the marketplace, but an individual franchisee does not want to make the change or the change has some disparate impact on a single franchisee or small group of franchisees even though it is in the best interests of the franchise system as a whole.

Therein lies the fundamental problem with using traditional good faith and fair dealing as the standard by which to judge a franchisor's decisions and decision-making process. If a franchisee doesn't like the franchisor's decision (especially if the decision requires change—it's human nature to object to change and maintain the status quo) or the decision has any disparate impact on the franchisee's business, the franchisee claims a violation of the implied covenant of good faith and fair dealing. On the other hand, in responding to the competitive marketplace and the ever-changing demands of customers and balancing the need to look at the franchise system and franchisees as a whole, the franchisor believes it has acted reasonably and in good faith in implementing change. If this situation goes unresolved and lawyers get involved, it is often up to a judge or arbitrator to determine the fate of the dispute and often times the fate of a key component of the franchise system. As this situation unfolds, the franchisee and franchisor will ask their lawyers to predict how the case will be decided. The response is likely to be: "Well, that depends on who we get as a judge or arbitrator." There must be a better way.

In light of this constant tension or potential for tension on matters that are critical to the sustainability of a franchise system, some franchisors have incorporated into their franchise agreements "business judgment rule" language similar to the language included in Part I. Contrary to what franchisee lawyers claim, this language is not intended to give franchisors an absolute free reign on what they can do regardless of the impact on franchisees. Rather, the business judgment rule language provides a franchisor with a higher degree of certainty and confidence in executing its key role in balancing the interests of the franchisor, franchisees, and system as a whole than the second-guessing that often results under a good faith and fair dealing standard standing alone. In turn, the franchisor and franchisees will have a more complete understanding of and alignment on their respective roles and interests as stakeholders in the brand, especially in those franchise systems where franchisors implement the best practices that are described later in Part V of this article.

Is the business judgment rule perfect? Of course not. It does, however, allow a franchisor to fulfill its role in a manner that is far more effective and efficient than constantly battling disputes when franchisors and franchisees have divergent views over what constitutes good faith or fair dealing and having a court or arbitrator decide the fate of the franchise system. That approach with its overabundance of uncertainty hurts franchisors, franchisees, and franchising.

In this analysis of whether the business judgment rule is appropriate in franchising, it is important to understand that the business judgment rule is not a standard governing every decision a franchisor makes that may have an impact on one or more franchisees. It is a standard for resolving whether a franchisor has complied with the implied covenant of good faith and fair dealing. As such, it applies only where the franchisor does not have an absolute legal right to make a particular decision. If the franchise agreement gives the franchisor a right to make a particular decision, either specifically or by implication, exercise of that right is generally beyond legal challenge, i.e., the covenant of good faith and fair dealing and the business judgment rule do not apply. Although theoretically unnecessary, franchise agreements sometime describe the right as absolute to drive the point home.

Where, however, the franchise agreement states that the franchisor has "discretion" to make a particular decision, the good faith covenant as defined by the business judgment rule restrains the franchisor's exercise of that discretion. Although use of the word "discretion" leaves little doubt that the franchisor's decision is subject to the covenant, the discretionary nature of a decision may be evident from other words chosen by the parties. For example, changes in system standards that rise to the level of changes to the franchise agreement are presumably discretionary in nature and not beyond legal challenge.

Properly understood, the business judgment rule serves the legitimate interests of all stakeholders in business format franchising—the franchisor, franchisees, suppliers, and consumers.[31]

B. *Role of the Franchise Agreement*

In order to properly understand why the business judgment rule is appropriate in franchising, one must understand the vital role the franchise agreement plays in the franchise relationship.

At its foundation, the franchise agreement is the legal contract between the franchisor and franchisee, defining each party's rights and obligations regarding key functions each plays in the franchise system and important facets of the franchise relationship. Rather than ambiguity, clarity and predictability should be the desired outcome when addressing the franchisor and franchisee's rights and obligations in the franchise agreement.[32] For example, if a franchisor does not grant a franchisee any form of territory protection, the franchise agreement should clearly state that the franchisee has the right to operate at the authorized location only and the franchisor can develop additional locations under the same or different trademarks or use alternative methods of distribution in any way it deems appropriate.[33] Predictability should be another cornerstone principle of a franchise agreement.[34]

31. William Killion accurately describes the danger in viewing the franchise relationship too narrowly as one franchisor and one franchisee in *The Modern Myth of the Vulnerable Franchisee: The Case for a More Balanced View of the Franchisor-Franchisee Relationship*, 28 FRANCHISE L.J. 1 (2008). He notes

> [t]he problem with the modern myth of the vulnerable franchisee is that it turns on a myopic view of the franchise relationship as implicating the interests of only two parties, one franchisor and one franchisee. It disregards the interests of other stakeholders, including citizens who aspire one day to own their own businesses, consumers who turn to franchising to deliver goods and services, employees and suppliers who earn their living from franchising, and the other franchisees in a particular franchise system that are dependent on the continued success of the system.

Id.

32. Jamila Granger, David Oppenheim & Brian Schnell, *Fundamentals 201: Advanced Drafting of Franchise Agreements*, ABA FORUM ON FRANCHISING W2 (2013). In their article, the authors address the role of the franchise agreement in a similar manner to the manner described in this article. *See also* Aziz Hashim, Catherine Monson, Ann Hurwitz & Brian Schnell, *The Dynamics of the Franchise Relationship in Today's Business & Regulatory Environment*, IFA LEGAL SYMPOSIUM (2015), in which the authors discuss the role of the franchise agreement and its influence on the culture of the franchise system.

33. *Supra* note 32.

34. Granger et al., *supra* note 32, at 2–4.

No franchisor wants a court to second-guess its decision when the franchisor's intent was to be clear on what rights it was granting to the franchisee and what rights it was reserving for itself.[35]

The classic example of the ambiguity nightmare is the uncertainty arising when the franchise agreement is not clear on what territory rights are granted to the franchisee and what territory rights are reserved to the franchisor. Simply addressing only the territory rights granted to the franchisee in the current form of franchise agreement and not the rights reserved to the franchisor is poor drafting and would result in constant disputes, including good faith and fair dealing claims every time a franchisee felt that a new system outlet was opened too close to its existing outlet.[36]

While some assert that a franchisor's contractual reservation of rights allows franchisors to compete unfairly against the franchisee,[37] the franchisor and franchisee should both want to understand with complete certainty and predictability the rules of the game when it comes to the franchisor opening new locations near the franchisee's outlet, operating competing brands, or distributing products or services through alternative means of distribution.

A franchisee who clearly understands its territory rights (even if those rights are not as broad as the franchisee might prefer) and any rights reserved to the franchisor is in a much better decision-making position than a franchisee whose agreement is ambiguous on critical points. In the latter instance, the franchisee must later rely on good faith and fair dealing arguments before a judge or arbitrator, with results dependent on many factors outside the franchisee's control.

Beyond its foundational aspects, the franchise agreement is a "living, breathing" document that must allow the franchise system the opportunity to change over the life of that agreement. Franchisors often compete with larger companies with corporate locations as opposed to franchised locations. These companies can roll out new product lines or new marketing campaigns with executive decisions and immediately implement them. If a franchisor cannot compete effectively, neither the franchisor nor its franchisees will survive. Accordingly, a franchisor must reserve rights in its franchise agreement to implement system-wide changes and otherwise evolve the system.

35. *Id.*

36. This is, of course, the scenario in the seminal encroachment case *Scheck v. Burger King Corp.*, 756 F. Supp. 543 (S.D. Fla. 1994), where the court stated that Scheck was entitled to expect that Burger King would not destroy the rights of the franchisee to enjoy the fruits of the contract by opening too close to his existing location, especially given that no express language in the franchise agreement gave Burger King the right to open other locations nearby. *Id.* For an excellent discussion on territory-related contract issues, *see* Erika L. Amarante, Andraya C. Frith, and Karen B. Satterlee, *Territory, Exclusivity and Encroachment: Thinking Ahead of the Curve and Dealing with the Fallout*, ABA Forum on Franchising W23 (2009).

37. Peter Lagarias & Edward Kushell, *Fair Franchise Agreement from the Franchisee Perspective*, 33 Franchise L.J. 1 (2013). Lagarias and Kushell contend the franchisee should have a reasonable territory free from competition by its own franchise system and should strike the franchisor's reservation of rights language. *Id.* at 14–15.

Another core aspect to understanding the role the business judgment rule can play in the franchise agreement is knowing why breakdowns occur during conversations about the franchise agreement. Breakdowns often are due in large part to the failure to recognize and understand the different perspectives that franchisors and franchisees bring to the franchise relationship and agreement. Franchisors want to protect and grow the brand. On the other hand, franchisees want to protect and grow their investment. Although their perspectives are different, they are not necessarily at odds.

A franchisor's interest in protecting the brand requires that it have the right to make changes to the system in response to customers' demands. That interest also must allow the franchisor to deal with free-riding franchisees that refuse to play by the rules. The franchisee free rider that refuses to play by the rules creates great risk for all the other stakeholders in the franchise system. The franchisee that refuses to contribute to a brand marketing fund, that introduces unapproved menu items, products, or services, that uses unapproved vendors, or that violates the non-compete covenants hurts not only the franchisor, but also the franchisees that play by the rules and the system and brand as a whole. All stakeholders in the brand should want a franchise agreement that allows the franchisor to effectively deal with free-riding franchisees, rather than having such a free-riding franchisee resort to litigation, including claims that a franchisor's decision to protect the brand violated the implied duty of good faith and fair dealing owed to that particular franchisee.

While most franchisees recognize the franchisor's interest in protecting the brand, franchisors also must understand the franchisees' interest in protecting their investments. The franchisees' concerns often stem from their view that (1) they have little control about strategic decisions that the franchisor makes, even though the franchisees have made significant investments in their businesses; and (2) they have few remedies or recourse if the franchisor's decisions are bad or have a material negative impact on their bottom line.[38]

Highly successful franchisors talk about the critical role that franchisees play in the success of the franchise system and brand. These franchisors often emphasize the collaborative approach they take with their franchisees. Each franchisor should take a look at how its franchise agreements reflect that collaborative approach. Is there an opportunity to make a meaningful change on the collaboration front? The answer might be "yes" or "no." But the question should be asked and discussed in a meaningful and fully engaged manner. That type of review and consideration actually will be far more effective in creating solutions to challenges and opportunities confronting a franchise system than to unduly focus too much effort on good faith and fair dealing or the business judgment rule. Collaboration, however,

38. Hashim et al., *supra* note 32, at 4–5.

does not mean that a franchisor should have a franchise agreement that does not allow it to protect, grow, and evolve the brand.

The bottom line is that a strong franchise agreement with the appropriate use of the business judgment rule is critical to the franchisor's ability to: (1) enhance the likelihood that the franchise system will meet the needs of the franchise brand's customers, including making necessary innovations and changes as their demands and needs evolve; (2) protect the interests of the various stakeholders that have an interest in the brand, including the franchisor and its owners, the franchisees, and the brand customers; and (3) demonstrate that it has performed and enforced the franchise agreement in a legally appropriate manner, including any applicable good faith standard.

C. *Implied Covenant of Good Faith and Fair Dealing Isn't the Answer*

A close review of the cases cited in Part IV underscores the inadequacy of the implied covenant of good faith and fair dealing as the solution to balancing the interests and roles of the franchisor, the franchisee, and the franchise system as a whole, especially as it relates to the viability and sustainability of the franchise system and the need to embrace change in today's competitive marketplace. Cases like *LaQuinta Corp. v. Heartland Properties*[39] and *Clark v. America's Favorite Chicken Co.*[40] are not comforting to franchisees because they reflect the principle that the implied covenant of good faith and fair dealing cannot be used to override the express terms of the franchise agreement.[41]

The legal wrangling between Burger King Corporation and its franchisees over the system's Value Menu also highlights the fundamental problem with good faith and fair dealing (namely, it means different things to different people with the results of any dispute being unpredictable). As applied in the *Burger King* cases summarized below, Florida law on the covenant of good faith and fair dealing mirrors the law in most jurisdictions. Under Florida law:

> The implied covenant of good faith and fair dealing must relate to the performance of an express term of the contract and is not an abstract and independent

39. 603 F.3d 327 (6th Cir. 2010). In *LaQuinta*, the court determined that the franchisor's system-wide change to its hotel reservation system and the contract provisions that permitted the franchisor to change system standards, including the reservation system, did not result in any breach of good faith and fair dealing. *Id.* at 338.

40. 110 F.3d 295 (5th Cir. 1997). In *Clark*, the Fifth Circuit stated that no breach of the implied covenant of good faith and fair dealing existed because the franchise agreements expressly reserved the right for the franchisor to operate competing systems within the franchisee's territory. *Id.* at 297. The court also affirmed summary judgment in favor of the franchisor because there was no evidence that the franchisee was impacted any differently than the rest of the franchise system by the national marketing strategy. *Id.*

41. *See* Coldwell Banker Real Estate, LLC v. Plummer & Assoc., Case No. 09-1313(SRC), 2009 WL 3230840 (D.N.J. Oct. 2, 2009) (noting that the implied covenant could not override the express terms of the franchise agreement, the court determined the franchisor could not breach the implied covenant if it did not breach the express terms of the contract).

> term which may be asserted as a source of breach when all other terms have been performed pursuant to the contract requirements. The implied covenant of good faith and fair dealing requires the contracting parties to exercise the discretion contractually afforded them reasonably and with proper motive and not arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties.[42]
>
> To establish a breach of the implied covenant of good faith and fair dealing, a plaintiff must demonstrate a failure or refusal to discharge contractual responsibilities, prompted not by an honest mistake, bad judgment, or negligence but rather by a conscious and deliberate act, which unfairly frustrates the agreed common purpose and disappoints the reasonable expectations of the other party, thereby depriving that party of the benefits of the agreement.[43]

In *Burger King Corp. v. E-Z Eating, 41 Corp.*,[44] the Eleventh Circuit determined that Burger King's franchise agreement gave it the right to impose the Value Menu on its franchisees based on the contractual language whereby (1) franchisees agreed that changes in standards, specifications, and procedures may become necessary; and (2) the franchisees agreed to comply with those changes.[45] On the other hand, and in a decision with a completely opposite result only a year later, the U.S. District Court for the Southern District of Florida concluded that Burger King's decisions regarding the Value Menu may have breached the implied covenant of good faith and fair dealing based on language in the contract providing that any changes imposed by Burger King must be in the good faith exercise of its judgment to be desirable and reasonably necessary.[46]

For purposes of the good faith/business judgment rule debate, the key points in these two Burger King cases are two separate cases with different judges, but similar facts and similar language in the relevant franchise agreements. Still, they had two different results, likely with several hundreds of thousands of dollars spent in legal fees. Potential outcomes like *Burger King* make little sense if one tries to reconcile the cases and, as a franchisor or franchisee, one tries to make key strategic decisions on a proactive basis. As stated earlier, there must be a better way.

Based on decisions like *Scheck* and the *Burger King* Value Menu cases, franchisors responded by revising their franchise agreements to include

42. 27 Fla. Jur. 2d *Franchise Contracts* § 14. *See* Burger King Corp. v. Austin, 805 F. Supp. 1007 (S.D. Fla. 1992).

43. 27 Fla. Jur. 2d *Franchise Contracts* § 14. A claim for breach of the implied covenant of good faith and fair dealing is not actionable absent a breach of the contract's express terms; thus, where a franchisee fails to allege any breach of express contract terms, its breach of the implied covenant claim cannot stand. *See* Burger King Corp. v. Holder, 844 F. Supp. 1528 (S.D. Fla. 1993).

44. 572 F.3d 1306 (11th Cir. 2009).

45. *Id.* at 1307.

46. Nat'l Franchisee Ass'n v. Burger King Corp., 715 F. Supp. 2d 1232 (S.D. Fla. 2010). The franchisee association alleged that Burger King violated its duty of good faith under Florida law by setting the maximum price of a menu item at $1, thereby forcing the franchisees to sell the item at a loss and potentially leading to the bankruptcy of its franchisees. *Id.*

more clarity and more specificity to address ambiguities, uncertainties, and any potential for a good faith and fair dealing claim to override the express terms of the franchise agreement, especially when the franchisor's intent with respect to key rights and obligations is clear and unambiguous.

D. *Business Judgment Rule in the Franchise Context*

The origin of the business judgment rule in the franchise context stems from how the implied covenant of good faith and fair dealing has played out in franchise disputes over the last twenty or so years. Franchisors began to take notice of how the implied covenant of good faith and fair dealing could go beyond its common law "gap-filling" principles and be used to second-guess their decisions in instances where the language in the franchise agreement granted them broad discretion to make decisions. In a key respect, with the business judgment rule language expressly included in the franchise agreement, the franchisor and franchisee augment the covenant by defining the standards that will govern its application.

Most business decision-makers believe that having the discretion to make a decision generally means that their decision is absolute and final and not subject to challenge, except under extraordinary circumstances. For example, without good contractual language and as further described below, a franchisor who reserves the discretion to open new franchised outlets anywhere outside the protected area granted to an existing franchisee could easily be surprised when the franchisee sues on a good faith and fair dealing claim when the franchisor places a new outlet outside the franchisee's protected territory, but the franchisee still believes the new outlet is too close to its existing operation, thus creating potential harm to its business.

Many of these decision-makers have no idea that a number of courts would review those "discretionary" decisions by applying a good faith and fair dealing standard where the decision that the franchisor believes is made with some legitimate business interest (for example, increasing the brand market share in a trade area) might be challenged based on the impact on a single franchisee. In essence, the implied covenant of good faith and fair dealing requires that "a party vested with contractual discretion must exercise that discretion reasonably and with proper motive and may not do so arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties."[47] What constitutes "reasonable expectations," however, is primarily left to the discretion of the courts when a decision is challenged, a dispute ensues, and the parties do not resolve on their own. In *Story v. City of Bozeman*,[48] the court defined "reasonable expectations" as follows:

> Each party to a contract has a justified expectation that the other will act in a reasonable manner in its performance or efficient breach. When one party uses discretion conferred by the contract to act dishonestly or to act outside of accepted

47. Burger King v. Agad, 941 F. Supp 1217, 1221 (N.D. Ga. 1996).
48. 791 P.2d 767 (Mont. 1990).

> commercial practices to deprive the other party of the benefit of the contract, the contract is breached.[49]

In considering why the business judgment rule is appropriate for franchising, one must understand how it applies to the foundation and key aspects of the franchise business model rather than simply apply corporate law doctrine. *In re Sizzler Restaurants International, Inc.*[50] is the quintessential franchise case that bridges the application of the implied covenant of good faith and fair dealing with the business judgment rule. When determining whether a franchisor breached the implied covenant of good faith and fair dealing, the court placed the burden on the franchisee to

> offer evidence that Sizzler [the franchisor], to the extent that it made discretionary decisions pursuant to the license agreements, acted dishonestly or outside of accepted commercial practices, or with an improper motive or in an unreasonable manner that was arbitrary, capricious or inconsistent with the reasonable expectations of the parties.[51]

Furthermore, the court stated that "the inquiry into Sizzler's decision-making process is not an inquiry that looks to results, but more appropriately should examine the actual decision-making process to determine whether it was legitimate, i.e., honest or within accepted commercial practices."[52] The court ultimately concluded that the implied covenant of good faith and fair dealing is not a license for franchisees to second-guess the franchisor's business decisions.[53]

In 2000, utilizing *In re Sizzler* as a launching pad, Jeffrey C. Selman authored his article "Applying the Business Judgment Rule in the Franchise Relationship" to develop a theoretical framework of the business judgment rule from the franchise perspective.[54] Selman notes that "[a]ny effort to include from the corporate director context in determining franchisor duties, however, should also borrow the business judgment rule and the important limitations it places on judicial review, a step that courts have already begun to undertake in examining the duties franchisors owe their franchisees."[55] He

49. *Id.* at 775.
50. 225 B.R. 466 (Bankr. C.D. Cal. 1998).
51. *Id.* at 474.
52. *Id.*
53. *See also Agad*, 941 F. Supp. at 1221.
54. Selman, *supra* note 3 at 111, 114. In Selman's view, the business judgment rule in the franchise context should consist of five distinct elements:

> First, the rule would protect decisions made by a franchisor. Second, the rule would presume that a franchisor acted with disinterestedness and independence in making a decision that affects an individual franchisee or the franchise system as a whole. Third, under the rule, a franchisor's decision would presumably be made after a reasonable effort to become familiar with the relevant and available facts. Fourth, the rule presumes that a franchisor made the decision in good faith and with a reasonable belief that it was in the best interests of the franchise system. Finally, the rule would presume that a franchisor did not abuse its discretion in making a decision.

Id.

55. *Id.*

also states "[i]n the corporate director context, judicial reluctance to second-guess the decisions made by directors goes back more than 250 years to the English case of *Charitable Corp. v. Sutton*"[56] and "American courts have applied the rule, recognizing that 'directors are in most cases, more qualified to make business decisions than are judges.'"[57]

Since Selman's article, many franchisor lawyers have gone beyond the theoretical framework to draft business judgment language provisions that address the real world in which franchisors and franchisees are part of a collaborative business network. In order to be competitive in the marketplace and sustainable in the long run, the franchisor and franchisees must be nimble, proactive, and responsive to the needs, demands, and expectations of the brand customers.

In his analysis, Selman addresses how the rationales for the business judgment hold up in the franchise relationship. "First, franchisors are entitled to make bad decisions and still not breach their duties to franchisees, for 'bad faith is not synonymous with erroneous judgment.'"[58] "Second, franchisors should be encouraged to undertake risks on behalf of franchise systems."[59] "Third, courts are not inclined to second-guess the decisions reached by franchisors."[60] "Fourth, franchisees should not dictate these decisions through litigation."[61]

As Selman notes, the rationale for the business judgment rule in the corporate setting includes encouraging necessary risk in business decisions and the recognition that courts are ill equipped to make business decisions.[62] Selman concludes that there are a few advantages to the business judgment rule over the implied covenant of good faith and fair dealing in the context of a franchise system.[63] One of those advantages is that the business judgment rule can better assist the entire franchise system in assessing when a franchisor may face liability for any breach of the duties that it may owe its franchisees with greater predictability than "the current guesswork of whether a particular court or state's law will allow for a claim for breach of the implied covenant of good faith and fair dealing to stand."[64] As noted earlier, no franchisor or franchisee should want a court to decide

56. *Id.* citing 2 Atk. 400, 404 (1742).
57. Selman, *supra* note 3, at 112–13 (quoting Int'l Ins. Co. v. Johns, 874 F.2d 1447, 1458 n.20 (11th Cir. 1989)).
58. *Id.* at 112 (quoting Oil Express Nat'l, Inc. v. Burgstone, 958 F. Supp. 366, 369 (N.D. Ill. 1997)); *see also* Bonfield v. AAMCO Transmissions, Inc., 708 F. Supp. 867, 884–85 (N.D. Ill. 1989).
59. Selman, *supra* note 3, at 112.
60. *Id. See In re* Sizzler, 225 B.R. at 474; *see also* Svela v. Union Oil Co. of Cal., 807 F.2d 1494, 1501 (9th Cir. 1987) (court cannot second-guess franchisor's economic decisions if made in good faith); Burger King v. Agad, 941 F. Supp. 1217, 1222 (N.D. Ga. 1996) (implied covenant of good faith cannot be used to second-guess franchisor's legitimate business decisions).
61. Selman, *supra* note 3, at 112.
62. *Id.* at 113.
63. *Id.*
64. *Id.* at 116.

the fate of a franchise system; the business judgment rule provides the structure to develop a mutually beneficial relationship between franchisors and franchisees. In addition, the business judgment rule serves as a form of checks and balances in which franchisors "obtain the protections that place limits on the ability of a franchisee to sustain claims of breaches of these duties that the presumptions of the business judgment rule can afford."[65]

The business judgment rule is not intended to give a franchisor unlimited, unfettered, and uncontrolled discretion over the enforcement of rules and standards within the franchise system, but instead to bring more certainty to the franchise relationship and allow franchise systems to compete more effectively against competitors, including non-franchise systems. Recent developments from the National Labor Relations Board (NLRB), including actions filed against McDonald's Corp. alleging that McDonald's should be considered a "joint employer" of workers at its franchisees' restaurants,[66] underscore the importance of a well-balanced franchise system in which the franchisor is able to impose requirements and system standards to assure uniformity and protect its trademarks and the goodwill associated with those trademarks, while at the same time providing the franchisee with recommendations, guidelines, and best practices as to how to meet those systems standards, thereby allowing the franchisee to focus on the day-to-day operations of its business. As franchisors and franchisees seek to find ways to navigate through the significant issues raised by the NLRB on the joint employment issue, franchisors must understand the purpose of system standards is to protect the trademarks and brand and not to control a franchisee's day-to-day operations. The key is understanding the difference between establishing system standards versus unnecessarily mandating the manner and means of meeting the standards.

It is this balancing of the interests of the franchisor, the franchisee, and the system as a whole that will materially impact the sustainability of any franchise system. When a franchisee alleges claims based on the implied covenant of good faith and fair dealing in response to a franchisor's decision that is based on a legitimate rationale beyond the interest of that individual franchisee, the business judgment rule in the context of the good faith and fair dealing claim should be the standard used to judge the decision. That approach will lead to the best outcome for all the various stakeholders in the franchise brand. In essence, the business judgment rule provides the cer-

65. *Id.*

66. In one of the most recent joint employer related developments regarding McDonald's, the NLRB issued an order denying McDonald's request for an explanation of the factual basis for the claim that McDonald's and its franchisees were joint employers. McDonald's USA, LLC, 362 NLRB No. 168 (Aug. 14, 2015). Two weeks later, the NLRB held in *Browning-Ferris Industries* that two or more employers are joint employers if they "share the essential terms of employment." *Browning-Ferris Indus.*, Case 32-RC-109684 (NLRB Aug. 27, 2015). For the moment, this case changes the joint-employer test in a way that may implicate franchising, but is far beyond the scope of this article. Precisely how this decision will play out will most certainly continue to be a hot topic in coming years. *See infra* note 124.

tainty that is needed to enable franchisors and franchisees to deliver on what they need to do to build a sustainable franchise system that is customer-centric and evolves and changes to meet the demands and expectations of the brand customers.

Using the business judgment rule and the implied covenant of good faith and fair dealing standards, consider the following real world scenarios that occur in franchise systems every single day.

The first scenario involves system change. All stakeholders in a franchise system should understand the importance of system change to the long-term sustainability of the brand. The franchise landscape is littered with franchisors and franchisees that refused to embrace change, resulting in customers simply making decisions to spend their hard-earned dollars elsewhere. A franchise system either embraces change or dies.

With this irrefutable principle standing stoutly in the way of a franchise system's success, a franchisor must embrace its fundamental role in leading the franchise system through change that will make a difference. Now imagine how a franchisor approaches a system change decision if its decision will potentially be second-guessed by an individual franchisee or a judge, jury, or arbitrator (1) under a good faith and fair dealing standard or (2) under the business judgment rule where the parties have contractually agreed to the standard of review for any franchisor discretionary decision or any other decision where the implied covenant applies. Under the business judgment rule (and the specific franchise agreement language set forth in Part I), a franchisor can have a high level of confidence and certainty that its decisions will not be second-guessed if they are intended, in whole or significant part, to promote or benefit the franchise system generally. By way of example, decisions that promote or benefit the system include improved customer service and satisfaction or an improved competitive position of the system.

If one considers all the different decisions a franchisor must make to lead system-wide change, whether related to marketing, operations, technology, customer engagement, or other critical factors where a franchise system must change, the franchisor's strong preference is to be judged by the business judgment rule. A franchisor will have an even higher level of confidence and certainty if it collaborates with its franchisees and engages them in the process of system change.

Effective collaboration is important to a franchise system's success and sustainability regardless of whether a franchisor's decision is judged by the duty of good faith and fair dealing or the business judgment rule. For example, most franchisors establish some type of process where they solicit franchisee feedback in considering various options for system change. It's not that franchisees want a vote in the decision on the change, they simply want a voice. If they are heard and the franchisor meaningfully engages them in the process, they typically are comfortable with the franchisor making the decision. That's what most highly successful franchisors do with any material system change that will have an impact on the franchisees' bottom line.

Regardless of the level of collaboration, using a good faith and fair dealing standard to judge system change can result in dramatically different outcomes. Rather than certainty, there is absolute uncertainty. One need look no further than the Burger King/Value Menu cases discussed in Parts III.C and IV to conclude that uncertainty and unpredictability reign supreme when a franchisor's decision is judged by a typical good faith and fair dealing standard.

Even with franchisee involvement, the likelihood that an individual franchisee or a small group of franchisees might object to any franchisor decision is almost guaranteed, especially with the human tendency to resist change. Most people simply have a strong preference to keep doing things the way they always have. They resist change simply on the basis that they don't like any change at any time. Couple that with the added dimension of a legal dispute, potentially costing hundreds of thousands of dollars with no certainty as to the outcome. It's a nightmare. It's paralysis. It easily could result in no change at all and the eventual demise of a franchise system that doesn't embrace change.

IV. The Franchisee's Perspective on the Business Judgment Rule in the Franchise Relationship

A. *The Business Judgment Rule Is an Ill-Suited and Easily Abused Replacement for the Covenant of Good Faith and Fair Dealing*

While seemingly innocuous, the business judgment rule provides a minimal standard of review and presumptively upholds the discretionary acts of franchisors. Rather than reserve their "sole," "absolute," or "exclusive" discretion, franchisors invoke the business judgment rule as a discretionary standard to accomplish the same, except franchisees are less likely to understand its true implications, while courts are less likely to rein in contractual overstepping. In addition to reserving the right to act according to their "reasonable business judgment," franchisors typically reserve the right to promote their own interests. The following clause illustrates the type of language used by franchisors to engraft the business judgment rule into their franchise agreements:

> Whenever we reserve discretion in a particular area, or where we agree or are required to exercise our rights reasonably or in good faith, we will satisfy our obligations whenever we exercise Reasonable Business Judgment in making our decisions or exercising our rights. Our decisions or actions will be deemed to be the result of Reasonable Business Judgment, even if other reasonable or arguably preferable alternatives are available, if our decisions or action is intended, in whole or in significant part, to promote or benefit the System generally even if the decision or action also promotes our financial or other individual interests.

Because the implied covenant can be waived, this provision, in theory, prohibits courts from implying good faith and fair dealing into the franchise relationship. As we will discuss later, if language such as this is utilized in lieu of the covenant of good faith and fair dealing, franchisors that are checked in their conduct now will likely be given much more latitude to make decisions that are ultimately adverse to the interests of their contractual partners—the franchisees.

As Professor Gillian K. Hadfield observed in her article *Problematic Relations: Franchising and the Law of Incomplete Contracts*, the capital structure of franchise relationships leaves franchisees particularly vulnerable to franchisor "opportunism."[67] Franchisee investments are highly specific and have a diminished value, if any, in other lines of business.[68] Further, franchisees are subject to damages for early termination and their transfer rights are highly restrictive.[69] Accordingly, unsuccessful franchisees are more likely to remain in business than ordinary business ventures in order to protect their sunken investments and avoid future damages, such as unpaid future royalties.[70] The foregoing incentives that cause franchisees to remain in business leave them in a precarious position.[71] For instance, as Hadfield notes, franchisors can extract additional revenue from franchisees by levying fees; increasing royalties, the prices of goods sold to franchisees, and advertising fees; or requiring unnecessary renovations.[72] The business judgment rule presumably permits opportunistic conduct by franchisors because it requires only that a franchisor submit a plausible reason for its conduct or claim that its action was designed to benefit the franchise system as a whole.[73]

In sum, it is the franchisee lawyer's view that the business judgment rule inhibits opposition to franchisor discretionary decisions and changes to system standards and absolves any franchisor obligation to act in a commercially reasonable manner or to even consider the substantial impact its decisions may have on its franchisees. Furthermore, franchisors have even more leeway to opportunistically extract additional revenue from its franchisees under the minimal standard of review the business judgment rule provides. The specifics supporting this conclusion are inexorably bound up with the fundamental difference between shareholders and franchisees, as well as the way in which both the business judgment rule and the covenant of good faith are applied.

1. The Rationales for the Business Judgment Rule Do Not Hold Up in the Franchise Relationship

The business judgment rule is a judicially created exception to address the unique circumstances in which a corporation on behalf of shareholders seeks to impose personal liability upon corporate directors resulting from

67. *See* Hadfield, *supra* note 30, at 952.
68. *Id.* at 951.
69. *Id.* at 966.
70. *Id.* at 964.
71. *Id.*
72. *Id.* at 952.
73. Hadfield, *supra* note 30, at 982 (noting that under the business judgment rule, courts only "look for a plausible story why a particular franchisor decision is the result of the franchisor's business judgment").

breach of fiduciary duties. Not only are the circumstances different in the franchise context, courts have struggled to consistently apply the rule correctly in corporate law.[74] As such, it is simply not an appropriate standard of discretion for franchisors and should not be applied in the franchise relationship.

As noted earlier, courts have articulated three primary rationales for the business judgment rule, none of which holds up in the franchise context.[75] First, the business judgment rule shields corporate directors from personal liability, reasoning that the risk of personal liability for ordinary business decisions will deter competent directors from serving.[76] In the franchise context, however, franchisees have had minimal success, if any, in personal lawsuits against directors for breach of fiduciary duties.[77] The business judgment rule thus loses its primary rationale for franchisors, who are free from risk of personal liability for exercising their discretion and protected by unequivocal holdings that franchisors do not have a fiduciary obligation to franchisees in ordinary franchise relationships.[78]

Second, the business judgment rule is a judicial acknowledgment that business decisions entail necessary risk. Courts fear that retrospective analysis and subsequent litigation would discourage directors from taking risks and therefore inhibit business growth. However, the franchise business model imposes additional risk considerations on franchisors. Franchisor discretionary decisions involve not only the franchisor's own well-being, but also the franchisees' large, undiversified, and sunken investments in their stores or units. Further, franchisees are frequently obligated to shoulder the cost of discretionary changes. While the business judgment rule correctly encourages businesses to take risks, the nature of franchising calls for reasonable consideration of the shared and additional risks of franchisees.

Moreover, franchisors' direct interest in the subject matter of their discretionary decisions, by definition, prohibits the application of the business judgment rule.[79] Franchisors commonly collect revenue through alternative measures, including commissions from approved suppliers; in certain instances they own the companies that franchisees are required to purchase equipment and supplies from. As noted earlier, the first element of the American Law Institute's definition of the business judgment rule states that: " [a] director or officer who makes a business judgment in good faith

74. *See supra* note 6 and accompanying text (noting that the business judgment rule is one of the least understood concepts in corporate law).

75. *See supra* text accompanying note 10.

76. *See supra* text accompanying note 10.

77. *See* William L. Killion, 52 A.L.R. 5th 613 (noting that a "great majority of courts to consider the issue have refused to recognize the existence of fiduciary obligations between a franchisor and franchisee in an ordinary franchise relationship"). *See, e.g.*, MINN. STAT. § 80C.17, subd. 2. However, the majority of franchise cases do not name corporate directors personally liable for exercising discretion.

78. *See* Killion, *supra* note 77.

79. *See supra* text accompanying note 10.

fulfills the [duty of care] if the director or officer: (1) is not interested in the subject of his business judgment."[80] Not only should courts strike application of the business judgment rule by definition, they should hesitate to encourage risk when franchisors stand to benefit immediately as a result of their discretionary acts, regardless of franchisee success or failure.

Finally, courts recognize that directors, as business experts, are better equipped to make business decisions than the judiciary.[81] In her comprehensive study and analysis of the franchise relationship, Professor Hadfield observed that "courts are capable of answering [franchise disputes]," which she claims simply involve an inquiry into the nature of franchise commitments and sunken costs and franchisor opportunism.[82] Further, she notes that courts "should be at least as competent in understanding franchise disputes as they are in analyzing medical malpractice cases, product liability issues, and antitrust suits,"[83] among other actions.

Given the uniqueness and complexity of the business judgment rule in the corporate context, it seems clear that it should not be indiscriminately applied to the franchise relationship in the absence of its theoretical basis.

2. Fundamental Differences Between Franchisors/Franchisees and Corporate Directors/Shareholders Support the Franchisee Perspective

At the core of this argument is an undeniable fact: franchisees have fundamentally different interests than shareholders.[84] Franchisees make long-term, undiversified investments and are subject to franchisor directives over the course of the relationship. Purchasing stock, on the other hand, is an entirely different investment.[85] It allows for diversification, voting rights, and most typically, an easy exit if the board goes in a direction with which the shareholder does not agree. Not so for a franchisee who is subject to substantially greater risk resulting from unreasonable discretionary changes than a shareholder. The business judgment rule only amplifies the disparity in risk.

80. *Principles of Corporate Governance* § 401, Am. Law Inst. *See also* text accompanying note 10.

81. *See* supra text accompanying note 10.

82. *See* Hadfield, *supra* note 30, at 989–90.

83. *Id.* at 990.

84. In his 2000 article, Selman suggested substituting the corporate director with the franchisor and substituting the corporation with the franchise system. Selman, *supra* note 3, at 113. However, "corporations" and "franchise systems" are entirely impersonal characterizations of the real party of interest in both derivative actions by corporations against corporate directors and franchisee lawsuits against franchisors. In derivate actions, while the corporation in name brings a lawsuit against directors, individual shareholders are the force behind these actions and the real party of interest. Similarly, while it is true that large groups of franchisees have brought class action lawsuits against franchisors, franchise disputes are commonly between the franchisor and an individual franchisee or smaller group of franchisees, as opposed to the entire "franchise system."

85. Hadfield, *supra* note 30, at 983 (discussing the difference between franchisees and stock purchasers).

3. Substantially Unequal Transfer Rights Result in Harsh Consequences for Franchisees Under the Business Judgment Rule

Foremost, franchisees and shareholders have distinctly different transfer rights. Most shareholders have the freedom to liquidate shares without restriction and in many cases, immediately on large secondary markets such as the New York Stock Exchange or NASDAQ. As such, shareholders are free to avert what they perceive as risks in a corporation's new strategy.

Conversely, franchise agreements severely limit a franchisee's ability to assign or transfer its rights under the agreement. Franchise agreements invariably require prior approval of franchisee transfers, which are subject to numerous conditions that make transfers burdensome, especially for struggling franchisees. Some of the more onerous conditions include franchisor's right of first refusal; franchisee's general release of all claims against the franchisor; franchisee assumption of all liabilities from prior operation; and franchisee compliance with all past and current obligations under the agreement, including payments due, without being in breach of the agreement in any way. Moreover, not only do franchise transfers result in lost investments and franchisee transfer fees, many franchise agreements call for damages for non-compliant transfers or unilateral termination on behalf of the franchisee. As a result of standard transfer restrictions in franchise agreements, franchisees are stuck with franchisor discretionary conduct that is not always contemplated at the execution of the agreement. Shareholders are commonly free to sell their shares on secondary markets to avoid the effect of discretionary changes.

In light of the practical inability to transfer or terminate, the business judgment rule leaves franchisees entirely helpless against franchisor discretionary acts in a way that shareholders subject to the business judgment rule are not.

4. Franchisor Discretionary Decisions Often Require Additional Investment from Franchisees

Being a franchisee frequently requires additional investment as a result of decisions made by the franchisor. Franchisees bear the direct cost of the decision made by the franchisor whether it's a small investment in ad campaigns (which are perpetual); mid-range expense for new equipment, branding materials, or signage; or the major expense of remodeling an asset that could cost millions of dollars, As many franchisee lawyers have noted, it's easy for franchisors to make a difficult decision when they are spending other people's money. Conversely, shareholders are rarely, if ever, required to invest additional capital as a result of decision-making by a board of directors.

Given that shareholders are not obligated to make financial commitments beyond their initial investment, application of the business judgment rule results in less harm to shareholders. In the franchise context, however, franchisor discretion may result in continual extraction of funds from franchisees, and the business judgment rule inadequately monitors franchisor discretionary conduct given the potential for abuse upon franchisees. For example, imagine a franchisor seeking to boost revenue to compensate for decreasing royalties. Under the business judgment rule, as long as franchisors can articulate a rational business purpose for their decision, they can line their pockets with the implementation of a store renovation program in which franchisees are required to source all equipment from the franchisor's subsidiary. The implied covenant, however, would balance the franchisor's business objectives against the reasonable economic interests of franchisees, providing a more exacting check on these types of practices. Opportunities for this kind of abuse are not present in the traditional shareholder context in which the business judgment rule evolved.

5. Franchisors Are Not Fiduciaries

Franchisors and franchisees have different legal relationships and duties when compared with corporate directors and shareholders. In numerous instances, courts have refused to find that franchisors owe a fiduciary duty to their franchisees,[86] while corporate directors owe fiduciary duties to their shareholders.[87] The business judgment rule was created to ease the burdens imposed by fiduciary duties.[88] However, the business judgment rule has no application to the franchise relationship because there is no fiduciary duty for it to defend.

6. The Business Judgment Rule Can Act as a Waiver of Implied Covenant of Good Faith and Fair Dealing—Making Things Unacceptably Perilous for Franchisees

To the extent that a franchise agreement calls for application of the business judgment rule, there is the distinct possibility that by doing so, the parties may have contracted around the implied covenant of good faith and fair dealing. While the covenant is typically present in all contracts, it can be waived.[89] While most franchisors who are actually trying to sell their fran-

86. *See* Killion, *supra* note 77.

87. *See, e.g.*, Model Bus. Corp. Act § 8.30.

88. *See* text accompanying note *supra* note 10 (discussing the director-centric rationales for the business judgment rule).

89. Courts have found that discretionary reservations, similar to the "business judgment" approach, limit the application of the implied covenant of good faith and fair dealing. *See, e.g.*, Burger King Corp. v. H&H Rest., LLC, 2001 WL 1850888 (S.D. Fla. Nov. 30, 2001) (illustrating the limited effect of the implied covenant of good faith and fair dealing when a franchisor reserves its "sole discretion"); *but see* Nw., Inc. v. Ginsberg, 134 S. Ct. 1422, 1425 (2014) (despite a reservation of "sole discretion," the Court found that under Minnesota law the implied covenant cannot be waived or contracted around). The Supreme Court has, however, acknowledged that the implied covenant of good faith and fair dealing may be waived or contracted around. *Ginsberg*, 134 S. Ct. at 1433, n.2 (citing Steiner v. Thexton, 226 P.3d 359, 365 (Cal. 2010); Shawver v. Huckleberry Estates, LLC, 93 P.3d 685, 693 (Idaho 2004); Farm Credit Servs. of Am. v. Dougan, N.W.2d 24, 28 (S.D. 2005)).

chise would not likely say "we don't agree to act in good faith," consider the first sentence of the example clause in Part 1, one example of the burgeoning number of clauses that incorporate the business judgment rule in lieu of the implied covenant: "Whenever we reserve discretion in a particular area, or where we agree or are required to exercise our rights reasonably or in good faith, we will satisfy our obligations whenever we exercise Reasonable Business Judgment in making our decisions or exercising our rights."

This language would likely be read as a waiver of the covenant of good faith—and a substitution of the more permissive standard established by the business judgment rule.[90] As we continue to examine in the next section, such a swap could be disastrous for a franchisee.

In sum, the business judgment rule should not be utilized in the franchise context. There is little to no justification for its use in the history of the rule, and its application can do nothing to further the mutual interest of franchisors and their franchisees. Instead, from this franchisee lawyer's perspective, a balanced and thoughtful approach to the use of the implied covenant makes much more sense.

B. *The Implied Covenant of Good Faith and Fair Dealing Is a More Suitable Doctrine for Use in Franchising*

The inherently divergent interests of franchisors and franchisees in the franchise business model inevitably results in disputes, and the implied covenant of good faith and fair dealing is one of the few weapons in the franchisee's arsenal to combat unreasonable franchisor conduct. Foremost, the "implied" aspect of good faith and fair dealing necessarily limits the disadvantages inherent in the adhesive nature of franchise agreements, which are invariably drafted by and in favor of franchisors.

While franchisor detractors of the covenant claim "it's vague," "it's unclear," "illusive," and "interfere[s] in contracting relationships between con-

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90. At least one California court has found such an attempted substitution to be unconscionable. See Vlahos v. International Baking Co., Inc., Case No. A102335, 2005 WL 1632089 (Cal. Ct. App. July 12, 2005), in which the California Court of Appeal stated that the business judgment rule found in the franchise agreement was unconscionable. *Id.* at *8. International Baking Co., dba Sara Lee Fresh (SLF), argued that the business judgment rule provision applied only to "unspecified discretionary decisions" and that it was commercially reasonable because it permitted SLF to make decisions that benefited the distribution network as a whole, despite benefitting "certain distributors more than others." *Id.* The court rejected SLF's arguments, reasoning that the business judgment provision prohibited the arbitrator from considering whether SLF's actions constituted "fraud, bad faith, overreaching or an unreasonable failure to investigate material facts." *Id.* The court additionally reasoned that:

> [U]nder California law, a covenant of good faith and fair dealing is implied in every contract, including franchise agreements. Even where a contract confers on one party the discretionary power affecting the rights of the other, a duty is imposed to exercise that discretion in good faith and in accordance with fair dealing. Creating an irrefutable presumption in favor of SLF's discretionary decisions supplants the implied covenant of good faith and fair dealing . . . [and] is unconscionable.

Id. (internal quotations and citations omitted).

senting parties that is needed to freely develop new franchise businesses,"[91] the reality is that the covenant, developed over decades of jurisprudence, is precisely the right tool to regulate the franchise relationship when franchisors get overzealous while spending "other people's money." A recent feud between a well-known franchisor and one of its franchisees illustrates a common dispute in franchise relationships and shows how the business judgment rule and the implied covenant would differ in their application.

In December 2014, Wendy's brought a lawsuit against one of its largest multi-unit franchisees, DavCo, for failure to remodel its stores and install a point of sale (POS) system that enabled mobile ordering and payment and marketing programs.[92] Wendy's estimated that the remodel would cost its franchisees anywhere from $450,000 to $650,000 per store.[93] While franchisors like Wendy's are interested in the implementation of uniform changes to address constantly changing market conditions, perhaps not surprisingly, not all franchisees enjoy the financial stability to weather a half million dollar expense. In these scenarios, resistance to bearing the cost and risk of system changes, even at the risk of termination and loss of substantial investments in the franchise, becomes a viable option for franchisees. Franchisees resist what they believe are unreasonable system changes under theories of breach of contract, violation of state franchise relationship statutes, and finally, breach of the implied covenant of good faith and fair dealing.[94] The implied covenant plays an important role in the court's review and at times may be the "decisive factor while determining legal liability."[95] If the covenant is waived and the business judgment rule inserted in its stead, it would be far more likely, in this franchisee lawyer's opinion, that the franchisor's requirement would hold up under judicial scrutiny—even when extinction of the franchisee's business is in the balance.

Further, to the extent that a franchise agreement expressly permits the actions taken by a franchisor, even the implied covenant of good faith and fair dealing will likely not save a franchisee. Courts generally hesitate to invoke the implied covenant to override express terms. For instance, in *La Quinta Corp. v. Heartland Properties LLC*, pursuant to its license agreement, La Quinta attempted to enforce system-wide changes to its computer reserva-

91. *California Franchise Relations Act, 2013: Hearing on SB 610 before the Assembly Judiciary Committee*, Cal. State Leg., 2013–14 Leg. Sess. (2013) (statement of Dennis E. Wieczorek, Gen'l Counsel, Int'l Franchise Ass'n).

92. *One of Wendy's biggest franchisees won't follow remodeling program, gets sued*, COLUMBUS BUS. FIRST (Dec. 31, 2014), http://www.bizjournals.com/columbus/news/2014/12/31/one-of-wendy-s-biggest-franchisees-won-t-follow.html?page=all

93. *Id.*

94. *See, e.g.*, Beilowitz v. Gen. Motors Corp., 233 F. Supp. 2d 631 (D.N.J. 2002); JOC, Inc. v. ExxonMobil Oil Corp., Case No. 08-5344(FSH), 2010 WL 1380750 (D.N.J. Apr. 1, 2010), *dismissed as moot*, 507 Fed. App'x 208 (3d Cir. 2012).

95. Frank J. Cavico, *The Covenant of Good Faith and Fair Dealing in the Franchise Business Relationship*, 6 BARRY L. REV. 61, 62 (2006).

tion system, which cost franchisees approximately $35,000.[96] One franchisee brought an action against La Quinta after being terminated for refusal to comply with system standards, alleging breach of the agreement and the implied covenant of good faith and fair dealing. The court ruled in favor of La Quinta, specifically relying on provisions that permitted La Quinta to "add, amend, and/or delete System Standards," including the "reservation system," and required "[the franchisee] to participate in and bear such costs."[97] The court noted that "where the contracting party complains of acts of the other party that are specifically authorized in their agreement, we cannot see how there can be any breach of good faith and fair dealing."[98]

Said another way, the common iteration of the implied covenant, filling gaps consistent with the expectation of *both* parties—not just one—works. When a franchisor needs certain authority, it needs to have some basis in authority that it expressed in the agreement at the outset of the relationship. Substituting that process with the business judgment rule would strip even this minimal protection from the franchisee because it would shift from a standard that defers to the expectations of both parties to a standard that always defers to the benefit of just one of them.

Similarly, in *Burger King Corp. v. E-Z Eating, 41 Corp.*, the Eleventh Circuit held that Burger King did not breach the implied covenant with the imposition of its Value Menu.[99] Section 5 of the agreement provided that franchisees:

> [a]gree[] that changes in the standards, specifications and procedures may become necessary and desirable from time to time and agree[] to accept and comply with such modifications, revisions and additions to the MOD Manual which BKC in the good faith exercise of its judgment believes to be desirable and reasonably necessary.[100]

Emphasizing the express terms of the franchise agreement, the court stated that "there is simply no question that BKC had the power and authority under the Franchise Agreements to impose the Value Menu on its franchisees."[101] Notably, despite the "good faith" provision in Section 5, the court did not inquire as to the franchisee's specific costs attributable to implementing the Value Menu.[102]

96. 603 F.3d 327, 331 (6th Cir. 2010).
97. *Id.* at 336.
98. *Id.* at 338.
99. 572 F.3d 1306 (11th Cir. 2009).
100. *Id.* at 1308.
101. *Id.* at 1313.
102. *Id.* at 1308. Interestingly, courts have been receptive to good faith and fair dealing claims if good faith and fair dealing are set forth as a discretionary standard in the franchise agreement. In *National Franchisee Association v. Burger King Corp.*, 715 F. Supp. 2d 1232 (S.D. Fla. 2010), the court noted that Burger King's contractual "good faith" standard in holding that the imposition of a certain product on the Value Menu may have violated its "contractual . . . duty of good faith."

La Quinta and *E-Z Eating Corp.* are representative of a number of courts that refuse to permit the implied covenant of good faith and fair dealing to override the express terms of the franchise agreement.[103] Thus, the implied covenant does not preclude all franchisor discretion. However, the "business judgment" rule grants franchisors unchecked discretion and, therefore, unlimited authority.

On the other hand, the implied covenant has provided significant protection to franchisees. Some courts permit the implied covenant to influence the franchisor's express contractual rights. After the *E-Z Eating* decision, in *National Franchisee Association v. Burger King*, the U.S. District Court for the Southern District of Florida found that Burger King's Value Menu may have breached the implied covenant of good faith and fair dealing and permitted the claims to move past summary judgment.[104] The court noted that the Eleventh Circuit "determined, as a matter of law, that the clear and unambiguous language of Section 5(A) of the Agreement grants BKC the right to impose the Value Menu on its franchisees."[105] However, the court further stated that "[e]ven though BKC has the authority under Section 5 to impose maximum prices, the [National Franchise Association (NFA)] can challenge the imposition of the maximum prices under the good faith provision of Section 5."[106] The NFA specifically alleged that requiring franchisees to sell double cheeseburgers at a loss could lead to bankruptcy.[107] Thus, the NFA's allegations were sufficient to proceed for a determination of whether the sale of the double cheeseburger at $1 violated BKC's contractual or implied duty of good faith.[108]

In *JOC, Inc. v. ExxonMobil Oil Corp.*, Exxon had the contractual authority to determine its franchisees' gasoline prices and purchase requirements.[109] A group of franchisees sued Exxon, alleging that Exxon's prices were too high for them to remain profitable. The U.S. District Court of the District of New Jersey denied Exxon's motion to dismiss the franchisees' good faith and fair dealing claim, noting that, under New Jersey law, "a party's performance under a contract may breach [the] implied covenant even though that performance does not violate a pertinent express term."[110]

If the franchisees in *National Franchisee Association* were subject to a business judgment provision, Burger King would likely have had the authority to

103. *See, e.g.*, Clark v. America's Favorite Chicken Co., 110 F.3d 295, 298 (5th Cir. 1997) (refusing to find breach of an implied duty of good faith and fair dealing when the franchise agreement explicitly provided franchisor the ability to compete with franchisees and to administer its marketing fund).

104. *Nat'l Franchisee Ass'n*, 715 F. Supp. 2d 1232.

105. *Id.* at 1242.

106. *Id.* at 1244–45.

107. *Id.* at 1245.

108. *Id.*

109. Case No. 08-5344(FSH), 2010 WL 1380750 (D.N.J. Apr. 1, 2010), *dismissed as moot*, 507 Fed. App'x 208 (3d Cir. 2012).

110. *Id.* at *5 (citing Wilson v. Amerada Hess Corp., 168 N.J. 236, 244 (N.J. 2001)).

implement a system change that threatened to put franchisees in bankruptcy.[111] Similarly, in *Exxon*, Exxon would likely have been permitted to set gasoline prices and purchase requirements that prohibited distributors from making profits and perhaps driving them out of business.[112]

Similarly, in *Carvel Corp. v. Diversified Management Group, Inc.*, the franchise agreement left Carvel with considerable discretion for matters such as advertising campaigns, store location, and wholesale sales.[113] A Carvel distributor and sub-franchisor complained that Carvel arbitrarily rejected proposed store locations, refused to allow changes to store blueprints, and made abrupt and unexplained changes to advertising policies. The court noted that while Carvel may have "acted within the bounds of its discretion, [it] would be in breach [of the implied covenant] if it acted unreasonably."[114]

The implied covenant has also led to franchisor liability for failing to provide operating support to the franchisee,[115] encroaching upon exclusive territory,[116] and opening nearby competitive franchises.[117] In all of these cases, the franchisor's discretionary decisions significantly harmed the franchisee when making changes to the franchise system as a whole. The moral of the story is that decisions made by franchisors, which already have an immense amount of power, need to be checked. The implied covenant provides such a check, whereas the business judgment rule does not.

Some commentators have observed that "franchise contracts are precisely the type of contract whose interpretation and enforcement can be assisted by the appropriate use of the implied covenant."[118] Franchise agreements do not contemplate a single event, such as purchasing a vehicle, but rather conduct as far as ten to twenty years out from the execution of the original agreement. Absent clairvoyance, it is necessary to give at least one party the power of discretion during the term of the agreement. In part due to the adhesive nature of franchise agreements, the lion's share of this necessary discretion for future conduct in franchise agreements is generally left in the hands of the franchisor.[119] That may be appropriate. However, the other half of the relationship must be granted some agency. It is the franchisees that are

111. *See Nat'l Franchisee Ass'n*, 715 F. Supp. 2d 1232.

112. *ExxonMobil Oil Corp.*, 2010 WL 1380750.

113. 930 F.2d 228 (2d Cir. 1991).

114. *Id.* at 232.

115. Dunafon v. Taco Bell Corp., Bus. Franchise Guide (CCH) ¶ 10,919 (W.D. Mo. Mar. 13, 1996).

116. Emporium Drug Mart, Inc. v. Drug Emporium, Inc., Bus. Franchise Guide (CCH) ¶ 11,996 (A.A.A. Sept. 2, 2000).

117. *See* Scheck v. Burger King Corp., 756 F. Supp. 543, 549 (S.D. Fla. 1991), where the court ruled that the franchisor could not open franchises at will and that an existing franchisee could pursue a claim that the franchisor breached the implied covenant of good faith and fair dealing by opening a nearby franchise.

118. Douglas D. Choe, *Vylene Enterprises v. Naugles: Remedies for Franchisor Encroachment*, 27 SW. U. L. REV. 353, 365–66 (1997).

119. 2 FRANCHISE & DISTRIBUTION LAW & PRACTICE § 8:28 ("the franchisor may have discretion with respect to the selection or approval of locations, the frequency of restaurant visits, or the manner of evaluating performance").

almost unilaterally obligated to act in accordance with specific duties in the franchise agreement and the ever-changing operations manual. The imbalance in discretion is especially concerning for franchisees that have made large investments into their franchises because a simple exercise of the franchisor's discretion can easily put a franchisee's entire investment at risk.[120]

The implied covenant effectively balances the franchisor's business objectives against the franchisee's economic expectations, prohibiting franchisors from exercising their discretion in a way that unreasonably compromises the franchisee's economic position. At the same time, good faith and fair dealing is not an automatic exemption from complying with franchisor obligations flowing from contractual discretion. As such, good faith and fair dealing appropriately permits franchisors to act in accordance with its express rights, while protecting the reasonable expectations of franchisees in an otherwise vulnerable position.

The business judgment rule is an ill-suited substitute masquerading as common sense. Neither its history nor its application suits the franchise relationship. Whatever the solution to the ever-present tension between franchisees and franchisors may be, one thing is certain: that solution is not the business judgment rule.

V. Our Shared Conclusion: A Modified Businesss Judgment Rule Based on Broad, Rational Discretion Plus Collaboration

A good faith and fair dealing standard to judge franchisor decisions may lead to constant second-guessing, which, in turn, may not produce the desired outcome that a franchisor and its franchisees want, which is sustainability and bottom-line success at the unit level and franchisor level. Likewise, a traditional invocation of the business judgment rule leaves too much at risk for franchisees. Instead, we suggest franchisors include *modified* business judgment rule language designed to reduce fights with individual franchisees on good faith and fair dealing claims, while also stipulating a responsibility to exercise discretion in a rational way and instilling a culture of collaboration with their franchisees. A well-designed "modified business judgment rule plus collaboration" approach would lead to more sustainable franchisor-franchisee relationships.

What does "modified business judgment rule plus collaboration" approach look like?

The authors agree wholeheartedly on what effective collaboration looks like when it works. Where we still cannot find alignment is the specific franchise agreement language for a modified business judgment rule. But rather than do nothing because of an inability to reach agreement, we are fully aligned that the business case for effective collaboration among a franchisor and its franchisees simply can't be ignored. When a franchisor and its fran-

120. *See* Hadfield, *supra* note 30, at 928.

chisees are fully engaged and focused on (1) the brand promise and delivering on that promise to the brand customers; (2) an obsession on unit-level economics; and (3) balancing the interests of the franchisor, franchisees, and the system as a whole, all brand stakeholders have a much higher likelihood of success. Collaboration results in franchisees who are much more engaged in the brand as accountable business owners rather than constantly second-guessing and challenging franchisor decisions and franchisors who focus on ways to enable franchisees to be profitable at the unit level.

Unhappy franchisees with little or no collaborative efforts from the franchisor lead to more lawsuits, more failed units, poor franchise validation, and constant challenges to key franchise initiatives like system change. Franchisees with this mindset also are far less likely to take accountability for the results of their own businesses and likely will not motivate their employees, who in turn will care less about delivering on the brand promise to customers. Conversely, franchisors who are not of a collaborative mindset can often lose their way when designing and implementing initiatives that make economic sense on the street where it counts. None of these is a cornerstone for sustainable success of any franchise system.

Some may prefer different terms other than "collaboration" when defining what leads to success in franchising, but we should not get hung up on what terms are used. The key is for each franchisor and its franchisees to focus on what will make a meaningful difference in their franchise system. It is franchisor and franchisee leadership determining who are the right people to have the right conversations about the right challenges and opportunities—with an understanding that there often is more than one right answer because perspective matters, and franchisors and franchisees often have different perspectives. If a franchisor is willing to engage in that kind of effective dialogue, and as long as the franchisees have a voice and their views are considered, franchisees should embrace and understand that they will not always agree with the franchisor's decisions. Attitude, culture, and leadership will always make a meaningful difference.

As the well-known leadership guru Harvey Mackay notes

> [t]here is power in collaboration. It is a great way for companies to work together to achieve success in unexpected ways. In today's fast-paced marketplace it is crucial to develop mutually beneficial partnerships to leverage creativity, experience and resources. This allows companies and individuals to innovate much more quickly and create solutions to problems.[121]

While Mackay is not specifically talking about franchising, the same principles apply to any franchise system willing to embrace them.

121. Harvey Mackay, *Collaborate to Increase Your Success Rate*, Minneapolis Star Trib., Aug. 20, 2015. In his article, Mackay states that collaboration is different than teamwork. Referencing an article from the Association for Information and Image Management (AIIM), the global community of information professionals, Mackay indicates that collaboration at the conceptual level includes awareness, motivation, self-synchronization, participation, mediation, reciprocity, reflection, and engagement.

As noted earlier, no dynamic is more important to the sustainability of a franchise system than system change. As a quick reminder, franchisors must have a franchise agreement that allows them to effectively and efficiently grow, maintain, protect, and evolve the brand and system. Franchisees, however, need some protection and assurance that in exchange for the grant of such broad rights or discretion, franchisors will (1) take into account the franchisee's perspective as they make decisions that will impact the franchise system and its stakeholders (which absolutely includes franchisees); and (2) be rational in the exercise of any discretion.

When addressing system change, it is helpful for a franchisor to have clear and unambiguous language in the franchise agreement regarding its right to implement system change with clear guardrails on that authority. No one wins other than lawyers if system-change issues get bogged down in litigation. But far more important in many respects are the culture, attitude, and relationship in a franchise system. Do franchisees feel like they are stakeholders in the brand? Do franchisees feel like their franchisor listens? Does the franchisor truly seek and take into account franchisee input and embrace creative tension on system change and other key areas in a collaborative manner? These are healthy franchisor/franchisee conversations that should be held regularly in any franchise system.[122]

If one is to truly transform the franchise relationship and enhance the likelihood of sustainability and success, franchisees must have meaningful input and a franchisor that truly seeks input, listens, encourages creative tension in the process, and clearly explains its decisions and the reasons for the decisions. This does not mean a franchisor gives up its decision-making authority, but it does mean franchisees are actively involved in the process. Too often, franchisors pass down changes without soliciting input, essentially telling franchisees (often without much advance notice) that a system change is happening; it must be implemented on a preordained date; it will cost a prescribed amount (regardless of the fiscal conditions in any given franchise); and all franchisees must comply because some provision of the franchise agreement (or newly amended operations manual) gives the franchisor the authority to compel compliance.

Of course, this type of transformative change requires mechanisms for execution. Some obvious possibilities include:

(1) Input from the Franchise Advisory Council (FAC), some other franchisee leadership group or committee (for example, a technology committee to help steer technology changes), or franchisees generally.[123] This is the approach most successful franchisors take, even

122. System change was the primary topic in an article posted at IFA's FranSocial Forum by Aziz Hashim and Brian Schnell, *System Change: The Role of the Franchise Agreement* (Nov. 7, 2014). Hashim and Schnell also posted the following installment on collaboration: *What Does Successful Franchise Collaboration Look Like?* (June 27, 2014).

123. From a franchisee perspective, franchisors would be much better served by making sure whatever group they consult with is independent, or at least not a "hand-picked" group of

if the franchise agreement does not require franchisee input. In other words, even if not contractually required, many successful franchisors seek and value franchisee input on system-change matters;

(2) Franchisors will use some form of test or pilot program regarding proposed changes before they roll them out system-wide. The test or pilot program typically includes some combination of corporate and franchise locations;

(3) Some franchisors do have FAC language in their franchise agreement where they commit to discuss system change. Here is one example:

> *Franchisor's executive team will meet with the FAC (in-person or through conference call) to discuss issues of system-wide importance. These meetings will occur on at least a quarterly basis.*

Based on our mutual experience, here are a few other best-practice tips for the modified business judgment rule plus collaboration approach:

- *System Standards: The Cornerstone of Any Franchise System*. System standards define a franchisor and illustrate to the outside world the core principles of the franchise brand and can separate a franchisor and its franchisees from their competition. By protecting system standards, a franchisor protects the investment of the franchisor and franchisees and ensures the future of the franchise system. Successful franchisors develop, maintain, modify, and enforce system standards effectively and consistently with the appropriate balance of establishing the standards but not unnecessarily mandating the manner and means of meeting the standards. Further, the most highly successful systems create a culture where the franchisees have helped forge, and will defend, these principles in their execution of their independently owned and operated businesses. The franchisor and the franchisees are brothers and sisters in arms in protection of the brand but also understand the differences in their roles and responsibilities.

- *Compliance Is Less About Inspections and More About Providing Effective Leadership in the Franchisee Community*. Changing or upgrading system standards must be grounded in a "reasoned factual basis" rather than a whim. Franchisors should thoroughly evaluate the impact of the proposed changes, including the impact on profitability at the unit level, and lead by example in any company-owned locations. Franchisors should also test and refine any proposed changes in limited franchisee-owned locations. Because any change in system standards will have an impact on franchisees' operations and bottom line, franchisors should

favored franchisees (who will be perceived as a group that simply agrees with the franchisor changes without any debate or dialogue). That sort of consultation will often quickly be dismissed by the franchisees-at-large as merely a rubber stamp.

explain the business reasons that necessitate or are driving the change. In addition, franchisors should measure the result of significant changes in system standards by looking at same-store sales or similar outcome-based measures. Franchisors that have taken this approach and involved franchisees, their FAC, or an independent franchisee association in developing the standards have experienced far greater success with franchisees embracing system standards.

- *Resell the Franchise*. Do not just announce a system standard or system change. Clearly communicate system standards to franchisees, including reiterating the importance of such standards. Ideally, use influential franchisees that have shared in the testing of the standards to help make and sell the announcement. Above all else, resell the franchise to reluctant franchisees: illustrate why franchisees should want to do everything possible to benefit their businesses and the brand. The bottom line is that a franchisor must manage franchisees' perceptions on an ongoing basis.

- *Show the Franchisees the Franchisor Cares: Listen to Their View*. Listen carefully to any concerns or objections franchisees raise. Understand and address their issues and concerns. Don't hesitate to provide assistance as franchisees work through compliance issues. Some options are:
    1. Develop roll-out programs and timetables;
    2. Get a handle on costs associated with changes and communicate them to franchisees (and, when appropriate, make accommodations for terms or other direct or indirect financial support); and
    3. Bounce ideas off the FAC, an association, a franchisee focus group, and/or other influential franchisee leaders.

- *Approach System Standards Enforcement Creatively*. The written agreement is one of the last places a franchisor should turn to in an attempt to force compliance with system standards. Instead, encourage reluctant franchisees to voluntarily comply with standards by employing the persuasive powers of influential franchisees who have voluntarily complied and who can tout the benefits of the system standards. Collaboration is about finding ways to get as many as possible to come along. Except for instances like health or safety risks, all avenues of persuasion should be exhausted before a franchisor pursues default and/or termination.

- *Survey Says*. Conduct a customer satisfaction survey and share the results with the franchisees. Utilize feedback from the franchisee's own customer base to illustrate the necessity of the system standard change and the positive effect it will have on the franchisee's business. (And don't simply disregard a survey that suggests otherwise. If it shows the major system change doesn't really matter to the customer, that may mean a re-evaluation of the initiative is in order.) One other approach is to use a mystery shopper program. It will be hard for a franchisee to argue with the importance of system standard changes or upgrades when presented with direct evidence from the franchisee's customer base.

- *Minimize Subjective Enforcement.* Demand that everyone on the franchisor's team is on the same page when it comes to communicating and enforcing system standards. Mixed messages from franchisor personnel or different levels of enforcement frustrate franchisees and can lead to difficulties with enforcement. Develop—ideally with franchisee buy-in and input—a straightforward evaluation process with the support of the franchisees, and establish routines for franchisees to follow that enhance the opportunity for positive results and evaluations.

- *Too Late to Communicate? Never.* When it comes to system standards, remember that it is never too late to communicate. Effective communication can overcome many potential issues. Further, to avoid any argument that the franchisor waived its right to demand compliance with the system standard, the franchisor should provide the franchisee with clear and conspicuous notice of its existence and enforcement.

- *Be Prepared to Remove Free-Riding Franchisees or Franchisees Who Don't Play by the Rules.* For reluctant franchisees, sometimes the best (but not necessarily the easiest) solution is to end the franchise relationship. Once the vision between franchisor and franchisee ceases to be aligned or the trust no longer exists and all reasonable avenues of reconstruction of the relationship have been exhausted, the franchise relationship likely has passed the point of no return. Neither party should simply "hope" things will change. Hope is not a strategy. Finding viable exit strategies for both parties is far better than resorting to litigation to resolve disputes.

The bottom line is that franchisees understand the need to implement change and evolve the franchise system to meet the ever-changing needs of customers and remain competitive in the marketplace. Their fear, though, is that franchisors will mandate changes without properly testing or piloting them; without taking into account the franchisees' return on investment in implementing and executing the changes; and without any meaningful input from the franchisees on what these changes should look like on an individual case basis. The issue, therefore, is not necessarily the change itself, but how it is formulated, communicated, and implemented. The key isn't necessarily what language is included in the franchise agreement; highly successful franchise systems and struggling franchise systems often have very similar franchise agreements. Rather, the differentiator is how a franchisor designs and implements system change. Given that dynamic, it is reasonable to assert that the franchise agreement often is not the problem. But with the current state of affairs in this new era of franchising, the franchise agreement will be subject to greater degrees of scrutiny. In fact, no one should be surprised if more prospective franchisees begin to take notice of key contract provisions like the franchisor's right to make system change and whether that right is unlimited or limited in some manner, a franchisor's use of the business judgment rule, or its commitment to collaboration.

We hope that to this point it is clear that we mutually believe a culture of collaboration is essential. And, as you can see above, we think the business strategies to start this change are identifiable and achievable. As lawyers, however, we know the devil is clearly in the details. Despite the fact that we have noted the importance of the franchise agreement throughout, we have yet to be able to agree on how this "culture" should be captured in a contractual clause. Accordingly, we are sharing our best individual efforts for your consideration.

From a franchisor perspective, one option for the modified business judgment rule is simply to recognize in the franchise agreement that a franchisor will consider franchisee input in its decision-making process as further noted in the italicized language below (which is added to the reasonable business judgment language included in Part I):

> *Our Reasonable Business Judgment*. Whenever we reserve discretion in a particular area or where we agree to exercise our rights reasonably or in good faith, we will satisfy our obligations whenever we exercise reasonable business judgment in making our decision or exercising our rights. Our decisions or actions will be deemed to be the result of reasonable business judgment, even if other reasonable or even arguably preferable alternatives are available, if our decision or action is intended, in whole or significant part, to promote or benefit the franchise system generally, even if the decision or action also promotes our financial or other individual interest. Examples of items that will promote or benefit the franchise system include, without limitation, enhancing the value of the trademarks, improving customer service and satisfaction, improving product quality, improving uniformity, enhancing or encouraging modernization and improving the competitive position of the franchise system. *We also recognize that in certain instances as we deem appropriate franchisee input will be one of the factors we consider in making our decisions or exercising our rights.*

One final takeaway for a franchisor who is considering making changes to its franchise agreement is that any change should be intentional, thoughtful, and informed by a nuanced understanding of (1) the history, legacy, and current state of affairs in that particular franchise system and the impact that any changes will have on the future opportunities and challenges for the system; (2) any potential impact the change has on the franchisor's right to make change to grow, evolve, and protect the brand; (3) how the change reflects appropriate and "make a difference" collaboration; and (4) how a franchisee might use that provision in a lawsuit against the franchisor (and vice versa). For example, a franchisee litigator could argue that a franchisor has certain duties and obligations regarding system change based on the language included in the preceding paragraph; a franchisor should clearly understand and be prepared to address those arguments appropriately.

Franchisees want to see a stronger commitment to getting franchisee involvement or insight as noted below in italics, especially as it relates to system change:

> *Our Reasonable Business Judgment.* Whenever we reserve discretion in a particular area or where we agree to exercise our rights reasonably or in good faith, we will satisfy our obligations whenever we exercise reasonable business judgment in making our decision or exercising our rights. Our decisions or actions will be deemed to be the result of reasonable business judgment, even if other reasonable or even arguably preferable alternatives are available, if our decision or action is intended, in whole or significant part, to promote or benefit the franchise system generally (even if the decision or action also promotes our financial or other individual interest), *as long as we involve our franchisee community in the decision-making process. (We may outline the manner of franchisee involvement in the Operations Manual or other franchisee communication.) In exchange for participation by franchisees in these decisions, you agree that we have the right to make a final decision to modify, add to, or rescind any requirement, standard, or specification that we prescribe under this Agreement to adapt the System to changing conditions, competitive circumstances, business strategies, business practices and technological innovations, and other changes. Assuming we have met our obligation to involve the franchisee community in the decision-making process, you must comply with these modifications, additions, or rescissions at your expense, subject to any express limitations as stated in this Agreement. All modifications, innovations, and improvements to the System become our property regardless of who developed the modification, innovation, or improvement.*

From the franchisee perspective, no franchisor should simply adopt changes to its franchise agreement without consultation with its franchise council (i.e., FAC, association, or otherwise) and careful consideration of all the various pressure points and how that language will stand the test of time.

VI. Finding Common Ground

As franchisors continue to recruit more sophisticated and qualified franchisees, these franchisees can fuel sustainable growth that, if done properly, can result in a franchise system and brand outpacing their competitors. Franchisors that recognize and proactively address this changing landscape should benefit compared to franchisors that sit on the sidelines or wait and react too late to change. These more sophisticated and qualified franchisees likely will take into account not only critical factors like unit level profitability, but they also will take a closer look at specific terms of a franchisor's franchise agreement and whether that franchise agreement reflects an attitude of collaboration in ways that they will find meaningful. This key point also underscores the importance of culture, collaboration, and attitude in the franchise relationship because these factors will be increasingly more important going forward as franchisors and franchisees must work together on critical issues like the recent NLRB "joint employer" developments[124] and other external forces impacting franchising, as well as unit level profitability. The bottom line is that effective collaboration should help, not hurt, if it is done in the most effective manner and on the right issues that make the biggest difference in franchising that recognize and reinforce the key roles and responsibilities of the franchisor and franchisee.

Franchisors should ask whether their current franchise agreement is conducive toward recruiting and retaining multi-unit franchisees or other franchisees that will become key stakeholders in taking the brand and system to the next level. Franchisors who think they can do it on their own without getting the right franchisees fully engaged in delivering on the brand promise will struggle. Franchisors who are willing to explore ways to enhance franchisee engagement and do so without compromising their ability to grow, protect, and evolve the brand will have a distinct competitive advantage. Rather than simply relying on the franchise agreement it has used for years, a franchisor should at least consider the opportunity to provide more balance in some key provisions in the franchise agreement. For some franchisors, change toward more balance in some key provisions may make sense. For other franchisors, change may not make sense. For many multi-unit and sophisticated franchisees, it may make a difference in their decision to join a system. That is the beauty of franchising. There is no one approach or one answer. One size does not fit all.

Our mutual request is that franchisors take a constructive look at their franchise agreements. They should consider how the franchisor and its franchisees interact and collaborate with one another and whether the system focus is on the brand and brand customers. Highly successful franchisors include franchisees in conversations regarding system-wide decisions, value franchisee input, and do not mind productive difference of opinion, all of

124. On August 27, 2015, a divided (three-to-two) National Labor Relations Board changed the standard for joint employment under the National Labor Relations Act (NLRA) in its forty-nine page decision in *Browning-Ferris Industries of California, Inc.*, 362 NLRB No. 186 (Aug. 27, 2015). Through this ruling, the NLRB has dramatically expanded the joint employer standard beyond requiring *actual* exercise of direct and immediate control over workers, and instead makes the mere *right* to control, even if that right is never exercised, sufficient to establish a joint employment relationship. This decision represents a significant departure from existing precedent and substantially expands the likelihood that certain companies, such as those that use labor from staffing agencies or those that are franchisors, will be deemed "joint employers" with the staffing agencies and franchisees that actually employ the workers. Notably, how the *Browning-Ferris* decision will impact franchising likely will not be known for months as the cases against McDonald's proceed through the NLRB process (*see supra* note 66) and will be the subject of considerable debate among all stakeholders in franchising.

which creates a sense of shared vision while still reserving their rights as franchisors to make system-wide decisions. These franchisors explain their decisions in the spirit of consensus building, rather than simply saying, "I can make this decision because I am the franchisor and you must comply because you are the franchisee." The franchise agreement then permits the franchisor to protect the brand, typically with the blessing and consent of its vision-sharing franchisees, if free-riding franchisees refuse to play by the rules. When this assessment and conversation is done in a meaningful and productive way, the results will be a stronger foundation on which the parties can build something that is sustainable for all stakeholders.

Finally, let us conclude with some examples of how certain franchise agreement provisions might be more collaborative.[125] In discussion with their franchisees and legal and other professional advisors, franchisors may determine that none or some of these points make sense for their system, or they may address the points outside of the franchise agreement. Franchisees also likely will continue to push harder on these examples. The key is for a franchisor to engage in the discussion (keeping in mind the points identified in Part V regarding an intentional, thoughtful, and informed approach) and then make decisions that work for them, their brand, and where they are at in the growth and evolution of their franchise system, rather than simply not engage in the discussion at all:

1. Understand the franchisee's emotional and financial investment in the brand and make that understanding explicit in some way. In so doing, consider how that investment should be recognized beyond simply a license to use the franchisor's trademarks and system. Treat franchisees as stakeholders in the brand—they deserve respect and ongoing transparency into a franchisor's decision-making process in areas that impact unit level profitability or overall brand performance (e.g., How was the decision made? What was the motivation for the decision? What considerations were made with respect to the concerns expressed by franchisees?);

2. Have franchisee profitability as a pillar of brand decision-making. Policies that enrich only the franchisor through sales increases, without regard to the impact on franchisees, will not be sustainable in the long run. In fact, almost nothing will hurt an otherwise well-developed brand (with committed franchisees) more than decisions that are made that maximize franchisor revenue at the cost of franchisee margin;

125. Several of these suggestions also appear in an article authored by Aziz Hashim and Brian Schnell, *A New Era in Franchising Continues to Emerge: Should a More Balanced Franchise Agreement Play a Role*, Franchising World (Apr. 22, 2014), *available at* http://franchisingworld.com/a-new-era-in-franchising-continues-to-emerge-should-a-more-balanced-franchise-agreement-play-a-role/.

3. Allow franchisees an opportunity to monetize their equity. If franchisees can't see the franchisor's way as the right way, allow them to move on by including reasonable transfer provisions and designing a proactive franchise resale program;
4. Make it explicit from the outset that there may be few or no post-term rights (because of the non-compete and related restrictions in the franchise agreement) so that franchisees understand, before they invest, that a certain level of return on their investment may not be realized if they do not plan appropriately;
5. Allow the franchisees to manage their risk. Unlimited personal guaranties, post-term guarantees, and guarantees of future assignees can create significant contingent liabilities. Minimize the use of these tools by instead creating limited guaranties in appropriate circumstances as to duration, scope, and cost that fulfill the franchisor's legitimate needs;
6. Commit to some level of franchisee consultation on material issues that have a system-wide impact. Listen to that consultation and be guided, but not controlled, by what is learned;
7. Examine the impact of supply chain decisions on unit profitability and determine ways to be transparent about sources of revenue from the supply chain;
8. Have reasonable exit provisions if the business doesn't perform even though the franchisee has done all the right things in trying to grow the business. If a franchisee fails and the franchisor believes the location/territory is viable, consider whether the franchisor might be in a position to take the unit back and resell it. If the location/territory isn't viable, consider a reasonable liquidated damages provision that will allow the franchisee to pay something to avoid a long-term losing investment;
9. If appropriate, offer practical territorial protections for the particular business being franchised;
10. Commit to franchisee engagement in the franchise agreement through reference to meeting with franchise advisory councils or franchisee associations; and/or
11. Use the operations manual appropriately. Some franchisors use the operations manual to make policy changes because they cannot make the change through the franchise agreement. Such an approach will frequently lead to unhealthy tension and, often, litigation. Unless

a franchisor wants to be a test case for the business judgment rule and how far courts will take it, we do not recommend this tactic.

Keep in mind we are not suggesting that a franchise system must or even should address all of these points in its franchise agreement. We are suggesting that a franchisor should consider whether one or more of these points deserve attention beyond perhaps the way they have been addressed in the past. Whether these points are addressed within (clearly a franchisee's perspective) or outside the franchise agreement is not as important as franchisors and franchisees having meaningful conversations, alignment, and direction on whatever are the key drivers or pressure points in their franchise system.

In the end, neither the historical covenant of good faith and fair dealing nor the business judgment rule can always serve the successful franchise system well. If franchisors and franchisees cannot find a way to collaborate, the authors clearly disagree on which of these standards may better protect the rights of the parties. But our agreement is stronger than our disagreement: when it comes to critical areas that will make a difference to the overall success of the franchisor and franchisees (like changing system standards), a franchisor and its franchisees should eschew conflict for meaningful collaboration, based on mutual respect and an understanding and acceptance of limitations, challenges, and opportunities both parties face in transforming the brand.