The Evolution of the Species: Successfully Managing Franchise System Change

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It is not the strongest of the species that survive, nor the most intelligent, but the one most responsive to change.—Charles Darwin

Darwin's theory of natural selection posits that as environmental conditions change, species adapt by the survival and proliferation of those that have the most favorable characteristics for the given conditions. Through the slow process of inherited characteristics and natural selection, species evolve over generations.[1]

In modern business, of course, change happens much more rapidly. The natural selection process, operating at warp speed, can blow previously successful enterprises off the road if they neglect to evolve, and franchise systems are no exception. To prosper long-term, franchisors must adapt to changing demographics, consumer preferences, competitors, and technology by modifying their business concepts, operating procedures, products, and services. Moreover, successful adaptation can never be the product of franchisor fiat; it requires the active cooperation of franchisees, which can often be difficult to obtain.

Consumers frequently want something new and different, but franchisees entering long-term franchise agreements may assume that the concept and products will remain substantially the same for the life of the contract. This servicing of two constituencies, i.e., consumers and franchisees, often places franchisors in the difficult position of seeking to improve the system by implementing changes that consumers desire but franchisees resist.

For franchisors, therefore, survival requires not only the ability to adapt to changing environments, but also the skill of justifying to franchisees change and its accompanying costs and disruption. When system changes either do not improve or, in the worst case, substantially harm a franchisee's financial position, the franchisor may face not only resistance, but also a variety of claims, including charges that it (1) fundamentally altered the original system, thereby breaching the franchise agreement or the implied covenant of good faith and fair dealing, or (2) violated the franchisee's statutory protections.

Nevertheless, successful franchisors have no choice but to continually adapt their systems to evolving circumstances. In a marketplace that can shift quickly from low-fat to low-carbohydrate diets and from the importance of personal attention to the ease of e-commerce, no business can cling too tightly to tradition without sacrificing market share and eventually jeopardizing its existence. Careful planning and thoughtful implementation increase the benefits and decrease the risks of adaptation. This article will survey cases addressing a variety of system change issues and offer recommendations to help franchisors gain franchisee support, avoid claims, and protect themselves if litigation ensues.

A Few Basic Principles

Despite the risks in implementing system change, franchisors should take some comfort in the legal system, which generally supports a franchisor's right to modify its system in response to market forces. For all the changes in logos, menus, marketing strategies, and unit designs and sizes that have occurred in countless franchise systems over the years, there are few reported cases directly addressing challenges to systemwide changes, and most of these have upheld the franchisor's right to adapt and improve its system.

A review of this precedent yields two generally dispositive principles. First, a franchisor cannot breach a franchise agreement by acting according to its express terms. When franchisees have claimed that system changes breached their franchise agreements, franchisors have generally prevailed by relying on the express franchise agreement reservation of rights, allowing a franchisor to change the system in its sole discretion and as may be required from time to time. The franchise agreement language reserving the franchisor's right to modify the concept is often the deciding factor in resolving breach of contract claims through summary judgment. A warning, however: Whatever the contract may say, absolute discretion rarely exists in the real world. Accordingly, if they want to defeat system change claims, franchisors exercising discretion under their franchise agreements should act with commercially reasonable, not arbitrary or capricious, business judgment.

Second, the law does not require a franchisor to guarantee the success of its strategy. Mistakes and misjudgments are part of business, and a failed strategy alone does not prove franchisor liability. If a franchisor can demonstrate that it had a reasonable basis for changing its system and reasonably believed that the changes would benefit the system, most courts are unwilling to second-guess that business judgment, whatever its consequences might have been for a particular franchisee.[2]

Franchisee protection statutes, however, may create an exception to this rule. In New Jersey, for instance, the franchise relationship statute provides powerful support for a franchisee's claims that system change has violated its rights.[3] Under the statute, discussed in more detail below, franchisors cannot require franchisees to execute renewal contracts with substantially different terms, and franchisors are prohibited from requiring an "unreasonable standard of performance."[4] When dealing with any franchisee protected by a franchise relationship statute, franchisors should be

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mindful of any overriding statutory restrictions on their express contractual rights.

The Franchise Agreement

The terms of the franchise agreement are a threshold consideration in any potential system change. To state the obvious, before altering a franchise system in any material way, a franchisor should first confirm that its franchise agreements authorize the proposed modification. At a minimum, the franchise agreement should acknowledge the franchisor's right to modify the system from time to time. Because the franchise agreement establishes the parties' obligations, a franchisor looking to require substantial new action by, and to impose significant new costs on, franchisees should be comfortable that the contract supports its plan.

In *Carlock v. Pillsbury Co.*, an ice cream shop franchisor used the language of its agreement to defeat a challenge to its decision to distribute its products through competing outlets.[5] According to the sixteen franchisee-plaintiffs, the franchisor's sale of ice cream pints in convenience stores and supermarkets breached their franchise agreements and the implied covenant of good faith and fair dealing. The franchisees relied on franchise agreement recitals stating that "[f]ranchisor has created unique products of the highest quality, sold in the finest establishments."[6] The franchisees claimed that this language imposed an obligation on Haagen-Dazs (and its parent company Pillsbury) to sell its products only through upscale outlets. The franchisees alleged that Haagen-Dazs breached this provision through its mass distribution of pints in a variety of markets and that but for this breach, the franchisees would not have suffered the losses that market saturation of Haagen-Dazs products allegedly caused.[7]

The Minnesota federal court rejected the franchisees' contract claim for two reasons. First, Judge MacLaughlin concluded that the language in the recitals was merely precatory, designed to establish the franchisor's efforts to build goodwill. Second, the court held that the franchisees' position directly conflicted with the express language of the franchise agreement, which reserved for the franchisor the right to distribute its product through any channels that might be established. The contract provided thus:

> Franchisee acknowledges and agrees that the Franchisor and the Haagen-Dazs trademark owner has the right and may distribute products identified by the Haagen-Dazs trademarks not only through Haagen-Dazs shoppes but through any other distribution method which may from time to time be established.[8]

Based on the franchisor's right to distribute the product via any method it chose and notwithstanding evidence that the franchisor ignored the impact of the pint sales on franchised stores, the court held that the franchisor did not breach the franchise agreement. Judge MacLaughlin also dismissed the franchisees' claim that Haagen-Dazs's marketing of its product breached the implied covenant of good faith and fair dealing because that claim directly conflicted with the express terms of the franchise agreement.[9]

Carvel Corp. v. Baker demonstrates how specific contract language can decide the outcome of a breach of contract action over system change. In *Baker,* the plaintiff franchisees claimed that Carvel's supermarket program breached the express terms of their franchise agreements and the implied covenant of good faith and fair dealing.[10] In 1992, despite earlier statements that supermarkets were the company's "enemy," Carvel began a test program selling its products in branded supermarket freezers to examine whether customers would purchase Carvel products in supermarkets. After some success with the program, Carvel offered its franchisees the opportunity to service local supermarket accounts as route dealers for an additional investment of $34,500 to $65,000.[11] Certain franchisees claimed that they could not afford the route dealer fees and sued Carvel for injunctive relief and damages.

Unfortunately for Carvel, its franchise agreements did not all contain the express reservation of rights that worked for Haagen-Dazs in *Carlock.* There were two versions of the Carvel franchise agreement. The earlier, from 1984, granted the franchisee a limited license to manufacture Carvel products and to use Carvel's trademarks, and it said that "[a]ll other rights in and to the names 'Carvel' and the Carvel trademarks are reserved to Carvel as the owner of that name and those trademarks."[12] The 1984 agreement also provided, however, that as long as the franchisee complied with the contract, Carvel would not establish another Carvel retail unit on the same street for one-quarter mile in either direction.

In 1992, the same year that it launched the supermarket program, Carvel developed a new franchise agreement, which expressly recognized Carvel's right to pursue alternative distribution:

> The license granted to Licensee is non-exclusive, and Carvel, in its sole and absolute discretion, has the right (i) to grant other licenses in, to and under the Carvel trademarks in addition to those already granted, both within and outside Licensee's trading area, (ii) to develop and license other names and trademarks on any such terms and conditions as Carvel deems appropriate, and (iii) to sell or license to sell products under Carvel trademarks or otherwise through the same or different delivery systems or other distribution channels or concepts.[13]

Carvel moved for summary judgment in *Baker*, arguing that the supermarket program did not violate either generation of the franchise agreement because (1) the supermarket freezers were not "Carvel stores" within a quarter mile of any franchisee and therefore complied with the 1984 agreement, and (2) the 1992 agreement specifically authorized supermarket distribution. Chief Judge Covello of the Connecticut federal court agreed that the 1992 agreement "unambiguously allows Carvel to implement the supermarket program" but reasoned that Carvel had not framed its argument on the 1984 agreement correctly.[14] To obtain summary judgment, the court said, Carvel had to show that the 1984 agreement expressly authorized the supermarket program; it could not merely argue that the program did not violate the agreement's express terms. The court concluded that whether the 1984 agreement reservation of rights permitted Carvel's new distribution was a disputed material fact for the jury to decide, and it therefore granted summary judgment on the franchisees' breach of contract claims for the 1992 agreement only.[15]

Economou v. Physicians Weight Loss Centers of America also illustrates the critical importance of the franchise agreement terms in defending claims arising from system change.[16] There, terminated franchisees moved to enjoin a diet center franchisor from enforcing its covenants not to compete; the franchisees argued that the franchisor allegedly breached the agreements by modifying the diet offered through the franchise system. The Ohio federal court held that the franchise agreement authorized the franchisor to change its system for the benefit of the public.

When the plaintiff-franchisees first joined the system, Physicians Weight Loss Centers of America (PWLC) offered a 700-calorie diet known as the "very-low-calorie diet," which guaranteed its clients a five- to seven-pound weekly weight loss. In 1989, after a report questioned the safety of this diet, PWLC developed a Dieter's Information Sheet, which detailed the health risks associated with a low-calorie diet, including temporary hair loss, lightheadedness or fainting during physical activity, and susceptibility to easy bruising.[17] Although franchisees knew these risks from franchisor-sponsored education programs, they claimed that the required disclosure of this information to clients substantially decreased their sales in 1989. PWLC later introduced a 900-calorie diet that ultimately promised a weekly weight loss of only two pounds. The franchisees asserted that the change in diets and decrease in the weight-loss guarantee resulted in customer dissatisfaction and a dramatic decrease in sales.[18]

The Ohio federal court held that PWLC's distribution of the Dietary Information Sheet did not breach the franchise agreement because the franchisees failed to show any causal relationship between the information sheet and their decline in sales. Judge Bell also reasoned that PWLC did not breach the franchise agreement through its efforts to inform customers for their own protection about the diet's potential side effects. The franchise agreement provided as follows:

> Franchisor reserves the right to modify or change the System, Marks the various training programs offered to Franchisees and their employees, and the Manuals at any time, . . . and such modification shall be made in the sole judgment of Franchisor to protect Franchisor Marks and goodwill, to comply with any applicable law, statutes or judicial or administrative decision, or to improve the quality of services, training or products offered.[19]

Based on this explicit right to modify the system and products, the court held that the franchise agreement authorized PWLC to change its dietary products, including the very-low-calorie diet, and this express contract term defeated the franchisees' breach of contract claims.[20]

Increasing Franchisee Costs

Franchisors sometimes decide to require franchisees and developers to open larger, more expensive, and more complicated-to-operate units than were previously the norm. When franchisees or developers are subject, upon penalty of termination, to contractually established development targets, such changes may cause substantial friction because they make those targets harder to hit or impose significant new costs that the franchisee or developer did not contemplate when entering its agreement. Under these circumstances, claims for breach of contract and breach of the implied covenant of good faith and fair dealing will hardly be a surprise, and well-drafted agreements are essential tools in the franchisor's defense.

In *TLH International v. Au Bon Pain Franchising Corp.*, an Au Bon Pain franchisee sued the franchisor for fraud, alleging that the franchisor misrepresented store construction costs, management costs, profitability, and store size.[21] The franchisee claimed that Au Bon Pain's materials misrepresented that an "average retail shop requires only 950 square feet of space"; the franchisee's shops averaged 1,700 square feet.[22] The franchisee also contended that Au Bon Pain presented the concept as a "small bakery/café atmosphere specifically designed to avoid the larger restaurant concept of Vie de France, its only competitor."[23] According to the franchisee, by 1982, Au Bon Pain knew or should have known that its franchisees would be required to open larger restaurant facilities and that its representations regarding the smaller cafés were untrue.

The Massachusetts federal court rejected the franchisee's arguments and dismissed all counts against Au Bon Pain. First, Judge Mazzone held that Au Bon Pain's offering circular represented that store sizes ranged from 400 to 1,200 square feet, not 950 square feet as the plaintiff alleged. Even considering that this range was substantially less than the area of the franchisee's stores, the court did not see any fraud, reasoning that the figures were estimates and that the franchisee's inability to meet those estimates did not require a finding of fraud.[24]

As for the change in the marketing concept, the court concluded that nothing in the complaint indicated that Au Bon Pain's decision to change to larger restaurant facilities in July 1982 made its earlier statements about the concept fraudulent, especially because the development agreement specifically provided that the marketing concept and system "may be changed, improved, and further developed by franchisor from time to time."[25]

Finally, the franchisee claimed that Au Bon Pain misrepresented the franchisee's ability to develop twenty-two stores in five years and that the system changes made these development obligations "inherently impossible."[26] To Judge Mazzone, however, the complaint revealed only a failed business venture with no guarantees by the franchisor:

> Here again, the plaintiff may be choosing to ignore its own inability to correctly assess and carry out a business program and seeks to characterize its own shortcomings as a fraud perpetrated upon it by the defendants. It would be a rare opportunity which could guarantee the expansion described and it would be a rather naïve franchisee who believed the statements were a guarantee.[27]

As *TLH International* illustrates, system changes can be particularly troublesome when franchisees and developers are required to open units that cost more than, or otherwise substantially differ from, the concept offered when they joined the system. In 1998, Arby's faced a similar problem when it commissioned a new freestanding building design called the Pinnacle and required all new restaurants to be developed as Pinnacle buildings.[28] In 1999, an Arby's developer in Tennessee, who had committed to open a specific number of Arby's restaurants, sought a declaratory judgment that Arby's could not require him to use the Pinnacle design in his new units. The developer argued that the new requirement breached the development agreement and the implied covenant of good faith and fair dealing because (1) it would force the developer to abandon established goodwill by using a design inconsistent with the developer's fourteen existing Arby's restaurants; (2) the new design was more expensive to construct; and (3) Arby's was using this requirement to drive the developer from the system.[29]

In *Johnson v. Arby's, Inc.*,[30] Magistrate Judge Murrian of the Tennessee federal court relied on the language of the development agreement to hold that the modification of the building design and requirement that all new restaurants incorporate the design did not breach the agreement or the duty to act in good faith.[31] Because the development agreement expressly authorized Arby's to vary its building design requirements, the court concluded that the franchisor's exercise of its right to modify these specifications was not a breach. The agreement said:

> Arby's reserves the right in its sole discretion to vary its specifications, standards and operating practices and requirements among Licensees, including, without limitation, those relating to building, equipment, signage, operations and Licensed Products. Arby's may impose such variations to address differing or unique circumstances or for other reasons Arby's, in its sole discretion, deems good and sufficient. Licensee understands and acknowledges that such variations may lead to different costs or obligations among Licensees.[32]

The court also held that the developer's obligation to comply with the operations manual, as revised to require new restaurants to be developed in the Pinnacle design, provided further evidence that Arby's did not breach the contract or any implied duty. The court therefore granted Arby's summary judgment, explaining that "[t]he performance of a contract according to its terms cannot be characterized as bad faith."[33]

As these decisions reflect, franchise and development agreements that reserve a franchisor's right to change its system in every respect and that require compliance with operations manual changes give franchisors significant protection from franchisee claims that system changes breached the agreement or the duty to act in good faith.

Mergers and Acquisitions

A franchisor's decision to merge with or acquire a competing system can involve a complex analysis of the potential for conflict with franchisees of both systems. Encroachment and conversion disputes often follow these transactions, but other challenges may also arise from the franchisor's efforts to market the merged systems and distinguish them from each other. Again, the language of the franchise agreement, coupled with a showing of good faith business decisions, provides the best defense to any claims.

In *Clark v. America's Favorite Chicken Co.,* Popeye's Fried Chicken franchisees from Detroit, Michigan, sued their franchisor, America's Favorite Chicken Company (AFC), over changes associated with the acquisition of franchise rights for Popeye's competitor, Church's Fried Chicken.[34] In 1989, AFC's predecessor purchased the Church's chain and immediately formulated a marketing strategy to maximize sales for the two systems. The Strategic Realignment Plan, as it was called, created separate marketing strategies focused on the historic demographic differences between the chains. Church's advertising concentrated on value, targeting the "low-end" chicken market in lower-income urban areas. Popeye's, on the other hand, aimed at suburban and higher-end urban areas by promoting its high quality and unique products.

Before the acquisition, plaintiffs opened nine Popeye's restaurants in lower-income urban areas in close proximity to existing Church's restaurants. In 1996, plaintiffs sued AFC for breach of contract, breach of the implied covenant of good faith and fair dealing, violation of the Louisiana Unfair Trade Practices and Consumer Protection Act, promissory estoppel, tortious interference, and abuse of rights. Plaintiffs alleged that the new marketing strategy hurt their businesses because it prevented them from advertising less expensive "dark meat only" meals. The district court granted AFC summary judgment on all claims.[35]

The U.S. Court of Appeals for the Fifth Circuit affirmed after examining the terms of the plaintiffs' contracts. In the Popeye's franchise agreements, the franchisor expressly reserved the right to acquire a competing franchise system. It also reserved the right to administer the national advertising program in its sole discretion and for the benefit of the Popeye's system as a whole, without regard to individual franchisees. Concluding that the franchisor simply acted in accordance with the franchise agreement terms, Judge Davis wrote for a unanimous panel that the franchisees' claim that the advertising made them less competitive did not establish bad faith: "If, as the franchise agreements make clear, AFC retains the right to develop and establish competing franchise systems, it cannot be a breach of good faith or fair dealing for it to adopt an effective marketing strategy for operating those systems."[36] Because the franchisees failed to show that the franchisor intended to injure or actually injured the Popeye's system as a whole with its marketing strategy, the franchisor prevailed.[37]

Course of Dealing

Although franchise agreement language is a paramount consideration in effecting any system change, a franchisor must consider other factors as well, including whether it has previously exercised its rights under the franchise agreement in such a way as to create a potentially binding course of dealing between the parties. In *Montgomery Mall Service, Inc. v. Motiva Enterprises, Inc.,* the Maryland federal court proved that no franchisor can be too confident in its contract language when courts are left to interpret the contract and the parties' reasonable expectations.[38]

In a series of contracts with the plaintiff gasoline dealer, Motiva, a Texaco subsidiary, reserved the right to set gasoline prices and to change the prices from time to time. Early in the parties' relationship, Motiva fixed its dealer wholesale prices countywide, charging every dealer within a particular county the same tank wagon price. In 1998, Motiva instituted "zone pricing," which set wholesale prices more narrowly based on the retail street price charged in the dealer's designated zone. The plaintiff dealer alleged that the new zone pricing structure caused him to have the highest gasoline prices of any Texaco dealer in his county and to lose customers and revenue.[39]

Reviewing the dealer's claims against Motiva, the court held that the dealer failed to show that Motiva engaged in any illegal price-fixing by setting its wholesale gasoline prices for Texaco dealers more narrowly. The court also acknowledged that Motiva had the express contractual right to establish wholesale prices. Because Motiva acted precisely according to the contract terms in setting the dealer's prices, this express right, under the reasoning of *Carlock* and *Baker,* would have defeated the dealer's claim that Motiva breached the agreement.

Nevertheless, based on the dealer's argument that the change to zone pricing breached the parties' course of dealing, Judge Chasanow denied Motiva's motion to dismiss the breach of contract and implied covenant of good faith and fair dealing claims,. According to the dealer, his prior course of dealing with Motiva established an agreement that the supplier would establish the same price for the entire county. The court acknowledged that the parties' contract contained an "unqualified open price term" but ruled that the way the supplier exercised its rights in the past might restrict its reserved rights and, more importantly, its right to change its system.[40]

Although *Motiva* may be restricted to its facts, the holding is a warning to franchisors planning to rely solely on express contract language. Essentially, the court held that despite the express reservation of rights in a contract, a party's failure to exercise its reserved rights in a particular way may affect its ability to rely on them in the future. Applied to the reservation of rights to modify a franchise system, this analysis could restrict a franchisor from changing its system if the parties had not anticipated the proposed change based on their earlier dealings. Of course, holding that a course of dealing could trump a contract provision specifically designed to preserve the right to change (i.e., to depart from the prior course of dealing) would seem to reverse the parties' actual bargain. But franchisors should be aware that a course-of-dealing argument allowed at least one dealer to avoid dismissal of his challenge to the supplier's altered practice.

Duty to Act in Good Faith

Another limitation on a franchisor's right to exercise its express rights is the duty to act in good faith. Many courts dealing with claims that a system change violated the implied covenant simply ask whether the contract authorized the franchisor's decision,[41] but others investigate whether the franchisor's exercise of discretion, expressly permitted by the franchise agreement, was reasonable under the circumstances. The court in *Baker* (discussed above) held that Carvel's 1992 franchise agreement authorized the franchisor's distribution through supermarkets and entered summary judgment on the franchisees' breach of contract claims.[42] In its motion for summary judgment, Carvel argued that it was also entitled to judgment on the franchisees' implied covenant claims because the implied covenant cannot create new obligations or be used to vary or contradict express contract terms. The franchisees conceded that the 1992 franchise agreement vested Carvel with discretion to use different distribution systems but argued that Carvel was obligated to exercise its discretion reasonably and in good faith.[43] According to the franchisees, when Carvel elevated its own wholesale distribution in supermarkets over the financial stability of its franchisees, it did not act reasonably.

Chief Judge Covello denied Carvel's motion on the implied covenant of good faith. Without challenging Carvel's assertion that the implied covenant cannot contradict the contract, the court reasoned that the doctrine of good faith performance limited Carvel's exercise of its discretion by requiring that Carvel act "reasonably and with proper motive, not arbitrarily, capriciously or in a manner inconsistent with the parties' expectations."[44] The court held that (1) although Carvel had discretion to distribute its product, its franchisees were "entitled to expect that Carvel [would] not act to destroy the right of the defendants to enjoy the fruits of the contract,"[45] and (2) the franchisees had raised an issue of fact regarding whether Carvel exercised its discretion reasonably and in good faith.

After the *Baker* ruling, Carvel lost three separate jury trials involving the supermarket program, and the franchisees were awarded compensatory and punitive damages. In *Carvel Corp. v. Noonan,* Carvel appealed the judgments (and the *Baker* decision) on the franchisees' claims that the supermarket program intentionally interfered with their prospective economic advantage and breached the franchise agreement and the implied covenant of good faith.[46] After hearing oral argument, the U.S. Court of Appeals for the Second Circuit certified two questions to the New York Court of Appeals: (1) whether the facts presented a case for tortious interference with prospective economic advantage under New York law, and (2) whether a finding of public harm was required for an award of punitive damages.[47]

In the opinion certifying these questions, the Second Circuit discussed some of the key issues for Carvel in implementing the supermarket program, which may have distinguished the Carvel cases from *Carlock.* First, Carvel's contracts did not all expressly reserve Carvel's rights to change its distribution system. In addition, Carvel had never distributed through supermarkets before 1992 and repeatedly advised its franchisees that it would not do so, even going so far as to invoke Haagen-Dazs as an example of a supermarket strategy that ruined franchisee operations. On the good faith performance claims, the franchisees presented evidence that Carvel rejected its consulting firm's advice to study the impact of the supermarket program on the franchised stores and specifically instructed the firm not to analyze the issue. A former Carvel employee also testified that he questioned the impact of the program on franchisee profitability and that, in response, the company's chief executive officer said that he "didn't give a f—k about the franchisees."[48] Finally, the franchisees presented expert testimony that Carvel's supermarket program violated franchising standards by cannibalizing its franchisees' sales.[49]

In October 2004, the New York Court of Appeals answered the Second Circuit's certified questions regarding the franchisees' tortious inference claims. The Court of Appeals held that Carvel's inducement of customers to purchase lower-priced products from supermarkets was not tortious interference with the franchisees' economic advantage under New York law. Writing for the majority, Justice Smith explained that because Carvel's conduct was not criminal or an independent tort, the franchisees' claims of interference with a nonbinding relationship had to be supported by a showing that the defendant acted for the sole purpose of inflicting harm on the plaintiffs. The court concluded that Carvel acted only in its own economic self-interest, not to injure its franchisees, and advised the Second Circuit that the facts did not support a claim under New York law for tortious interference or the accompanying punitive damages.[50]

After *Baker* and *Noonan,* a franchisor should carefully consider the reasonableness of its actions when implementing change, even when the franchise agreement expressly permits modifications. Although the franchise agreement itself may defeat breach of contract claims, implied covenant claims may instead turn on the reasonableness of the franchisor's business judgment. Especially if a franchisor is contemplating a substantial concept change, which is likely to impose material new costs on franchisees or developers, the rationale for its decision should be clear; and the franchisor should be able to explain convincingly to third parties why it is fair, taking everything into account, to impose the consequences of the decision on franchisees/developers.

The importance of reasonable business judgment is the cornerstone of the *Sizzler Restaurants* case. In 1996, Sizzler Restaurants International and its affiliated companies petitioned for bankruptcy protection under Chapter 11 of the Bankruptcy Code. In *In re Sizzler Restaurants International, Inc.,* a terminated Sizzler franchisee filed a $5 million general unsecured claim in the bankruptcy based on its allegation that Sizzler breached the license agreement by failing to provide management assistance and by abandoning its buffet court concept.[51] Sizzler objected to the claim. On Sizzler's motion for summary judgment, Bankruptcy Judge Greenwald reviewed Sizzler's decision to refocus its marketing to emphasize its grill concept over the buffet, noting that Sizzler based the decision on the low revenues generated by the buffet, that Sizzler did not require its franchisees to discontinue offering the buffet, and that the Sizzler franchisee association supported the franchisor's new strategy.

In a 1991 Marketing Committee Report, the franchisee association stated:

> The committee supports the Sizzler position that Buffet Court is not the long term answer to sales and profitability for the Sizzler system. Higher food costs, much lower average checks, and an extremely high share of our guests ordering Buffet Court as a meal requires a change in Sizzler position.[52]

The association identified three reasons for its support: (1) the profitability issues with the buffet court, (2) the franchisees' difficulty in maintaining quality in the buffet, and (3) marketing studies showing that emphasis on the buffet caused customers to perceive Sizzler as a lower-quality restaurant.[53]

Judge Greenwald rejected the franchisee's position that the implied covenant of good faith and fair dealing required the franchisor to insure its franchisees against failure, and granted Sizzler summary judgment on the implied covenant claim. The court declined to "second-guess the result reached, as long as the decision-making process was honest and was within accepted commercial practices."[54] The court found uncontroverted evidence that Sizzler had good cause or a legitimate business reason for its decision to refocus its marketing, and it concluded that the franchisee failed to establish that Sizzler "acted dishonestly or outside accepted commercial practices, or did so with improper motives, or arbitrarily, capriciously or in a manner inconsistent with the reasonable expectations of the parties."[55] Despite the franchisee's argument that the court should consider the result of the decision rather than the reasons behind it, the court held that "where there is good cause, there is no bad faith."[56]

As *Sizzler Restaurants* demonstrates, courts are reluctant to substitute their judgment for the franchisor's reasonable business decisions and require only that the franchisor make its decisions through a legitimate good faith process.[57] Cavalier judgments, made without regard to the potential consequences for franchisees, would not meet the standard; a franchisor should always be conscious of the need to demonstrate that, in requiring system change, it acted with real deliberation in what it sincerely believed were the best interests of the system.[58]

Statutory Restrictions

Even when a franchisor has complied with the franchise agreement and acted with reasonable business judgment, that still may not carry the day because state and federal statutes may specifically restrict a franchisor's rights to modify aspects of its business system.

The federal Petroleum Marketing Practices Act, which covers gasoline dealers, allows franchisors to refuse to renew a franchise if the franchisee fails to implement changes required by the franchisor.[59] The Act also requires, however, that system changes must be made in good faith and not simply to prevent renewal of the franchise.[60] As a result, gasoline dealers often rely on this statute to try to override a franchisor's purportedly absolute contractual right to change its system.[61]

In addition, Wisconsin and New Jersey franchise statutes impose restrictions on a franchisor's right to effect change. The Wisconsin Fair Dealership Law (WFDL) addresses both traditional franchise relationships and other distributorships.[62] Along with restrictions on termination and nonrenewal, the WFDL prohibits a franchisor from substantially changing the competitive circumstances of a dealership without good cause. The statute does not, however, give franchisees carte blanche to resist change.

In *Remus v. Amoco Oil Co.,* an Amoco franchisee sued for violation of the WFDL and common law fraud because Amoco launched a mandatory "discount for cash" program, under which Amoco would reimburse its franchisees ninety-six cents for every dollar of credit card sales.[63] On appeal from the district court's entry of summary judgment for Amoco, the U.S. Court of Appeals for the Seventh Circuit held that Amoco's program did not "substantially change the competitive circumstances of the franchisee's dealership agreement without good cause," as defined under the WFDL.[64] Writing for a unanimous panel in a case of first impression, Judge Posner reasoned that the statute's purpose was to protect franchisees from, among other things, constructive termination, where the franchisor makes "the dealer's competitive circumstances so desperate that the dealer 'voluntarily' gives up the franchise."[65] As there was not "a shred of evidence that Amoco ha[d] ever wanted to drive [the plaintiff] out of business," the court held that the plaintiff could not rely on a constructive termination claim or the statute to challenge the "discount for cash" program.[66] In Judge Posner's view, Amoco's program tried to improve dealers' competitive circumstances by allowing them to compete with other stations that offered low prices for cash purchases. The Seventh Circuit concluded that the WFDL was not intended to prevent franchisors from instituting nondiscriminatory systemwide change without their dealers' consent, and it affirmed summary judgment.[67]

In contrast, franchisees have successfully invoked the New Jersey Franchise Practices Act (NJFPA) to resist systemwide changes.[68] In *Beilowitz v. General Motors Corp.,* for example, a New Jersey distributor claimed that GM violated the NJFPA by requiring him to execute a renewal contract that contained terms specific to GM's new global restructuring program for marketing AC Delco products.[69] GM advised the distributor that his failure to sign the new agreement would effectively end his distribution agreement. The distributor sued GM for violation of the NJFPA and moved for a preliminary injunction to prevent the nonrenewal of his franchise.[70] Under the NJFPA, a franchisor is not permitted to impose unreasonable standards of performance on its franchisee.[71]

After concluding that the distributor was entitled to protection under the NJFPA, the New Jersey federal court held that the distributor was reasonably likely to succeed on his claim that GM's new agreement imposed an unreasonable standard of performance because it required him to sacrifice $1 million in sales and incur new operating losses between $1 million and $1.6 million over the first three years of the new program. The court said, "It is clearly an 'unreasonable standard of performance' within the meaning of the NJFPA to require a franchisee to operate at a substantial financial loss while the franchisor attempts to implement a new and unproven marketing strategy."[72] Moreover, the court held that GM's failure to renew the distribution agreement was more than reasonably likely to be found to be "without good cause."[73] Because GM presented no reason for its business strategy or for its failure to renew the franchise, the court concluded that the plaintiff had a reasonable likelihood of success on his claims under the NJFPA.

In *Beilowitz* and other cases, courts have interpreted the NJFPA to redefine the parties' obligations to one another concerning renewal and termination. As a result, New Jersey stands out as a jurisdiction offering substantial protection to its franchisees. This is particularly evident in market withdrawal cases, when franchisors and suppliers argue that their withdrawal from particular markets is a nondiscriminatory change necessitated by business conditions. Many courts have held that franchisors and suppliers are entitled to make such alterations in their market strategies, even to the detriment of their franchisees. In New Jersey, however, this argument does not always prevail.

In *Harter Equipment, Inc. v. Volvo Construction Equipment North America, Inc.,* a heavy equipment distributor sued Volvo when it ceased production of a line of excavators.[74] After the distributor refused to execute a new agreement that amended the products that it was allowed to sell, the parties' contract expired. The distributor sued Volvo for breach of contract and violations of the NJFPA; Volvo argued in a summary judgment motion that its decision to discontinue the excavator product was a nondiscriminatory market withdrawal that was good cause for nonrenewal under the NJFPA. Following *Freedman Truck Center v. General Motors Corp.,*[75] the New Jersey federal court acknowledged that a franchisor can withdraw from a market if an industry decline for the franchisor and its franchisees compels it.[76] Judge Chesler denied Volvo summary judgment, however, finding that a genuine issue of material fact existed as to whether the market withdrawal was driven by economic necessity and whether Volvo therefore had good cause under the NJFPA not to renew the distributor's agreement.[77]

Whether such claims are ultimately successful, the NJFPA (and other state protection acts) may provide franchisees with significant leverage in resisting system change. Because statutory restrictions may exceed common law duties of contractual compliance and the duty of good faith, franchisors should address potential statutory impediments to system change before implementation.

Improving the Odds

A franchisor must consider potential system changes carefully, not only to determine whether the overall strategy will be successful, but also to assess the risk that it will cause some franchisees financial harm and spark expensive, distracting litigation for the franchisor. We offer a few straightforward guidelines for this analysis.

Try to Do No Harm

A brilliant business theory is only brilliant if it translates into actual profits when put into practice. Just as a start-up franchisor should test its concept and systems by operating its own outlets, selling a few franchises, and establishing that typical operators can run them profitably before pursuing major growth, a mature franchisor contemplating a significant system change should take sensible steps to determine whether its newest brainstorm from the boardroom works in the showroom. Hastily rolling out system change without adequate consideration of the full range of potential consequences on franchisee profitability, ease of operation, and consumer response can be a recipe for disaster.

Courts recognize that a franchisor's exercise of reasonable business judgment does not make the franchisor liable for breach of contract or the implied covenant of good faith and fair dealing even when that judgment results in financial loss to franchisees. Careful consideration of concept changes not only will maximize the chances that the changes will actually strengthen the system (and individual franchisees) as competitors, but also will help build a persuasive body of evidence to present to franchisees that must implement the change and to third-party fact finders in the event of later claims.

Have a Solid Franchise Agreement

Because even the most reasonable business judgment must comport with the terms of the franchise agreement, every franchisor should draft its franchise agreement to reserve for itself the right to make system changes that it believes are in the best interests of the brand and the system.

The franchise agreement should contain provisions reserving the right of the franchisor to change its system, its marks, and its manual as business conditions may require. The following is one example:

> Franchisor reserves the right to modify or change the System, Marks, the various training programs offered to Franchisees and their employees, and the Manuals at any time, and from time-to-time by the addition, deletion or other modification to the provisions thereof, and such modification shall be made in the sole judgment of Franchisor to protect Franchisor Marks and goodwill, to comply with any applicable law, statutes or judicial or administrative decision, or to improve the quality of services, training or products offered.

Other typical provisions grant the franchisor the absolute right to change its distribution methods, pricing, and policies. These contract terms are crucial to give the franchisor the flexibility it needs to improve the system, to respond to consumer and economic trends, and to defeat claims from franchisees challenging system change.

As discussed above, courts have generally favored franchisors armed with express provisions granting them the right to make system changes, notwithstanding their effects on individual franchisees. Although absolute discretion is generally not granted, courts defer to a franchisor's judgment when the franchisor has reserved the right to exercise its discretion and has acted in a commercially reasonable, not arbitrary or capricious, manner. When drafting the franchise agreement, therefore, franchise counsel should work closely with franchisor staff to provide the greatest flexibility for the franchisor to exercise its judgment in determining what types of changes may be needed in the future to protect the franchise system and its franchisees.

In addition, when considering a shift in strategy, a franchisor should determine whether to issue a "new day" letter to its franchisees, advising them that they may not rely on the franchisor's prior conduct to guide the relationship and that the franchisor intends strictly to enforce its rights under the franchise agreement, including its right to implement changes necessary for system survival and improvement. This letter cannot rewrite the parties' relationship, but it may be helpful in cutting off a franchisee's course-of-dealing arguments.

Get Your Franchisees on Board

The support of a majority of franchisees can help safeguard the franchisor against system-change claims by individual franchisees. Franchisees challenging system change typically argue that the franchisor acted for its own benefit, without regard to the impact on franchisees. When a substantial portion of the franchisees endorses a franchisor's altered business strategy, that common contention becomes impossible to sustain. Even more important, of course, is that with significant franchisee "buy in," the chances of smooth and commercially successful implementation of system change increase dramatically.

But how does a franchisor secure franchisee support without surrendering its autonomy to a franchisee referendum (or constant collective bargaining) on its business decisions? In systems with active franchisee advisory councils or franchisee associations, franchisors have a forum to obtain meaningful feedback without granting the franchisees an official veto. These associations, if relations have not previously soured, can give franchisors a good sense of the franchisees' reaction to strategies and the resistance that franchisors may face in implementation. Ideally, the association, like the one in *Sizzler Restaurants,* will support the franchisor's new business strategy. With or without a council or association, franchisors can solicit the opinions of franchisee leaders, form ad hoc committees, and use franchisor-friendly franchisee stores as test sites for new products or system ideas.

In some circumstances, a majority of franchisees will react negatively to a proposed change, which will put the franchisor in the position of making a choice: abandon the idea; press ahead despite opposition; or engage in a constructive dialogue to determine whether, with some modifications in the initial proposal, the franchisees can be brought on board. For obvious reasons, the last is by far the preferable course if it can be achieved. There may be times when franchisors conclude that notwithstanding stiff franchisee resistance, material change is essential to preserving system viability, but success under these circumstances is probably always a long-shot given the likelihood of persistent foot-dragging by noncompliant franchisees and the possibility of widespread litigation, which a system already in trouble can ill afford.

Strategies that strike a sensible balance between a franchisee's increased costs and the potential benefits of change have a far greater likelihood of receiving franchisee support. Most franchisees, as businesspeople, understand the need to adapt to the changing demands of the marketplace. A franchisor's expertise is one of the principal benefits that franchisees get in consideration for their franchise fees and royalties, and they expect their franchisors to develop ideas to make their business more attractive to consumers and more successful. The approach of any franchisor facing a need for systemwide change should be to determine whether the franchisees as businesspeople will support the change. If this support comes, the franchisor accomplishes two goals: a smoother implementation of the new program and a solid defense to franchisee claims arising from the change.

Know the Law

A reasonable business judgment exercised pursuant to express franchise agreement rights may still result in actionable claims in jurisdictions providing statutory protections to franchisees. As stated, the NJFPA restricts a franchisor from changing its system in a way that demands an unreasonable standard of performance from its franchisees, and the WFDL prohibits a franchisor from substantially changing the competitive circumstances for its franchisees. These statutes both incorporate the common law requirement of good faith performance and the exercise of reasonable business judgment, but the NJFPA goes further, potentially blocking a franchisor's rights to implement changes that may cause substantial financial loss to its franchisees. Therefore, even when a franchisor has taken steps to act reasonably and in accordance with the franchise agreement, it must still consider the potential effects of a system modification on those franchisees that have statutory protections available to them.

Conclusion

Franchisors confronting the need to keep pace with an ever-shifting market cannot shrink from change. But they also should never proceed haphazardly. The successful evolution of any franchise species requires a high degree of care:[78] careful drafting of the franchise agreement and operations manual; careful thought, planning, and testing before full-scale implementation of material systemwide change; and a careful effort to garner franchisee support, which will increase the odds of business success, decrease the likelihood of litigation, and improve the chances of defeating any claims that do arise.

Endnotes

1. Charles Darwin, The Origin of Species (1859).
2. *See, e.g.,* Remus v. Amoco Oil Co., 794 F.2d 1238 (7th Cir. 1986).
3. N.J. Stat. Ann. §§ 56:10-1 *et seq.*
4. *Id.* § 56:10-7.
5. 719 F. Supp. 791 (D. Minn. 1989).
6. *Id.* at 816.
7. *Id.*
8. *Id.* at 802–03.
9. *Id.* at 812. *See also* Rosenberg v. Pillsbury Co., 718 F. Supp. 1146 (N.Y. 1989) (under the same facts, the court granted summary judgment to Haagen-Dazs; breach of contract claims defeated by an express reservation of distribution rights and franchisees' knowledge of the company's supermarket distribution before entering the franchise relationship).
10. 79 F. Supp. 2d 53 (D. Conn. 1997).
11. *Id.* at 56–57.
12. *Id.* at 57.
13. *Id.* at 58.
14. *Id.* at 64.
15. *Id.* at 60, 64. *See also* Silverman v. Carvel Corp., 778 N.Y.S.2d 515 (N.Y. App. Div. 2004) (affirming dismissal of the franchisee's breach of contract claims based on the supermarket program because the franchisee failed to allege that a Carvel store or any other store offering Carvel products existed within one-quarter mile of the franchisee's store in breach of the 1984 franchise agreement).
16. 756 F. Supp. 1024 (N.D. Ohio 1991).
17. *Id.* at 1027.
18. *Id.* at 1028.
19. *Id.*
20. *Id.* at 1037. *But see* Stevens v. Physicians Weight Loss Ctrs. of Am., Inc., Bus. Franchise Guide (CCH) ¶ 10,739 (N.D. Ohio Aug. 21, 1995) (on the same facts, franchisees that joined PWLC in 1989 claimed that PWLC violated state laws and breached their contracts by failing to disclose a contemplated diet and failing to give training on such new diet; court denied PWLC's motion for summary judgment because a material issue of fact existed as to training obligations and the franchisor's duty to disclose information to clarify misleading statements under Indiana and Connecticut statutes).
21. Civ. A. No. 86-2061-MA, 1986 WL 13405 (D. Mass. Nov. 13, 1986).
22. *Id.* at *5.
23. *Id.*
24. *Id.*
25. *Id.*
26. *Id.* at *6.
27. *Id.*
28. Johnson v. Arby's Inc., Bus. Franchise Guide (CCH) ¶ 12,018 (E.D. Tenn. Mar. 15, 2000).
29. *Id.* at 33,918.
30. Bus. Franchise Guide (CCH) ¶ 12,018 (E.D. Tenn. Mar. 15, 2000).
31. *Id.* at 33,918.
32. *Id.* at 33,916.
33. *Id.* at 33,918.
34. 110 F.3d 295 (5th Cir. 1997).
35. *Id.* at 296.
36. *Id.* at 298.
37. *Id.* at 299. *See also* John Keenan Co., Inc. v. Norrell Corp., 2001 U.S. Dist. LEXIS 10473, Bus. Franchise Guide (CCH) ¶ 12,148 (E.D. La. July 19, 2001) (no breach of contract or breach of implied duty of good faith from franchisor's operation of dual systems if it segregates information and does not share confidential business information).
38. Bus. Franchise Guide (CCH) ¶11,839 (D. Md. Oct. 4, 1999).
39. *Id.* at 33,023.
40. *Id.* at 33,026.
41. *See, e.g.,* Carlock v. Pillsbury Co., 719 F. Supp. 791, 812 (D. Minn. 1989); Economou v. Physicians Weight Loss Centers of America, 756 F. Supp. 1024, 1037 (N.D. Ohio 1991).
42. *Baker,* 79 F. Supp. 2d at 66.
43. *Id.* at 65.
44. *Id.* at 65–66.
45. *Id.* at 66.
46. 350 F.3d 6 (2d Cir. 2003).
47. Carvel Corp. v. Noonan, 818 N.E.2d 110 (N.Y. App. Div. 2004)
48. *Noonan,* 350 F.3d at 10.
49. *Id.*
50. *Noonan,* 818 N.E.2d at 1107.
51. *In re* Sizzler Rest. Int'l, Inc., 225 B.R. 466, 469 (C.D. Cal. 1998).
52. *Id.* at 471.
53. *Id.*
54. *Id.* at 474 (citing line of cases in which courts refused to substitute its judgment for franchisor's legitimate business decisions).
55. *Id.*
56. *Id.*

57. *Id.*

58. For further discussion of the business judgment rule and the implied covenant of good faith and fair dealing, see Jeffrey C. Selman, *Applying the Business Judgment Rule to the Franchise Relationship,* 19 FRANCHISE L.J. 108 (2000).

59. 15 U.S.C. § 2802.

60. *See, e.g.,* Roberts v. Amoco Oil Co., 740 F.2d 602, 606 (8th Cir. 1984); Meyer v. Amerada Hess Corp., 541 F. Supp. 321, 330 (D.N.J. 1982); Munno v. Amoco Oil Co., 488 F. Supp. 114, 118–21 (D. Conn. 1980).

61. *Id.*

62. WIS. STAT. ANN. §§ 135.01 *et seq.*

63. 794 F.2d 1238 (7th Cir. 1986).

64. *Id*. at 1240.

65. *Id.*

66. *Id.* at 1241.

67. *Id.* at 1242. *See also* Montgomery v. Amoco Oil Co., 804 F.2d 1000 (7th Cir. 1986) (discount-for-cash program allowed dealers to charge lower prices to cash customers and was authorized by credit card contract; "Amoco's decision to unbundle the cash and credit sales was neither a breach of the credit card contract nor a violation of the [Indiana Deceptive Franchise Practice Act]"); Re/Max N. Cent., Inc. v. Cook, 160 F. Supp. 2d 1004, 1008 (E.D. Wis. 2001).

68. N.J. STAT. ANN. §§ 56:10-1 *et seq.*

69. 233 F. Supp. 2d 631 (D.N.J. 2002).

70. *Id.*

71. N.J. STAT. ANN. § 56:10-7.

72. *Beilowitz,* 233 F. Supp. 2d at 644.

73. *Id.*

74. Bus. Franchise Guide (CCH) ¶ 12,651 (D.N.J. Sept. 23, 2003).

75. 784 F. Supp. 167 (D.N.J. 1992).

76. *Harter Equip.,* Bus. Franchise Guide (CCH) ¶ 12,651, at 37,089. The *Harter* court reviewed the line of New Jersey market withdrawal cases beginning with *General Motors, Inc. v. Gallo GMC Truck Sales, Inc.,* 711 F. Supp. 810 (D.N.J. 1989), in which a federal court interpreted the NJFPA's "good cause" requirement for termination or nonrenewal as requiring a showing of franchisee breach. The court held that a decision to withdraw from a market did not constitute "good cause" and the franchisee was entitled to damages. This holding was later narrowed by *Freedman Truck Center v. General Motor Corp.,* 784 F. Supp. 167 (D.N.J. 1992), in which the same federal court held that full-scale market withdrawal could be considered "good cause" where "the franchisor and all of its franchisees suffered industry declines, such that there can be no implication that the franchisor is exploiting its position over the franchisee." *Harter Equipment,* Bus. Franchise Guide (CCH) ¶ 12,651, at 37,089. For a more complete discussion of market withdrawal, see Michael J. Lockerby, *Market Withdrawal: Judges and Juries Aren't Buying What Terminated Dealers Are Selling,* 22 FRANCHISE L.J. 151 (2003) and J. Michael Dady, *The Olds Market Withdrawal: Is What's Past, Prologue?,* 21 FRANCHISE L.J. 65 (2001).

77. *Harter Equipment,* Bus. Franchise Guide (CCH) ¶ 12,651, at 37,089.

78. This is not to suggest that franchisors owe franchisees a duty of care. That is not the law, and it would be a mistake to try to graft that concept, drawn from the law of negligence, onto the franchise relationship, which is already governed by contract and, in many states, by statute. *See* Edward W. Dunham, *Federal Franchise Legislation and Congress's Own Duty of Competence and Due Care,* 21 FRANCHISE L.J. 67, 69 (2001); Robert T. Joseph, *Do Franchisors Owe a Duty of Competence?,* 46 BUS. LAW 471 (Feb. 1991).