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Business Torts Journal (ISSN 1549-2923) is published quarterly by the Committee on Business Torts Litigation, Section of Litigation, American Bar Association, 321 N. Clark Street, Chicago, IL 60654-7598. The views expressed within do not necessarily reflect the views of the American Bar Association, the Section of Litigation, or the Committee on Business Torts Litigation.
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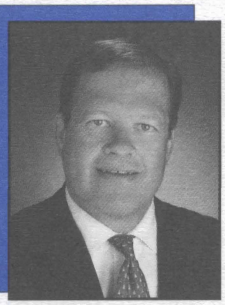
Section of Litigation
AMERICAN BAR ASSOCIATION

Business Torts Journal

Fiduciary Duty Issue

VOL. 17 NUMBER 2 ■ WINTER 2010



The Exculpatory Clause Defense to Shareholder Derivative Claims

By Richard B. Kapnick and Courtney A. Rosen

A director's responsibilities in serving on a corporation's board of directors are accompanied by significant personal financial risks. When shareholders disagree with the director's actions or believe that the director harmed the corporation by inaction, they can assert a breach of fiduciary duty claim. Exculpatory clauses—or, in the parlance of Delaware law, section 102(b)(7) clauses—provide a defense. When properly invoked, exculpatory clauses can provide a basis for the dismissal at the outset of a case of certain types of breach of fiduciary duty damages claims brought derivatively by shareholders. Recent Delaware Chancery Court decisions have accepted exculpatory clauses as a valid defense for director-defendants at the motion to dismiss stage. This article explores how exculpatory clauses work to shield directors from personal liability for non-intentional breaches of fiduciary duties owed to the corporation.

Background on Exculpatory Clauses

Directors have always been able to maintain some measure of control over the threat of any breach of loyalty claim by maintaining their independence vis-à-vis corporate decision making. With respect to the duty of care, however, following the *Smith v. Van Gorkom*[1] decision in 1985, directors were confronted with the very real possibility that courts would second-guess the care with which they made corporate decisions. The resulting personal financial risk became a serious concern to directors. As a result, the legislatures of many states enacted legislation permitting exculpation to shield directors from certain lawsuits.

For instance, Delaware adopted a statute in 1986 that permitted the limitation of directors' personal liability for monetary damages for breaches of the duty of care. Specifically, section 102(b)(7) authorizes shareholders to include a clause in a corporation's charter eliminating personal liability of a director to shareholders for monetary damages for breach of fiduciary duty, provided that such clause does not eliminate liability (1) for "any breach of the director's duty of loyalty," (2) "for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law," and (3) "for any transaction from which the director derived an improper personal benefit."[2]

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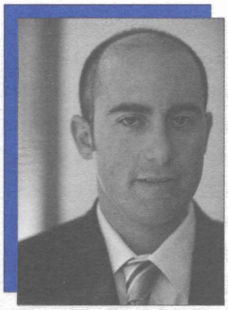

Fading Fiduciary Duties Between Franchisors and Franchisees

By Zachary D. Schorr

The recent economic downturn has wreaked havoc on businesses nationwide. Over the past year, businesses have been failing, nearly across the board. This includes franchises and distributorships, which represent approximately 50 percent of all retail sales in the United States.[1] Indeed, we have seen previously strong franchises and distributorships like General Motors, Chrysler, and even operators of Dunkin' Donuts struggle, close stores, and file for bankruptcy.[2]

When such widespread failure occurs, disputes between franchisees and franchisors are, like litigation in general, inevitable. During litigation, franchisees commonly assert claims for breach of contract, fraud, and misrepresentation, and, on occasion, they attempt to assert a claim for breach of fiduciary duty. Many of these claims arise out of the franchisor's sudden and often unexpected termination of the franchise or distributorship agreement.

A majority of jurisdictions hold that there is no fiduciary duty between a franchisor and a franchisee. However, some jurisdictions have found a fiduciary duty between a franchisor and a franchisee as a matter of law. Others have made this issue a question for the jury. Even in jurisdictions where such a fiduciary duty is recognized, the duty is being knocked down by subsequent case law.

No Fiduciary Duty Between a Franchisor and a Franchisee

The majority of state and federal jurisdictions have determined that there is no fiduciary duty between a franchisor and a franchisee.[3] In fact, this is the rule in at least 34 states nationwide.[4] In these jurisdictions, the courts view the relationship between the franchisor and the franchisee as an arm's length business transaction.

For example, in New York, courts have consistently failed to recognize a fiduciary relationship between a franchisee and franchisor absent extreme or "awesome" circumstances.[5] Indeed, in *Adiel v. Coca Cola Bottling Company of New York, Inc.*, the plaintiff alleged, among other things, a breach of fiduciary duty based on the defendant's oral representations by its officers that it would renew the plaintiff's distribution rights indefinitely or at least until the plaintiff returned or sold those rights. The plaintiff claimed that, relying on these representations, he had spent "hundreds of thousands of dollars" on existing Coke accounts and that he had invested substantial amounts of time, energy, and money to increase the sales of Coke products in his territory.[6] The plaintiff also claimed that Coke never advised him of the possibility that it would not renew its distributorship agreement. The court disallowed any claim for breach of fiduciary duty by finding an absence of extreme or "awesome" circumstances.

Likewise, in *Walker v. KFC Corp.*, a California court refused to recognize a fiduciary duty between a franchisor and a franchisee. The court, relying on *Main v. Merill Lynch*, determined that a fiduciary duty "arises only when the person in whom confidence is reposed acquires some control over the affairs of others."[7] It seems rather axiomatic that franchisors necessarily exercise control over the affairs of others, but the amount of control is dispositive.

More recently, in *Broussard v. Meineke Discount Muffler-Shops, Inc.*, the U.S. Court of Appeals for the Fourth Circuit, applying North Carolina substantive law, also refused to recognize a fiduciary relationship between a franchisor and a franchisee. The *Broussard* court explained that a fiduciary bears the extraordinary obligation to "never place his personal interest over that of the persons for whom he is obliged to act."[8] The court provided the following reasoning: "[T]he near-universal rejection of imposing fiduciary duties in the franchise setting reflects recognition that these obligations are out of place in a relationship involving two business entities pursuing their own business interests, which of course do not always coincide."[9] The *Broussard* decision rested both on North Carolina law and the law of a majority of other jurisdictions that do not recognize a fiduciary duty in this context.

Exceptions to the Rule—Recognizing a Fiduciary Duty

There are jurisdictions that have recognized fiduciary duties in the franchisee/franchisor setting either as a matter of law or based on the evidence before the court.

Recognizing Fiduciary Duties as a Matter of Law

At least three jurisdictions have held that a fiduciary duty exists between a franchisor and a franchisee as a matter of law. The decisional law in South Dakota, Missouri, and Arizona certainly represents the minority view. In fact, subsequent cases have chipped away at the holdings in these cases in a move toward the majority view.

In what may be the strongest language of this line of cases, a federal court in South Dakota, in *Arnott v. American Oil Co.*, held "inherent in a franchise relationship is a fiduciary duty."[10] In that case, the court instructed the jury that a fiduciary relationship existed between the plaintiff service station dealer and the defendant oil company. The court found a fiduciary duty based, in part, on its view that the relationship between the service station dealer and the oil company "is essentially a form of commercial venture a franchise for the marketing of Shell's products, in which both parties have a common interest and profit from the activities of the other."[11] In finding a fiduciary duty, the court also determined that the plaintiff was not solely pursuing his own business interests in his relationship with the defendant—especially given that the plaintiff was selling products under the defendant's name.

> The current recession has caused more than 15,000 retail franchise businesses to close.

Likewise, the defendant was exercising control over Arnott, as Arnott was expected to remain open 24 hours a day, was responsible for hiring adequate help, and was subject to inspections from Amoco representatives. Further, the defendant exercised control over product advertising and issued pricing directives. Ultimately, the plaintiff's building of goodwill for the franchisor, while building its own goodwill, led the court to conclude that the franchisor had a fiduciary duty not to terminate the franchise arbitrarily.

Based on these factors, it would seem to follow that the existence of a fiduciary duty between a franchisor and franchisee would be somewhat common, but it is not. This begs the question as to the amount of weight courts give to the level of control the franchisor exercises over the franchisee. Surely, if other courts gave this factor any significant weight, such claims for breach of fiduciary duty would be much more commonplace. Yet, the *Arnott* decision is not widely followed.

For example, the court in *Picture Lake Campground, Inc. v. Holiday Inns, Inc.*, expressly chose not to follow the decision reached in *Arnott*. Instead, the court held that the fiduciary duty recognized in *Arnott* "is not the fiduciary duty traditionally found in the trustee-beneficiary or attorney-client relationships that requires the utmost good faith and prohibits self dealing on the part of the fiduciary."[12] The court determined that the application of a fiduciary duty to the franchisor-franchisee relation was inappropriate and pointed to the following passage from Judge Bright's dissenting opinion in *Arnott*: "The parties in this case entered into a business relationship, not a fiduciary relationship. Each party served the interest of the other, but each also quite properly sought its own interest."[13] In the end, the *Picture Lake Campground* court failed to find a fiduciary relationship in the franchise context; instead, it characterized the relationship as a mere business relationship.

In *ABA Distributors, Inc. v. Adolph Coors Co.*,[14] a Missouri court did find a fiduciary duty between a franchisor and a franchisee under Missouri common law and statutory law. Indeed, the court found that Coors's attempt to terminate ABA's distributorship without notice, based on ABA's sale of beer outside its distribution area, was a breach of Coors's fiduciary duty to ABA, the duty of good faith and fair dealing it owed to ABA, and a breach of the distributorship agreement between the parties. Interestingly, this case, like others, seems to equate the fiduciary relationship to the implied covenant of good faith and fair dealing in contract law. While this case is frequently cited by franchisees alleging causes of action for fiduciary duty, courts have been hesitant to follow its precedent. For example, in Ohio, in *Power Motive Corp. v. Mannesmann Corp.*,[15] the court expressly chose not to follow the ruling in *ABA Distributors.*

Fiduciary Duties Based on the Evidence

Even though only a limited number of cases recognize the existence of a fiduciary duty between a franchisor and franchisee as a matter of law, a larger number of jurisdictions have been willing to submit the question to the jury to determine whether a fiduciary duty existed based on a special relationship between franchisor and franchisee.

The most extreme example of the creation of a fiduciary duty based on the evidence occurred in New York in *Sbarro Holding, Inc. v. Shien Tien Yuani*, where the court described the relationship between franchisor and franchisee as "awesome."[16] In *Sbarro*, the plaintiffs were Taiwanese immigrants who contracted with Sbarro, who acted as developer, architect, builder, lawyer, supplier, and guidance counselor to the plaintiffs. "Sbarro's representatives convinced their franchisees there was nothing to worry about, Sbarro would handle it all."[17]

Because of the disparity between the parties, the court determined that their relationship "was founded on confidence on the part of the Yuans [the plaintiffs] in the integrity and fidelity of Sbarro."[18] For that reason, neither party had the right, under rules of equity, to take selfish advantage of the trust or to permit either party, particularly the franchisor, to benefit by prejudicing the other. Accordingly, the court was able to allow a claim for breach of fiduciary duty based on the "awesome" evidence before it. Since this case, several New

York cases have taken great steps to limit the holding of this case to its specific facts.

Another example of finding a fiduciary duty based on the evidence before the court and not as a matter of law, comes from *Walker v. U-Haul Co. of Mississippi*. In that Mississippi case, a franchisee of U-Haul claimed that U-Haul fraudulently induced him to surrender his service station and to enter into a new lease and franchise agreement under which U-Haul then raised his rent to a level his business could not afford.[19] The court's opinion relied heavily on *Carter Equipment Co. v. John Deere Industrial Co.*, a diversity case under Mississippi law, which held that the existence of a fiduciary relationship between a franchisor and a franchisee is, in Mississippi, a question of fact for the jury.[20] That said, the court specifically excepted from its ruling breach of fiduciary duty claims grounded in conduct authorized by provisions of a contract, provided the contractual terms were are not unconscionable, illegal, or in violation of public policy. In citing, *Carter Equipment*, the court outlined several factors to guide the jury in determining when a contractual relationship can give rise to a fiduciary relationship, including when the parties have mutual or shared intentions and whether the franchisor has power to control the franchisee.

At least seven states have permitted the issue of whether a fiduciary duty exists to be submitted to the jury as a question of fact.[21] In other words, in these states, when it is possible to find a special relationship between a franchisor and a franchisee, courts will leave the issue to the jury to decide based on the parties' evidence.

Franchise Litigation in Today's Economy

According to the International Franchise Association, some 75 industries make use of the franchise system.[22] With these industries currently facing the reality of a less robust economy, litigation will continue to spike while businesses suffer.

Already, the current recession has caused more than 15,000 retail franchise businesses to close.[23] The number of business closures has exceeded the Franchise Business Economic Outlook for 2009, prepared by PricewaterhouseCoopers LLP, which predicted a loss of some 10,000 establishments.[24] Because franchise businesses account for 21 million jobs in the United States and already over 200,000 jobs have been lost in franchised businesses, the issue of potential liability for fiduciary duty claims between franchisors and franchisees will remain at the forefront of this type of litigation. Thus, as these businesses struggle, there is little doubt that aggressive franchisees will raise this issue to the forefront of franchising disputes once again, albeit with less likelihood of success in the majority of jurisdictions across the United States. ■

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Endnotes

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14. 542 F. Supp. 1272 (W.D. Mo. 1982).
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