Prophylactic Preparation for a Business Judgment Rule Defense

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Long-term relationship contracts seem to be the center of attention in the franchise community nowadays. As distinguished from typical distributorship agreements, which often last only one or two years and require not-too-substantial investments in the brand, product or service subject to such an agreement, franchise agreements usually have a greater sense of permanence. They often run up to 20 years in duration and are often renewable for similar lengths of time, or have perpetual renewal rights. It is frequently the case that the distributor will carry more than one brand, in contrast to a franchise that handles only one.

Because of their length and the changing nature of markets, franchise agreements customarily require that the franchisor be granted greater latitude in deciding how the business model may be adjusted as the world changes. Therefore, while franchise agreements may be specific with respect to obligations of the franchisor when addressing steps necessary to assist in making a franchise business operational, they are more fluid about what the franchisor can do in future situations. Thus, these agreements will use the word "may" rather than "shall" when addressing the franchisor's future obligations.

For example, the franchisor may be required, as part of its obligations, to set up a marketing fund, but the agreement may go on to say that the franchisor can decide how marketing dollars will be spent and what costs are appropriate to charge against the marketing fund, and may even go so far as to say that the advertising fund can be liquidated unilaterally by the franchisor. Moreover, while the total amount to be devoted by a franchisee to advertising his business might not be changeable without the franchisee's consent, the franchisor may have the right to alter the portion of those funds that will be dedicated to national, regional or local advertising, as well as the amount that the franchisor may retain to compensate it for its costs and expenses in managing the advertising function for the system.

Fifty years ago, advertising was spent primarily on radio and print advertising. Today, television, couponing and social media may be the preferred method of marketing a franchise system. Seventy years ago, television was in its infancy, and therefore, television advertising was not covered in franchise agreements, and social media, of course, would have been an incomprehensible concept.

While the franchisor's use of such non-committal word as "may" and "consider" give the franchisor a certain level of authorization to make changes to the franchise system without franchisee approval, franchisors nevertheless fear that franchisees will challenge the propriety of their decisions. In the corporate setting, the business judgment rule states that the courts should not be second-guessing business decisions made by companies absent bad faith or a clear, unequivocal arbitrary decision.

Franchise Setting

As pointed out in the recent Canadian case, *Bertico v. Dunkin' Brands Canada*,[1] the rule was adopted to protect a company's officers and directors in the corporate decision-making process from second-guessing by shareholders, courts and whoever else might pass judgment on the wisdom of that decision. Over time, at least in the franchise setting, the rule has been inserted in many franchise agreements for similar reasons.

A typical business judgment rule contract provision might state:

> Whenever Franchisor reserves discretion in a particular area or where Franchisor agrees to exercise its rights reasonably or in good faith, Franchisor will satisfy its obligations whenever it

> exercises Reasonable Business Judgment in making a decision or exercising a right. Franchisor's 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 Franchisor's decisions or actions are intended, in whole or significant part, to promote or benefit the System generally even if the decision or action also promotes Franchisor's financial or other individual interests. Examples of items that will promote or benefit the System include, without limitation, enhancing the value of the Licensed Marks, improving customer service and satisfaction, improving product quality, improving uniformity, enhancing or encouraging modernization and improving the competitive position of the System.

While the rule may trace its origin back to the area of corporate law, it seems neatly transportable into the area of franchise law.[2] Just like a corporation deciding how to manage its business, so, too, does a franchisor need to bob and weave when strategically managing the direction in which the franchisor will head. This often requires taking risks, or having to decide between two or more promising choices that the company might consider, and the company for various reasons can choose one or the other, but not both, because they are mutually exclusive or together too costly for the company. The business judgment rule, if enforced, allows franchise companies to make these decisions without fear of being excessively scrutinized.

Even when the discretionary right of franchisor decision-making is not incorporated into a franchise agreement, the franchisor will still need to make decisions from an array of alternatives. Absent the common-law business judgment rule, franchisors may be reluctant to make bold business decisions in fear that by doing so, they may be exposing themselves to claims of violating covenants of good faith, or even the express terms of a franchise agreement, in deciding how to make decisions that might appear to be a breach of discretion specifically granted in the franchise agreement.

Perhaps an example might be helpful in understanding the parameters of the business judgment concept. X company sells widgets and markets them through a combination of radio and television advertisements and point of sales advertising. X company executives, based on market research, determine that the millennials constitute a market in which the widget should prove popular, but the expected market penetration has, to date, not met the company's executives' expectations. Management concludes that social media might be a better way to reach out to these potential customers. One might also add in the fact that the company had presented the change in marketing strategy to its franchise advisory council, which wholeheartedly endorsed the change in direction.[3]

The marketing adjustment is made, and the results are disastrous. For whatever reason, the product does not turn out to be attractive to its newly targeted market. It is too expensive; the size and portability of the product are cumbersome, and, as a general principle, the product is not considered "cool" by the community of millennials. As a result, the franchisees, either by a class action lawsuit, or a multiple plaintiff proceeding, sue X company for breach of its express or implied obligations to the franchisee community. Under this scenario, X company will claim that its decision should not be second-guessed. There is no proof of fraud, misrepresentation, or bad faith (e.g., the CEO of the company has not hired his brother's company to manage the marketing campaign). X company presents evidence that the decision was made based on marketing data, and the franchisee advisory council endorsed the decision. Who wins?

In this case X company seems to have the better case if the business judgment rule is applicable. The decision was made in good faith, the company was not forced to adopt the new program, it had the financial wherewithal to do so, and the fact that it received the endorsement of the franchise advisory council meant that the decision did not appear to be off the wall. In this situation, the franchisees will have a difficult time in convincing a court that the company and its officers should be punished for taking on the involved risk.

Warding Off Claims

So, in light of this background, how can a company position itself to ward off claims of bad decision-making?

There are at least three actions that the company might take in its attempt to bulletproof itself. The first is to do its homework. Oftentimes, the CEO or management makes a decision based on intuition, rather than hard data. He or she simply knows what the right course to take is, and the board has come to trust his intuition.

This approach to decision-making is dangerous, because, if the program fails, the reasonableness of the approach smacks of arbitrariness. While the CEO may later be forgiven for his conduct, it is likely that the case, if not settled, will go to trial because the court could readily conclude that the case should not be decided on a summary judgment motion. There is a material fact as to whether the CEO has acted reasonably, which should be presented to a jury or other trier of fact.

The second action is to make sure that there is an absence of bad faith in fact and in the file. Nothing would be more damning than an email suggesting that the adopted decision might help the company, but would be deleterious to the franchisee community. As is commonly, known, in many franchise systems, the franchisor makes its money on the royalty revenue stream but the franchisee is focused on the bottom line. If the company knowingly adopts a plan that will increase franchisor revenues in a profitable manner, but at the franchisee's expense, it is likely, again, that the reasonableness of the decision will be presented to the trier of fact.

And, of course, malice, revenge, ego, evil motivation and other similar malevolent conduct will also be judged with eyes askance. Keep in mind that the conduct of the company will be judged by those having 20-20 hindsight.

And finally, franchisee involvement in the decision-making process also, as noted above, gives more creditability to the contention that the decision was reasonable. This assumes that the franchisee advisory council is not in the franchisor's pocket—there have been no improper incentives for the franchisee advisory council members to support the franchisor's decision, and the franchisees who were consulted have received full disclosure. Whether the decision turns out to be right or wrong, any conduct that suggests that the franchisor has not acted honestly in seeking franchisee endorsement may negate the protection by the business judgment rule.

All in all, the business judgment rule does not permit a franchisor to do what it pleases in managing the franchise system, but taking proper precautions can considerably reduce the franchisor's liability when risky decisions are made.

Endnotes:

1. 2012 QCCS 2809.

2. See Selman, Jeffrey C., "Applying the Business Judgment Rule to the Franchise Relationship," Franchise Law Journal 111 (Winter 2000) for a thorough discussion of the history of the business judgment rule and why it should become a cornerstone of franchisor-franchisee relationships.

3. Many franchise systems have councils which are used by the franchisor to bounce ideas off of. Some systems have none. And in a minority of franchise systems there are independent franchisee association that perform similar functions.

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