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Pure Hearts and Franchise Terminations: The Role of Good Faith under State Relationship Laws

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In a recent decision, the United States Court of Appeals for the Third Circuit affirmed the dismissal of a franchisee's claim that the franchisor's termination decision violated the New Jersey Franchise Practices Act ("NJFPA") because it was motivated by racial animus. While that decision is limited to the NJFPA, it raises the question whether other statutes require analysis of a franchisor's subjective motivation or good faith for a termination decision. The answer is that very few do, but courts in some states will also imply an obligation even if not explicitly written into the statute. This article will identify and analyze which state relationship laws expressly require a franchisor to show its termination decision was made in good faith and which jurisdictions' courts have fashioned a good faith requirement under the statute.

STATES WITH STATUTORY GOOD FAITH PROVISIONS

Connecticut

Under the Connecticut Franchise Act ("CFA"), a franchise cannot be terminated unless the manufacturer or distributor has: (1) satisfied the notice requirements of the statue; (2) good cause; and (3) has acted in good faith. Conn. Gen. Stat. § 42-133v(a). "The manufacturer or distributor shall have the burden of proof under this section." Conn. Gen. Stat. § 42-133v(c). Several Connecticut federal court decisions illustrate the parameters of the statutory good faith element. While the decisions are not comprehensive in nature, they do make clear that a franchisor's subjective motivation alone may not be enough to constitute bad faith. The courts looked to whether the franchisor frustrated the franchisee's ability to perform the agreement and also considered prior accommodations to the franchisee as evidence of good faith.

In *Chic Miller's Chevrolet, Inc. v. GMC*, the U.S. District Court for the District of Connecticut granted a franchisor's motion for summary judgment as to a claim for a violation of the CFA because the franchisee failed to offer evidence that the franchisor acted without good cause or good faith. 352 F. Supp. 2d 251, 260 (D. Conn. 2005). The court found that there was good

cause for the termination because the franchisee breached the dealership contract when it was unable to obtain new vehicle financing. *Id.* The court rejected the franchisee's argument that the franchisor acted in bad faith because it allegedly had a plan to reduce the market place from three to two dealers. *Id.* The court concluded that "a long term plan that called for reducing the number of dealerships in a possibly oversaturated market is not alone evidence of bad faith." *Id.* Further, the Court found that the franchisor extended the term of the franchise agreement several times to allow the franchisee to find a replacement loan evidencing "good faith." *Id.*

In a similar case, the court observed that the elements of good faith and good cause should be considered together when a franchisee alleges improper motive. *See Central Sports, Inc. v. Yamaha Motor Corp.*, U.S.A., 477 F. Supp. 2d 503, 505 (D. Conn. 2007). There, the franchisee entered into an agreement with the franchisor to sell motorcycles, snowmobiles, and related products. The franchise agreement required the franchisee "to maintain adequate working capital and lines of wholesale credit through floorplan financing agreements in order to maintain an inventory of defendant's products." *Id.* at 505-06. The franchisee struggled to meet these requirements over the course of five years, and the franchisor sent several termination letters outlining the franchisee's material breaches. Id. at 507.

Though it was clear the franchisor had satisfied the statutory first requirement of providing notice, and the franchisee admitted that it had failed to maintain the adequate line of credit required by the agreement, the franchisee argued that the financing requirements were unreasonable and that the franchisor improperly restricted potential sources of financing. *Id.* at 509. The court cited *Chic Miller's Chevrolet* and observed that if an agreement requires floor plan financing, a lack of such financing is good cause for termination. *Id.* The court then observed that bad faith termination may have been established if the franchisee could show that the franchisor rejected a fully conforming line of credit from a financier other than the one designated by the franchisor. *Id.* However, there was no evidence that the franchisee was able to obtain sufficient alternative financing or presented an alternative to the franchisor. *Id.* Lastly, the court found that throughout their relationship, the franchisor provided some accommodations to the franchisee instead of immediately seeking termination. *Id.* at 510. For all of these reasons, the court concluded that no reasonable fact-finder could find that the franchisor breached the CFA based on lack of good cause or good faith in terminating the franchise agreement. *Id.*

Delaware

Under the Delaware Franchise Security Law, "[n]o franchisor may unjustly terminate a franchise." 6 Del. C. § 2552(g). A termination is considered unjust if it is "without good cause or in bad faith." 6 Del. C. § 2552(a). Though this standard for lawful termination has been challenged before, the Delaware Supreme Court held that the standard is not unconstitutional for vagueness. *Globe Liquor Co. v. Four Roses Distillers Co.*, 281 A.2d 19, 21 (Del. 1971). The Court explained that the term "bad faith" may be defined by referring to other laws, such as the Uniform Commercial Code ("UCC"), which contain the same term. Id. More specifically, the UCC defines good faith as "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade." UCC 2-103.

There are few cases that shed light on what the Delaware courts may consider to be bad faith under the statute. However, in one case, the Delaware Chancery Court found that abandoning a distributor with little notice while continuing to supply other nearby distributors may constitute bad faith. See *Paradee Oil Co. v. Phillips Petroleum Co.*, 320 A.2d 776 (Del. Ch. Ct. 1971) (granting preliminary injunction after finding plaintiff "demonstrated a probability of success in proving that Phillips is attempting 'unjustly' to terminate and refuse to renew the relationship within the meaning of the Franchise Security Law").

STATES WHERE COURTS MAY IMPLY A STATUTORY GOOD FAITH REQUIREMENT

Several states, including Hawaii and Washington, have a general requirement of good faith that is not specific to termination in their relationship statutes. These general good faith provisions require the parties to deal with each other

in good faith. Though there is little case law interpreting them, courts may find that they govern all aspects of a franchise relationship and use them to imply a good faith requirement to termination. Sometimes, even, courts have discussed whether to imply a good faith requirement where a state relationship state does not have a specific or general good faith provision, as in the case of the New Jersey Franchise Practices Act.

Hawaii

Hawaii's Franchise Investment Law ("HFIL") requires that "[t]he parties shall deal with each other in good faith." HRS § 482E-6(1). The statute also states that it will be considered an unfair or deceptive act or practice or unfair method of competition if a franchisor "terminate[s] . . . except for good cause." HRS § 482E-6(2)(H). "[G]ood cause in a termination case shall include, but not be limited to, the failure of the franchisee to comply with any lawful, material provision of the franchise agreement after having been given written notice thereof and an opportunity to cure the failure within a reasonable period of time." HRS § 482E-6(2)(H). Hawaii state or federal courts have not analyzed the HFIL's good faith or good cause requirement as it pertains to terminations.

Washington

Under the Washington Franchise Investment Protection Act ("FIPA"), "[t]he parties shall deal with each other in good faith." Rev. Code Wash. (ARCW) § 19.100.180(1). The statute also makes it unlawful for a franchisor to terminate a franchise agreement prior to its expiration except for good cause which is defined to mean a failure by the franchisee to comply with a material provision of the franchise after receiving written notice of the breach and an opportunity to cure. *Id.* § 19.100.180(2)(J).

One federal court analyzing the legality of a franchise termination under FIPA seemed to impose an additional obligation of good faith with respect to terminations describing § 19.100.180(1) as the second allegation of a FIPA violation. *See Fleetwood v. Stanley Steemer Int'l, Inc.*, 725 F. Supp. 2d 1258, 1276 (E.D. Wash. 2010). In *Fleetwood*, the franchise agreements at issue could be terminated if the franchisees failed to pay any sum due to the franchisor. *Id.* at 1262. After the franchisees defaulted several times, the franchisor notified them of their defaults and provided them with the opportunity to cure. *Id.* However, the franchisees argued that assurances made by the franchisor that the franchisor would protect them from termination meant that the franchisor breached its statutory good faith obligations when it terminated the agreement even with cause. The court did not reject such a claim as a matter of law. Rather, it found that any assurances made by the franchisor were "akin to supportive commentary and opinion rather than words rising to the level of extra-contractual promises" and did not evidence violations of the franchisor's statutory good faith obligations. *Id.*

New Jersey

Some courts have engaged in a similar analysis even where a state relationship statute does not contain an explicit good faith requirement. For example, the NJFPA does not require a franchisor to show that its termination decision was made in good faith. This did not stop some federal courts from considering whether such an element should be implied. Former Third Circuit Chief Judge Becker previously addressed an appellant's argument that, under New Jersey law, an examination of whether a franchisor's termination was supported by good cause required an inquiry into whether the franchisor also acted in good faith. *GMC v. New A.C. Chevrolet*, 263 F.3d 296, 320 (3d Cir. 2001). Judge Becker observed "[a]lthough this argument is an interesting one, and, as we explain briefly in the margin, New Jersey law offers no clear answer on this point, resolution of this issue is not necessary to our disposition." *Id.*; *see also Maple Shade Motor Corp. v. Kia Motors of Am., Inc.*, 384 F. Supp. 2d. 770, 774, n. 4 (D.N.J. 2005) ("No court has resolved the issue of whether good faith by the franchisor is also required.").

The Third Circuit found that it did not need to address the "good faith" issue because the appellant failed to produce evidence to create a genuine issue regarding whether the appellee acted in good faith or without pretextual motive when it terminated the franchise. *Id.* In a footnote, however, the court noted that, although the plain language of the NJFPA does not include a good faith requirement, New Jersey courts have imposed one in certain circumstances when construing other

franchise-related statutes that similarly omit an explicit good faith requirement. *Id.* at n.11 (citing *Monmouth Chrysler-Plymouth, Inc. v. Chrysler Corp.*, 509 A.2d 161 (N.J. 1986)).

In *Chrysler,* the New Jersey Supreme Court analyzed a related but different statutory scheme, the New Jersey Motor Vehicle Franchise Act ("NJMVFA"). The NJMVFA allows an automobile dealer to challenge a franchisor's decision to relocate a new dealer into the same market area if the dealer can demonstrate that it will be "injurious." N.J. Stat. Ann. § 56:10-18. The statute also lists several factors that may be considered to determine whether the relocation would be injurious. N.J. Stat. Ann. § 56:10-23. Though the provision does not state that the franchisor's motivation or good faith are factors, the New Jersey Supreme Court considered the purpose of the statute and implied a good faith requirement. See *Chrysler Corp.*, 509 A.2d at 170 ("Accordingly, we conclude that an additional criterion to be considered in determining injury under the Motor Vehicle Franchise Act is the motivation of the franchisor in designating the new dealer. If the protesting dealer is able to prove that the manufacturer's decision to franchise a new dealer in the relevant market area was not made in good faith, but to coerce, intimidate, or retaliate against an existing dealer, then that proof, combined with some evidence of economic injury, would satisfy the statutory test of injury to the franchisee.").

Since the *GMC* decision, neither the district courts nor the Third Circuit have clarified whether a franchisor's termination decision under the NJFPA must be analyzed through the prism of good faith. But a recent decision from the Third Circuit involving a claim that a franchisor's termination decision was motivated by racial animus suggests these courts are not inclined to recognize such a good faith requirement under the NJFPA. See 7-Eleven, Inc. v. Sodhi, 2017 U.S. App. LEXIS 16177, at *7-8 (3d Cir. Aug. 24, 2017). In *Sodhi*, franchisor 7-Eleven discovered several accounting and employment issues after performing an audit and sent notices of material breach of the franchise agreement, which required the franchisee to pay all sales, payroll and income taxes related to the operation of the stores. *7-Eleven, Inc. v. Sodhi*, 2016 U.S. Dist. LEXIS 70794, *10 (D.N.J. May 31, 2016). 7-Eleven sued the franchisee and sought declaratory relief finding that it properly terminated the franchise agreements based on the franchisee's breaches. In response, the franchisee asserted several counterclaims, including claims for violation of the NJFPA and breach of the implied covenant of good faith and fair dealing.

The district court granted 7-Eleven's motion for summary judgment on the counterclaims and 7-Eleven's claim for declaratory judgment that the franchise agreements were properly terminated. The district court observed that the franchisee "admitted that he failed to pay payroll taxes, provide workers' compensation insurance, or withhold and pay Social Security taxes for employees of his Stores." *Id.* at 13. Importantly, the court found that the defendants did not dispute that these failures were a material breach of the franchise agreements. *Id.* at *14. The court held that these material breaches constituted good cause for 7-Eleven's termination of the agreements. The court went a step further and opined that "any purported ulterior motive of 7-Eleven, even if shown, is irrelevant to finding that 7-Eleven had good cause to terminate the Franchise Agreements." *Id.* at *15.

In its analysis of the franchisee's claim for breach of the implied duty of good faith and fair dealing, the court rejected several statements allegedly made by 7-Eleven as inadmissible hearsay. *Id.* at *17. The court did, however, consider documents listing Sodhi and other franchise owners who appeared to be of Indian descent as "Second Wave Target[s]." Though the court acknowledged that this evidence "suggest[ed] that 7-Eleven *may* have had an ulterior motive in terminating the Franchise Agreements," the implied duty of good faith and fair dealing does not preclude a party from exercising its express rights under such an agreement. Because "an ulterior motive does not preclude termination for good cause" under the NJFPA, the court found that 7-Eleven was entitled to judgment as a matter of law on the implied duty claim. *Id.* at *17-18.

The Third Circuit affirmed the district court's ruling that 7-Eleven properly terminated its franchise agreements for cause based on the franchisee's failure to pay taxes. *Id.* Though the Third Circuit's opinion was somewhat limited because the franchisee did not explicitly appeal

whether "good cause" existed for termination under the NJFPA, the Third Circuit reinforced the principle that the implied covenant of good faith and fair dealing cannot override an express term in a contract. Whether intended or not, in *Sodhi*, the district court and the Third Circuit missed an opportunity to clarify whether a franchisor's termination decision must be analyzed through the prism of good faith. But based on their express rejection of the franchisee's "motivation" defense in spite of allegations of the franchisor's bad faith, the New Jersey district court and the Third Circuit do not seem inclined to recognize such a good faith requirement.

Conclusion

Franchisors and franchisees alike, as well as practitioners who advise them, should be aware of the varying approaches to good faith requirements and remain conscious of them as they consider particular factual scenarios. In addition to consulting state relationship statutes and the cases interpreting them, it is advisable to analyze similar statutes outside the franchise context for guidance on how a state court might interpret a state relationship statute without an express good faith provision.■