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What Do These Common Contractual Words Actually Mean?

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I. INTRODUCTION

Mark Twain once said, "the difference between the almost right word and the right word is really a large matter—'tis the difference between the lightning bug and the lightning."[1] When Madonna proclaimed, in her 1985 song, 'Material Girl' that 'we were living in a material world and I am a material girl,' we understood she did not mean she was living in a significant world and that she was an important woman—rather we understood that she meant that we live in a world composed of material things and that accumulating material things is important"[2] However unlike Madonna's song, lawyers' use of the term "material" in contracts is far from that clear.

These two passages playfully but directly illustrate the importance of understanding the meaning of the words used in contracts which is a necessary condition to being able to choose the right word for the contract. Many times, practitioners will use terms in contracts out of habit or common practice without a full appreciation of how the term will be understood by the parties much less interpreted by courts. This includes routinely using forms without scrutinizing the time-worn terms and provisions. Similarly, practitioners will argue and negotiate over the use of terms, when the terms have not been interpreted in the way that either or both sides are ascribing to it.

In this vein, we explore terms and provisions such as:

- the role of the term "material" and the different tests and standards courts have used to define it when ascribed to a condition, event or breach of a franchise agreement.
- the "efforts clauses" including "best efforts" and whether courts recognize a difference between "reasonable efforts" and "best efforts" as well as what courts are looking for in determining whether a decision or action meets the applicable standard.
- the term "not to be unreasonably withheld" and what courts are looking for in this expression that turns on a double negative.
- the reasonable judgment provision which many franchisors use in their franchise agreements to attempt to create an agreed standard of reasonableness in conduct or decision-making and to displace application of the implied covenant of good faith and fair dealing.
- the terms used in a choice law provisions which can determine whether and to what extent procedural and certain substantive laws will be included or excluded from the application of the chosen law.
- the terms used to describe the types of damages that are recoverable and not recoverable in a damage limitation provision including use of the term

[1] MARK TWIN, THE WIT AND WISDOM OF MARK TWAIN (Bob Blaisdell eds, 2013).
[2] Glenn D. West, *Defining "Material"—What Matter Will Matter?*, GLOBAL PRIVATE EQUITY WATCH (Jan. 13, 2020), https://privateequity.weil.com/insights/defining-material-what-matter-will-matter/ (referencing MADONNA, MATERIAL GIRL (Sire Records 1984)).

"actual" to describe recoverable damages and drafting of limitations on recovery of lost profits.

Where helpful, we also examined issues affecting the enforceability of these terms and provisions.

II. "MATERIAL"

Practitioners, even the best legal drafters, use terms like the ones described in this Article many times without knowing how the term has been interpreted by courts or based on a misunderstanding as to how it will be interpreted by ascribing a meaning to it without sufficient justification or basis. The term "material" is one of those terms. It is, at its essence, vague and ambiguous and understanding it's import depends upon the context in which it is used.

In this Section, the cases provide the following guidance:

In determining whether disclosing information or the failure to disclose information is material or whether a breach of a representation or covenant promising compliance is material will likely turn on whether the information or failure to satisfy the covenant meets the standard of "changing the mix of information" upon which a buyer or investor reasonably relies in making a decision. Another way of saying this is that information, omitting of information, or failing to comply meets the materiality standard if it "affects the decision" of the buyer or investor.

It is also the case that a provision requiring compliance "in all material respects" does not necessarily by itself make the failure to comply with that condition an event permitting termination of the contract unless expressly providing so. This is seen most obviously in the Material Adverse Effect ("MAE") cases described in this Section.

In a breach context, the cases indicate that determining whether the failure or breach is material depends on factors evidencing the degree of impact on the contractual relationship including duration of the breach and harm caused; whether the event is described expressly as material and expressly subjects the contract to termination; and whether its breach goes to the essence of the contract including harm to a party, among others.

A. THE IMPRECISIONS OF DEFINING "MATERIAL"

Before considering the applications and potential ramifications of including phrases like "material" to qualify performance or conditions in drafting franchise agreements, it is helpful to set the stage by examining the typically known definitions. The adjective "material," by itself is defined by Black's Law Dictionary as "[h]aving some logical connection with the consequential facts,"[3] and "[o]f such a nature that knowledge of the item would affect a person's decision-making; significant; essential".[4] In the context of "material breach" of contracts, Black's Law Dictionary provides that a breach of contract that is significant enough to permit the aggrieved party to elect to treat the breach as total

[3] MATERIAL, Black's Law Dictionary (11th ed. 2019) (providing the example here of material evidence).
[4] *Id.* (providing the example here of material alteration of the document).

(rather than partial), thus excusing that party from further performance and affording it the right to sue for damages.[5]

Again, in the context of "material breach" the Restatement on Contracts notes the following circumstances are to be considered:

> in determining whether a failure to render or to offer performance is material . . . (a) the extent to which the injured party will be deprived of the benefit which he reasonably expected; (b) the extent to which the injured party can be adequately compensated for the part of that benefit of which he will be deprived; (c) the extent to which the party failing to perform or to offer to perform will suffer forfeiture; (d) the likelihood that the party failing to perform or to offer to perform will cure his failure, taking account of all the circumstances including any reasonable assurances; (e) the extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing.[6]

The common law understanding of material is described as follows:

> [An] uncured failure by one party to perform can suspend or discharge the other party's obligation to perform only if the failure is material or substantial. Generally, nonperformance would be material at common law "only when it goes to the root, heart or essence of the contract or is of such a nature as to defeat the object of the parties in making the contract. . . ."[7]

Particularly with respect to the use of the term "material" to describe an event or a representation or condition in a contract Ken Adams in his article *The Word Material is Ambiguous in Contracts, Why That's a Problem and How to Fix It*,[8] provides a unique but accurate picture of the use "material" in contract drafting as follows:

> The words *material* and *materially* are vague—there's no clear boundary between what's material and what isn't. And whether something is taken to be material in a given circumstance depends on whether a reasonable person would consider it material. Any effort to explain what *material* means will also be vague. For example, the *TSC Industries* standard uses three vague words—*substantial*, *reasonable*, and *significantly*—to explain what *material* means.[9]

The words themselves, *significant*, *reasonable*, and *significantly* are also ambiguous. Adams notes that:

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[5] BREACH OF CONTRACT, Black's Law Dictionary (11th ed. 2019).

[6] Restatement (Second) of Contracts § 241 (1979); *see also Bernstein v. Nemeyer*, 213 Conn. 665, 672 n.8 (1990).

[7] Ken Adams, *"Warranty" and "Condition": Revisiting Problematic English Terminology*, ADAMS ON CONTRACT DRAFTING, Feb. 6, 2022, https://www.adamsdrafting.com/warranty-and-condition-revisiting-problematic-english-terminology/ (quoting 14 Williston on Contracts § 43:6 (4th ed.)).

[8] Ken Adams, *The Word Material is Ambiguous in Contracts, Why That's a Problem and How to Fix It*, SCRIBES J. OF L. WRITING 84 (2023).

[9] *Id.* at 90–91 (referencing *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976)); *see also Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988) (applying the Court's *TSC* standard).

> *The Oxford English Dictionary* offers two contrasting definitions of *significant*, the first being "[s]ufficiently great or important to be worthy of attention; noteworthy; consequential, influential," the second being "[i]n weakened sense: noticeable, substantial, considerable, large." An example of the first meaning might be *a significant piece of legislation*. An example of the second meaning might be *It was significant that her first stop was Rome*, with *significant* in effect expressing the meaning "not insignificant."[10]

Adams posits that the challenge is to find other ways to express the alternative meanings of *material* stating:

> One problem they pose is uncertainty over the quantum involved. How far down from the maximum can you go before something stops being substantial? How far up from the minimum can you go before something stops being minor? Even if you think you know the answer, there's no guarantee that the other party feels the same way . . . and that the obvious alternative is *nontrivial*, with *trivial* expressing the obverse.[11]

This challenge of understanding when a franchisor or franchisee has failed to materially disclose information can occur prior to or any time during a franchise agreement and typically would relate to a specific incident of falsehood or omission to disclose.

The failure to comply with conditions often occurs in connection with renewal and transfer provisions in franchise agreements. The franchisee or transferor is typically required to meet certain conditions to be granted the right to renewal or have a proposed transfer approved. One common condition requires the franchisee to have materially complied during the term of the franchise agreement with all of its terms and conditions.

Specific questions may arise as to whether the falsehood or omission to disclose would have changed the receiving party's decision with respect to the relationship. With respect to performance of a party during the term of the franchise agreement, how do you measure the degree to which the franchisee has materially met that condition especially over a lengthy term of years? What if the franchisee failed to perform on several occasions only early on or even if later during the relationship, and cured each default and is in full compliance at the time of renewal or the transfer request? What if the provisions with which the franchisee did not comply including the making of a falsehood or omitting information did not negatively impact the performance of the franchised business.

Similarly, when is a breach such as the franchisee's failure to meet operating standards, obtain a new point of sale system, or deliver reports or financial statements important, significant, or consequential or goes to the root, heart, or essence of the contract (as noted in the foregoing definitions) meriting termination of the contract and/or a claim for damages? If a franchise agreement states the breach of certain provisions are material, does the franchisee lose or reduce its ability to argue that that termination is based on an immaterial breach because the franchisee signed the franchise agreement

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[10] *Id.* at 91 (quoting *Significant*, THE OXFORD ENGLISH DICTIONARY (2nd ed. 1989)).

[11] *Id.* at 92; *see also* Kenneth A. Adams, A Manual of Style for Contract Drafting § 9.1–9.16 (4th ed. 2017) (discussing material as a modifier could also be defined as "nontrivial" or "important enough to merit attention").

and agreed to that provision? Does that position change when the franchise agreement is silent as to materiality or says the franchise agreement can be terminated for a material breach without defining which terms are material?

This section will discuss how materiality is interpreted differently depending on various contexts and feature standards used by the courts to determine materiality which will hopefully be useful in determining when and how to use the term in contract drafting.

B. USES AND INTERPRETATION OF MATERIALITY

There are various ways in which "materiality "comes into play that illustrate the above—described imprecision.

1. DISCLOSURE

In 1976, the U.S. Supreme Court held in *TSC Industries, Inc. v. Northway, Inc.* attempts to articulate what *material* means in securities-fraud case:

> The general standard of materiality that we think best comports with the policies of Rule 14a-9 is as follows: An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. This standard is fully consistent with *Mills*' general description of materiality as a requirement that "the defect have a significant *propensity* to affect the voting process." It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.[12]

This case involved alleged omissions and misstatements in a proxy statement, but the *TSC* standard which prevails has been applied in the contracts context as well.[13] For example, the Court of Chancery of Delaware later used the *TSC* standard to review language in a merger agreement.[14] There, two oil refineries, Frontier and Holly, were in merger discussions when the parties discovered a forthcoming "highly-organized, well-funded" mass toxic tort suit against various oil companies for contamination linked to a Los Angeles oil rig.[15] As a result, Frontier and Holly negotiated new provisions to be added to the merger agreement including the provision that "there are no contracts or leases that are *material* to the business, properties, assets, financial condition or results of operations of Frontier and its Subsidiaries taken as a whole."[16] However, there was

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[12] *See TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 439 (1976) (quoting *Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375, 384 (1970)).

[13] *See id.*; *see e.g.*, *Smykla v. Molinaroli*, 85 F.4th 1228, 1235–38 (7th Cir. 2023) (recently finding that failure to disclosure of alternative non-taxable merger structures was not material by applying *TSC* standard).

[14] *See Frontier Oil v. Holly Corp.*, No. CIV.A. 20502, 2005 WL 1039027, at *38 (Del. Ch. Apr. 29, 2005), judgment entered *sub nom. Frontier Oil Corp. v. Holly Corp.* (Del. Ch. 2005).

[15] *Id.* at *6 (quoting preliminary hearing evidence of the Gibson Dunn risk memorandum).

[16] *Id.*at *37 (quoting the merger agreement) (emphasis added).

an undisclosed indemnity agreement which made Frontier directly liable for Wainoco liabilities, the owner of the oil well in the litigation and a subsidiary of Frontier.[17] The court examined if the litigation risks "would be material to Frontier's financial conditions at the time of the Merger Agreement, [and] if the litigation risks associated with that threatened litigation were sufficiently foreseeable and sufficiently large."[18] The court, relying on the *TSC* standard, found that the potential litigation could not raise to the level of material.[19] More specifically, the court found that (1) "the cost of the litigation itself cannot fairly be labeled material" and (2) the merits of the case had not been demonstrated on the record as clearly adverse.[20] The court specifically concluded that potential litigation could not be material without additional evidence of "likely consequences."[21]

The *TSC* standard has also been applied in the franchise context. In *Motor City Bagels*, the franchisor alleged fraud under the Indiana Franchise Act, which makes it "unlawful for any person in connection with the offer, sale or purchase of any franchise . . . to make any untrue statements of a *material* fact or to omit to state a *material* fact necessary in order to make the statements made. . . ."[22] The Indiana Supreme Court has adopted the *TSC* standard, where "[a]n item of information is material 'if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote,' or, put another way, there is a substantial likelihood that a reasonable investor would have viewed the information as 'having significantly altered the 'total mix' of available information.'"[23] The *Motor City Bagels* court concluded that the franchisor's alleged failure to provide accurate startup costs was material because such information was relevant to the franchisee, and the franchisee's reliance on such information is relevant to the alleged injury.[24] The court stated in their reasoning that the "initial investment cost constituted a central assumption in the plaintiffs' business plan and changes in this variable clearly have a dramatic impact on the profitability of such enterprises."[25] The court found that plaintiffs could demonstrate that they would not have agreed to such an aggressive development plan if the initial investment cost was not misrepresented.[26]

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[17] *See* i*d.*at *38.
[18] *Id.*
[19] *See* i*d.* at *38; *see also Gen. Elec. Co. by Levit v. Cathcart*, 980 F.2d 927, 935–36 (3d Cir. 1992) (finding that, in a shareholder derivative suit and applying the *TSC* standard, that "the mere possibility of litigation is not" material and pending litigation omitted from the proxy statement were not material to the raincoat provisions being voted on).
[20] *Id.* ("there is a lack of a scientifically-recognized causal connection between site operations and the various cancers suffered by the plaintiffs (at least on this record)").
[21] *Id.* (specifically referencing "substantial likelihood" in the *TSC* standard).
[22] *Motor City Bagels, L.L.C. v. Am. Bagel Co.*, 50 F. Supp. 2d 460 (D. Md. 1999) (quoting Ind. Code Ann. § 23-2-2.5-27(2) (West)) (emphasis added).
[23] *Enservco, Inc. v. Indiana Sec. Div.*, 623 N.E.2d 416, 423 (Ind. 1993) (quoting *TSC*, Indus., 426 U.S., at 449 (1976)); *see also id.* at 468, n.6.
[24] *See Motor City Bagels*, 50 F. Supp. 2d, at 473–76.
[25] *Id.* at 470.
[26] *See id.* The court denied both motions for summary judgment because there was a fact dispute as to what costs were represented, but the above discussion about materiality is viewing the facts in light of franchisee's failure to disclosure the increased startup costs. *See id.* at 473–74.

In a similar set of facts to *Motor City Bagels*, the *A Love of Food* court found that there was a reasonable question of fact, as to the reliance on the misinformation.[27] The court stated that the start-up estimates are material so long as they are reasonably relied on by the parties, but there was a specific disclaimer in the offering prospectus, the franchisees "boasted significant experience and business savvy," and franchisee had their own team of consultants separately provide anticipated startup costs.[28]

In *Morris v. International Yogurt Co.*, the franchise failed to tell franchisee, before entering into the franchise agreement, that the frozen yogurt recipe was available to non-franchisees.[29] Specifically, the franchise agreement stated that the yogurt mix was "unique," a "trade secret," and a "special formula."[30] But in fact, the developer of the formula sold the mix directly to non-franchisees.[31] The court held, in finding that this rose to the level of a material fact, that "proof of nondisclosure of a material fact establishes a presumption of reliance which the defendant may rebut by proving that the plaintiff *would still have purchased the franchise even if the material fact had been disclosed*."[32] In their discussion of materiality, the court reasoned like the court in *TSC*, and applied a definition of a material fact as "a fact to which a reasonable man would attach importance in determining his choice of action in the transaction in question"—in this case, entering into the franchise agreement.[33] The court focused on the omission that the yogurt mix was available to the public juxtaposed against the franchise agreement which "clearly indicates that the right to purchase this one-of-a-kind yogurt mix is a key feature of the franchise" such that "[a] person might not consider it worthwhile to invest in the franchise if he knew he could obtain the mix without paying the franchise fee."[34]

A Washington appellate court applied the *Morris'* reasoning to an alleged material omission that the franchisor planned to discontinue its outlet franchise model at the time franchisee entered the franchise agreement to open an outlet store.[35] Franchisor Something Sweet offered both outlet models, which only offered take-and-bake pizzas, and full restaurant models, which offered both prepared and take-and-bake pizzas, but the franchisee bought an outlet model.[36] The franchisee alleged the franchisor had sold the franchise when it planned to stop offering outlet models to new franchisees shortly.[37] In *Something Sweet*, the court found that not informing the franchisee of such plan was not a material omission chiefly because, unlike *Morris* where the yogurt mix was a key feature of the franchise, the franchisor's combination of outlet and full restaurant models

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[27] *A Love of Food I, LLC v. Maoz Vegetarian USA, Inc.*, 70 F. Supp. 3d 376, 403 (D.D.C. 2014). There, franchisor Maoz Vegetarian USA entered into a franchise agreement with A Love of Food, where franchisee brought suit after the franchise failed within the first three years, in part alleging that franchisor failed after franchisee made untrue statements regarding startup expenses. *See id.*

[28] *Id.*

[29] *Morris v. Int'l Yogurt Co.*, 107 Wash. 2d 314, 316 (1986).

[30] *Id.*

[31] *See id.*

[32] *Id.* at 330 (emphasis added).

[33] *Id.* at 323 (quoting *Shermer v. Baker*, 2 Wash. App. 845, 855 (1970)).

[34] *Id.* at 324.

[35] *See Something Sweet, LLC v. Nick-N-Willy's Franchise Co., LLC*, 156 Wash. App. 817, 823 (2010).

[36] *See id.*

[37] *See id.* at 819.

was not a key feature of the franchise agreement.[38] The court reasoned that the franchise agreement gave no indication that the number of outlet stores versus restaurant stores would remain static, nor did the franchise agreement require specific adherence to one model or the other, effectively allowing the franchisees to be flexible.[39] Furthermore, the franchisor put on evidence to show that support to existing outlet stores would continue, and standards for new stores would not wholly apply to the existing franchises.[40]

While courts have found that a franchisor is not required to voluntarily disclose a pending or anticipated sale of the franchisor, at least one court previewed that that may change when a franchisor expressly denies that fact..[41] The Southern District of New York found that Hilton's vague reassurances about a forthcoming sale of the Red Lion brand did not amount to a material misrepresentation or a fraudulent omission.[42] Specifically, while Hilton's representatives allegedly provided assurances and lead the franchisee to believe there was no intent to sell, franchisee could not specifically identify a representation that rose to the level of fraud.[43] In *Bixby's Food Sys., Inc. v. McKay*, the court reviewed two potential misrepresentations related to financial statements and the number of signed development agreements received by franchisees.[44] The court used the following materiality standard: "[a] material fact is one in which 'a buyer would have acted differently knowing the information, or . . . concerns the type of information upon which a buyer would be expected to rely in making a decision whether to purchase.' In other words, the fact 'must be essential to the transaction between the parties.'"[45] The first alleged misrepresentation related to expected earnings.[46] The franchisee alleged that the franchisor "drastically modified investment and earnings projections" within two weeks before it had signed the franchise agreement.[47] The court found that the franchisee failed to prove that the disclosure falsely presented material facts, stating that franchisors only expressed an option related to future events that was not a misrepresentation and denied their motion for summary judgment.[48] (This could be

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[38] *See id.* at 824.

[39] *See id.*

[40] *See id.*; *see also Kieland v. Rocky Mountain Chocolate Factory Inc.*, No. CIV.05 150 DWF/SRN, 2006 WL 2990336 (D. Minn. Oct. 18, 2006) ("Plaintiffs allege that Rocky Mountain failed to disclose that it had a policy and practice of waiving royalty fees for some franchisees. The Court finds that this claim fails as a matter of law. . . . Rocky Mountain executives testified that Rocky Mountain is currently waiving 5 of its 300 franchisees' royalty fees. The Court finds that, on this record, these waivers do not constitute a material fact that Rocky Mountain was required to disclose.").

[41] *See e.g.*, *O'Neal v. Burger Chef Sys., Inc.*, 860 F.2d 1341 (6th Cir. 1988) (finding that the franchisor had no duty to disclose the pending sale under Tennessee law, which created a duty to disclose only where there was a previous confidential relationship between the parties or where the contract or transaction was intrinsically fiduciary and called for good faith).

[42] *Century Pac., Inc. v. Hilton Hotels Corp.*, 528 F. Supp. 2d 206, 220 (S.D.N.Y. 2007), *aff'd*, 354 F. App'x 496 (2d Cir. 2009).

[43] *See id.* at 221.

[44] *Bixby's Food Sys., Inc. v. McKay*, 193 F. Supp. 2d 1053 (N.D. Ill. 2002).

[45] *Id.* at 1062 (quoting *Cozzi Iron & Metal, Inc. v. U.S. Office Equip., Inc.*, 250 F.3d 570, 576 (7th Cir. 2001)).

[46] *See id.* at 1061 (quoting *Cozzi Iron & Metal, Inc. v. U.S. Office Equip., Inc.*, 250 F.3d 570, 576 (7th Cir.2001)).

[47] *See id.* at 1061.

[48] *See id.* at 1065. The Court also found statements of future expected earnings were not present material facts, as required for a misrepresentation claim. *Id.* 1065; *see also Healy v. Carlson Travel Network Assocs.*, Inc., 227 F. Supp. 2d 1080, 1091 (D. Minn. 2002).

viewed as good news for franchisors in that producing amended franchise disclosure documents did not create a presumption that the prior version was false because of significant changes between years.) The second alleged misrepresentation related to the franchisor's description of the number of signed development agreements; the franchisor stated it signed more development agreements than it had.[49] The court granted summary judgment to the franchisee concluding that this overstatement of the number of agreements was "a knowingly false statement of a present material fact" [50] because the information was important to the prospective franchisee decision to execute the franchise agreement shortly after.[51]

In *FTC v. Transnet Wireless Corp.*, the FTC brought a deceptive trade act suit against two wireless phone companies for (1) their misrepresentations about potential earnings and (2) the availability of profitable locations.[52] Both phone companies offered public access internet kiosks in Florida in the early 2000s.[53] The companies' "salespeople told potential consumers that the average income generated from the business venture ranged from $1,000 to $2,000 per month per kiosk" and touted the companies' ability to find the "very best locations available."[54] In actuality, some owners made much less—for example one made as little as $300 in a year for a unit at a truck stop, and another only made $50 per month in a high traffic mall.[55] Importantly, the court applied a standard similar to the *TSC total mix* concept: "[a] representation is material if it is of a kind usually relied upon by a reasonably prudent person."[56] The court found that "Defendants made material representations, express or implied, that were likely to mislead reasonably prudent consumers . . . by making two material misrepresentations: (1) the potential earnings a consumer was likely to achieve by purchasing Defendants' internet kiosks and (2) claims about the availability and procurement of profitable locations for consumers' public access Internet kiosks."[57]

A take–away from these cases is that information that impacts the reasonable purchaser's or investor's decision should be disclosed and the failure to do so will likely meet *TSC*'s "total mix" standard or the similar "affects the decision" standard described below. When drafting provisions that address the materiality of a representation or satisfaction of a condition, it is advisable to describe expressly why the provision is material to the contract and that a breach of the provision subjects the contract to termination.

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[49] *See Bixby's Food Sys., Inc.*, 193 F. Supp. 2d at 1066.
[50] *Id.*
[51] *Id.* at 1062.
[52] *F.T.C. v. Transnet Wireless Corp.*, 506 F. Supp. 2d 1247 (S.D. Fla. 2007).
[53] *See id.* at 1253–55.
[54] *Id.* at 1255.
[55] *See id.* at 1260.
[56] *Id.* (citing *Fed. Trade Comm'n v. Jordan Ashley, Inc.*, No. 93-2257-CIV-NESBITT, 1994 WL 200775 (S.D. Fla. Apr. 5, 1994)).
[57] *Id.* at 1267. Note that the FTC has amended the franchise rule in 2007 to remove these specific definitions including "material," "material change," and "material fact." *See* 16 C.F.R. § 436.2 (as amended in June 2007).

Discussion of materiality also appears in the context of financial performance representations and Item 19.[58] In *Colorado Coffee Bean, LLC v. Peaberry Coffee Inc.*, the appellate court did not fully define *material* but discussed materiality in a way similar to that of the *TSC* standard, stating that the contemplated financial information was important to the prospective franchisee and should have been disclosed to make an informed decision.[59] Specifically, the franchisor only disclosed gross sales data for the company owned stores, which did not reveal losses as would have been clear if net financials were produced and did not disclose the financial data from franchised stores. .[60] The court found this was a concealment of a *material* fact. The court affirmed the trial court finding against the franchisee's however, on the basis that the franchisees did not reasonably rely on the undisclosed information.[61] The court found persuasive the disclaimers that the performance information provided was not predictive of franchise performance and the franchisees' admissions that they knew of franchisor's history of financial difficulty and that they used other publicly disclosed information to derive their own financial break even predictions.[62]

2. IN ALL MATERIAL RESPECTS

Another area in which courts grapple with the definition of material is the phrase "in all material respects." This phrase appears in the mergers-and-acquisitions context, often with the phrase *material adverse change* (or material adverse effect ("MAE")) which together plays an important role in statements of fact (known traditionally as "representations and warranties") and in closing conditions, which give the buyer the right not to close for a variety of stated conditions.[63] A traditional MAE clause has three components: (1) defined and plausible events or circumstances which will have MAE specific to the parties (for example, failure for buyer to acquire adequate funding); (2) carve-out occurrences, typically conditions which impact the market, industry, or businesses generally (i.e. natural disasters or acts of God); and (3) a disproportionate impact exemption which returns risk from the buyer to seller based on effects which are disproportionate as compared to the other industry peers.[64]

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[58] *See* 16 C.F.R. § 436.5(s).
[59] *See id.* at 22.
[60] *See id.* at 18.
[61] *See id.*
[62] *See id.* The court found that the missing information was material even though it was not required to be included in Item 19 under the FTC Franchise Rule. *Id.* at 1270.
[63] *See* Ken Adams, *The Word Material is Ambiguous in Contracts, Why That's a Problem and How to Fix It*, SCRIBES J. OF L. WRITING 84, 86 (2023).
[64] Todd H. Bartels & Zeshawn Qadir, *COVID-19* and Material Adverse Effect Clauses in Acquisition Agreements, 2 POLSINELLI PULSE, July 2020, at 2, https://polsinelli.gjassets.com/content/uploads/2022/02/ma_litigation-newsletter-vol-2-5.pdf; *see* also *In re IBP, Inc. S'holders Litig.,* 789 A.2d 14 (Del. Ch. 2001) ("The *IBP* reading added three glosses to materiality in this context in that a MAE closing condition will not be satisfied only if the event in question (1) lasts long enough to be meaningful, (2) is unexpected, and (3) is not otherwise addressed.").

In *Akorn, Inc. v. Fresenius Kabi AG*, the court reviewed materiality using MAE, the adjective *material*, and the phrase *in all material respects*.[65] Adams, discussing *Akorn*, notes that:

> two conditions (the court called them the "General MAE Condition" and the "Bring-Down Condition") were expressed using MAE. The contract also made it a condition to the buyer's obligation to close that Akorn, the seller, "complied with or performed in all material respects its obligations required to be complied with or performed by it at or prior to the Effective Time." The court called this the "Covenant Compliance Condition." To establish that Akorn had not satisfied the Covenant Compliance Condition, the buyer (Fresenius) contended that Akorn had not fulfilled its obligation to "use its . . . commercially reasonable efforts to carry on its business in all material respects in the ordinary course of business." The court called this the "Ordinary Course Covenant."[66]

The buyer argued that under the Covenant Compliance Condition, a failure to comply with its obligations "in all material respects," should be interpreted as a failure to comply that would rise to the level of a material breach under common law. The *Akorn* court rejected that argument:

> Treatises on M & A agreements suggest a different purpose for including the phrase "in all material respects." Drafters use this language to eliminate the possibility that an immaterial issue could enable a party to claim breach or the failure of a condition. The language seeks to exclude small, *de minimis*, and nitpicky issues that should not derail an acquisition. . . . Based on these authorities, the plain meaning of "in all material respects" in the Covenant Compliance Condition and the Ordinary Course Covenant calls for a standard that is different and less onerous than the common law doctrine of material breach. . . . It strives to limit the operation of the Covenant Compliance Condition and the Ordinary Course Covenant to issues that are significant in the context of the parties' contract, even if the breaches are not severe enough to excuse a counterparty's performance under a common law analysis.[67]

In support of this definition of *in all material respects*, the court cited an earlier Court of Chancery decision, *Frontier Oil*, that relied on the *TSC* standard when interpreting the phrase *in all material respects*.[68] The *Frontier Oil* court, as noted above, without specifically defining MAE or materiality, found that a nondisclosed indemnity agreement that made Frontier liable directly for matters that were the subject of "threatened litigation" was not a material contract. It determined that Frontier did not breach a warranty concerning the existence of material contracts. The court used the "affects-the-decision"

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[65] *Akorn, Inc. v. Fresenius Kabi AG*, No. CV 2018–0300–JTL, 2018 WL 4719347 (Del. Ch. Oct. 1, 2018), *aff'd*, 198 A.3d 724 (Del. 2018) (internal citations omitted). Delaware courts require that anyone claiming a MAE must make a strong showing, in one case referring to it as a "heavy burden." *Id.*

[66] Ken Adams, *The Word Material is Ambiguous in Contracts, Why That's a Problem and How to Fix It*, SCRIBES J. OF L. WRITING 84, 88 (2023) (citing *Akron*, 2018 WL 4719347) (italics to case references added).

[67] *Akorn*, 2018 WL 4719347, at *86 (footnotes omitted).

[68] *See id.*

standard in defining material and held that the risk that liability would result from such threatened litigation was too uncertain at the time the warranty was given to be "material."[69]

The *Akorn* court said that the *Frontier Oil* standard "fairly captures what I believe the 'in all material respects' language seeks to achieve."[70] This is notwithstanding the case that the indemnity agreement and threatened litigation would have likely met the "important enough to merit attention" standard.[71]

In a more recent Delaware Court of Chancery decision, *Channel Medsystems, Inc. v. Boston Scientific Corp.*, the court examined the meaning of *material* when used in other contexts of an acquisition agreement.[72] There the term *material* was used to modify a representation requiring the seller materially comply with certain laws and "in all material respects" with certain filing procedures as it related to a device.[73] Channel's vice present of quality falsified the representations at issue in a fraudulent scheme to syphon money from the company.[74]He produced false documents which ended up in Channel's FDA premarket approval application for a Class III Cerene device, including over one-hundred false test reports and a European Conformity certification which was never received.[75] The merger agreement permitted buyer to terminate if "(i) one or more of the representations . . . was inaccurate as of the Agreement Date and (ii) the failure of such representation(s) to be true and correct 'has or reasonably would be expected to have a Material Adverse Effect' on Channel."[76] Each of the representations had a materiality qualifier and there was no "materiality scape" provision to eliminate the representations from the Material Adverse Effect considerations.[77]

As noted above, the *Akorn* Court suggested that the *materiality* standard in a covenant requiring compliance "in all material respects" was "different and less onerous than the common law doctrine of material breach."[78] Instead *in all material respects* should be evaluated in light of a disclosure-based standard that "requires only a 'substantial likelihood that the . . . fact [of breach] would be viewed by a reasonable investor as having significantly altered the 'total mix' of information'" available to that buyer in deciding to enter into the agreement.[79] The standard is that an item is "something important enough that had it been known at the time of contracting it would have significantly altered the total information upon which the buyer was basing its decision to enter into the transaction, even if it would not have necessarily been so critical that it

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[69] *Frontier Oil*, 2005 WL 1039027, at *37.
[70] *Akorn*, 2018 WL 4719347, at *86.
[71] *See* Ken Adams, *Rethinking "Material" and "Material Adverse Change"*, ADAMS ON CONTRACT DRAFTING, Feb. 26, 2007, https://www.adamsdrafting.com/rethinking-material-and-mac/.
[72] *Channel Medsystems, Inc. v. Bos. Sci. Corp.*, No. CV 2018–0673-AGB, 2019 WL 6896462, at *17 (Del. Ch. Dec. 18, 2019), *judgment entered*, (Del. Ch. 2019).
[73] *See id.*
[74] *See id.* at *1.
[75] *See id.* at *7.
[76] *See id.* at *16 (internal quotations to acquisition agreement).
[77] Glenn D. West, *Defining "Material"—What Matter Will Matter?*, GLOBAL PRIVATE EQUITY WATCH, Jan. 13, 2020, https://privateequity.weil.com/insights/defining-material-what-matter-will-matter/ (discussing *id.*).
[78] *Akorn*, 2018 WL 4719347, at *86.
[79] *Channel Medsystems*, 2019 WL 6896462, at *17 (quoting *id.*).

would have resulted in a decision not to do the deal."[80] Ken Adams calls this the "affects a decision meaning."[81]

The Court in *Channel Medsystems* borrows from *Akorn* and the "*affects a decision"* meaning of *material* and applies it to several representations that the buyer claimed were inaccurate, finding that that the "*affects a decision"* standard was met in each of the affected representations except one where the Court concluded there was a failure to identify any evidence of material defect.[82] In each case, the Court concluded that the "reasonable acquiror would have viewed the existence of falsified documents as presenting a significant risk that the FDA approval would not be obtained."[83] Even if *not trivial* evidence of misrepresentation was required to meet the materiality standard, the court, however, found that none of the inaccuracies impacted the deal in such a way so as to rise to the level of MAE.[84] And still, even with the discussed precedent, other courts have ignored these decisions and relied upon dictionary meaning of material.[85]

Outside the M&A context, it is probably prudent not to rely on a covenant requiring compliance to be accurate *in all material respects* to be interpreted as sufficient basis for material breach of the franchise agreement unless expressly stated to be the case. Further with respect to such representations and covenants it would be advisable to include language setting the stage for how important the representation is to the enforcing party's decision to enter into the agreement.

3. MATERIAL CONDITIONS AND MATERIAL BREACH

In the franchise agreement drafting context materiality is used in at least two overlapping contexts; (1) material compliance with conditions; and (2) material breach.

In *Maple Shade*, the Third Circuit affirmed the district court's grant of summary judgment in favor of Kia Motors's good cause termination of the franchise agreement.[86] Kia Motors terminated the franchise agreement with Maple Shade Motors after franchisee failed to build an exclusive Kia showroom as described in an addendum to the franchise agreement.[87] The court, applying the New Jersey statute that requires good cause to terminate a franchise agreements.[88] The Court defined the good cause requirement to turn on "whether a franchisee has breached a material obligation of the franchise agreement."[89] The Court said "a breach is material if it 'will deprive the injured party of the benefit that is justifiably expected' under the contract."[90] The Circuit Court, affirming

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[80] *West*, *Defining "Material"—What Matter Will Matter?* (discussing Kenneth A. Adams, A Manual of Style for Contract Drafting §9.1-9.16 (4th Ed. 2017)).
[81] *Adams*, *Rethinking "Material" and "Material Adverse Change"*.
[82] *See Channel Medsystems*, 2019 WL 6896462, at *44; *West*, *Defining "Material"—What Matter Will Matter?*
[83] *West*, *Defining "Material"—What Matter Will Matter?*
[84] *See Channel Medsystems*, 2019 WL 6896462, at *29.
[85] *See e.g.*, *Schneider National Carriers, Inc. v. Kuntz*, No. CV N21C–10–157–PAF, 2022 WL 1222738 (Del. Super. Ct. Apr. 25, 2022).
[86] *Maple Shade Motor Corp. v. Kia Motors Am., Inc.*, 260 F. App'x 517, 519 (3d Cir. 2008).
[87] *Id.* at 518.
[88] *Id.* (citing The New Jersey Franchise Protection Act, N.J. STAT. §§ 56:10–1, *et seq.*).
[89] *Id.* (citing *Gen. Motors Corp. v. New A.C. Chevrolet, Inc.*, 263 F.3d 296, 315–17 (3d Cir. 2001)).
[90] *Id.* (citing *Gen. Motors Corp.*, 263 F.3d, 315-17 (quoting 2 E. ALLEN FARNSWORTH, FARNSWORTH ON CONTRACTS § 8.16, at 497 (2d ed. 1998)). Consider that the objective expectation standard

the District Court, found that because the franchise agreement expressly stated a franchisee's obligation to build a showroom, franchisor was "justified in expecting Maple Shade to build the Kia showroom as it was integral to the parties' agreement."[91] Thus, franchisee's failure to build the showroom was a material breach "as its existing facilities did not provide Kia with a benefit that it justifiably expected under the Addendum, an exclusive Kia showroom."[92]

In *General Motors*, the Third Circuit affirmed the District Court's granting of GM's summary judgment in their declaratory judgment suit on the grounds GM's termination of the franchise agreement was lawful, in part due to franchisee's material breach of the franchise agreement.[93] Franchisee added a Volkswagen franchise to the existing GM dealership, although at another site, over the objection of GM.[94] The Court held that franchisee's "decision to 'dual' a Volkswagen" and Chevrolet franchises is a breach of the franchise agreement.[95] While the franchise agreement itself defines what breaches are material, and in this case the addition of a vehicle line without GM's consent is a defined material breach, the Court's analysis of material breach did not stop there.[96] The Court reasoned that without provisions prohibiting 'dualling,' franchisee "would have the generally unfettered right to put its dealership property to the uses it sees fit . . . however, the parties mutually agreed to constrain the exercise of that right by conferring on GM the power to disapprove of a proposal to "dual" another vehicle line."[97] The Court therefore concluded, even putting aside the fact that the contract defined material breach, that "a franchisee's breach of a reasonable franchise obligation—committed over the express and persistent objections of the franchisor—is a material one."[98] The Supreme Court of New Jersey, which stated, as it relates to material breach, "[p]lainly, noncompliance by a franchisee with his reasonable franchise obligations, resulting in an actual or potential adverse effect upon the sales of the franchisor's products, would constitute substantial noncompliance thereof for purposes of termination, impairing as it does the franchisor's fundamental reason for initially entering into the relationship."[99] The court concluded that provision was material because of the parties' specific inclusion in the contract, GM's reliance, and subsequent objection over violation of the anti 'dualling' provisions.[100]

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specifically diverts from antiquated approaches to materiality like the "foregone opportunity approach", because such a subjective standard is difficult to apply where a fact finding about the individual's presence of mind when drafting the contract is necessary outside of the four corners. FARNSWORTH ON CONTRACTS, at 638.

[91] *Id.*

[92] *Id.*

[93] *See Gen. Motors Corp. v. New A.C. Chevrolet, Inc.*, 263 F.3d 296 (3d Cir. 2001).

[94] *See id.* at 315.

[95] *Id.* at 316.

[96] *See id.* "Article 13.1.5 specifically includes as a material breach, '[a]ny sale, transfer, relinquishment, or discontinuance of use by Dealer of any of the Dealership Premises or other principal assets required in the conduct of the Dealership Operations, without [GM's] prior written approval.'" *Id.*

[97] *Id.*

[98] *Id.*

[99] *Id.* (quoting *Amerada Hess Corp. v. Quinn*, 362 A.2d 1258, 1268–69 (N.J. 1976)).

[100] *See id.*

In *Peterbrooke*, the Eleventh Circuit analyzed whether violating the point of sale ("POS") requirement was a material breach of the agreement.[101] Peterbrooke's franchise agreement had a specific provision which required that at Peterbrooke's discretion, the franchisee would have to install changes, modifications, substitutions, or replacements to their POS system.[102] Franchisee failed to replace the previously required POS system with the updated required POS system, and instead installed a different POS system altogether.[103] Peterbrooke terminated the franchise agreement on that basis alone.[104] The Eleventh Circuit then vacated and remanded the district court's grant of summary judgment in favor of Peterbrooke, finding a material question of fact whether the POS system requirement was "material" or not.[105] While the franchise agreement itself did not use the term material, the Court, applying Florida law, found that the contract termination was only proper if the breach was "material."[106] Specifically, the court described a material breach to "go to the essence of the contract" and "[a] party's 'failure to perform some minor part of his contractual duty cannot be classified as a material or vital breach.'"[107] Franchisees presented compelling evidence of the immaterial nature of the POS system requirements, including their current POS system's equivalent functionality as the required POS system and that other franchisees were still using different POS systems at the time of the termination.[108]

In *S&P Brake Supply*, the Supreme Court of Montana confirmed the Montana Department of Justice's decision to approve the Daimler Trucks of North America ("DTNA")'s good cause termination of the franchise agreement with S&P.[109] At the hearing, DTNA articulated three bases of termination: "failure to adequately promote and sell Western Star trucks, failure to hire necessary personnel, and failure to submit required financial statements."[110] The Court provided a definition of material breach: "a substantial or material breach is one which touches the fundamental purposes of the contract and defeats the object of the parties in making the contract."[111] S&P argued that because DTNA provided a primary basis of termination, all other reasons for termination were secondary.[112] The Court rejected this idea, stating that "just because Daimler considered them to be secondary reasons for termination does not necessarily mean they

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[101] *See Peterbrooke Franchising of Am., LLC v. Miami Chocolates, LLC*, No. 21-10242, 2022 WL 6635136 (11th Cir. Oct. 11, 2022).
[102] *See id.* at *3 ("The appellants largely rely on § 4.6.4 of the franchise agreement, which states: 'Following [Peterbrooke of America's] testing and determination that it will prove beneficial to [Miami Chocolates], [Miami Chocolates] agree[s] to install at [its] own expense such additions, changes, modifications, substitutions and/or replacements to [the POS system].'").
[103] *See id.* at *2.
[104] *See id.*
[105] *See id.* at *6.
[106] *See id.* at *4.
[107] *See id.* (both quoting *MDS (Canada) Inc. v. Rad Source Techs., Inc.*, 720 F.3d 833, 849 (11th Cir. 2013)).
[108] *See id.* at *5.
[109] *S & P Brake Supply, Inc. v. Daimler Trucks N. Am., LLC*, 411 P.3d 1264 (Mont. 2018).
[110] *Id.* at 1266.
[111] *Id.* at 1270 (quoting *Norwood v. Serv. Distrib., Inc.*, 994 P.2d 25, 32 (Mont. 2000)).
[112] *See id.*

were not material."[113] The Court found they were each material provisions of the franchise agreement.[114]

In *Servepro*, the court granted franchisor's summary judgment against franchisee's breach of contract counterclaim asserting that terminating the franchise agreement was a breach of contract.[115] In finding such, the court analyzed the franchise agreement's use of the term "materially" as a basis for termination under the franchise agreement.[116] The notice of termination letter stated that "Section 10.4(c) of the Franchise Agreement authorizes Servpro to terminate the Franchise Agreement with notice and without affording Franchisee the opportunity to cure if Franchisee: (c) . . . engages in conduct that reflects materially and unfavorably upon OPERATOR and the reputation of the System."[117] ServePro then terminated the franchise agreement pursuant to nine formal complaints of overbilling, misbehavior, and potential fraud in twenty-two months.[118] "In the Court's view, the plain meaning of the latter clause permits termination where Servpro determines, in good faith, that a franchisee's conduct—either through the accumulation of customer complaints or the failure to promptly resolve those complaints—has a materially unfavorable effect on Servpro's reputation."[119] Further, the court stated that "at some point, the consistent and serious nature of unresolved consumer complaints can be a legitimate basis for termination if the franchisor can show the complaints resulted in damage to its reputation" regardless of the legitimacy of such complaints because of the public forming opinions which affect the reputation of the franchisor.[120] In its reasoning, the court relied on the Ninth Circuit's statement that material damage to a reputation is the "good faith belief of the franchisor that the franchisee is untrustworthy or engages in fraudulent practices that undermines the entire franchise relationship."[121] In sum, the court found that the continuous and unresolved nature of the complaints met the materiality threshold as it relates to an unfavorable reputation of the system.

In *Sioux Falls Pizza*, the court reviewed franchisee's action for declaratory judgment that it was entitled to renew its franchise agreement with franchisor Little Caesar's Pizza.[122] Franchisor initiated non-renewal of the franchise agreement following franchisee's filing of trademark violation litigation based on the assertion that franchisor stole franchisee's intellectual property for the mark "Hot-N-Ready."[123] The franchise agreement non-renewal provision, in relevant part, read as follows:

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[113] *Id.*
[114] *See id.* at 1271.
[115] *See Servpro Indus., Inc v. Woloski*, No. 3:17-CV-01433, 2020 WL 5629452, at *21 (M.D. Tenn. Sept. 21, 2020), *aff'd sub nom.*, *Servpro Indus., Inc. v. Woloski*, No. 21–5685, 2022 WL 633844 (6th Cir. Mar. 4, 2022).
[116] *See id.* at *4–5.
[117] *See id.* (quoting the franchise agreement).
[118] *See id.*
[119] *Id*. at *8.
[120] *Id.*
[121] *Id.* (quoting *Humboldt Oil Co., Inc. v. Exxon Co.,* 695 F.2d 386, 388–89 (9th Cir. 1982)).
[122] *See Sioux Falls Pizza Co. v. Little Caesar Enterprises, Inc.*, 858 F. Supp. 2d 1053, 1056–57 (D.S.D. 2012).
[123] *Id.* at 1058 (discussing *Pinnacle Pizza Co., Inc. v. Little Caesar Enter., Inc.*, 560 F. Supp. 2d 786 (D.S.D. 2008) *aff'd* 598 F. 3d 970 (8th Cir. 2010) (hereinafter "*Hot–N–Ready litigation*")).

> 2.2—Renewal Term of Franchise: Franchisee may, at its option, renew this franchise for one renewal term of ten (10) years; subject to the following prerequisites:
>
> 2.2.3 Franchisee shall have satisfied all monetary obligations owed by Franchisee to Little Caesar and its affiliates and shall not be in default of any provision of this Agreement, any amendment hereof or successor hereto, or any other agreement between Franchisee and Little Caesar or its affiliates, and, in the reasonable judgment of Little Caesar, Franchisee shall have substantially and timely complied with all the terms, conditions and obligations of such agreements during the terms thereof and the Manuals (as defined in Section 4.3).[124]

In its notice, Little Caesar advised Sioux Falls Pizza of its "substantial default under the expiring franchise agreements," due to filing the *Hot-N-Ready litigation*.[125] The court agreed with Little Caesars for two main reasons. First, following Little Caesars's interpretation, the second portion of Section 2.2.3 means that the basis of non-renewal is subject to Little Caesar's reasonable judgment whether they "failed to substantially and timely comply with all the terms and conditions" of the franchise agreement.[126] Second, the eighth circuit in *Hot-N-Ready litigation* separately concluded that the litigation was a violation of the franchise agreement.[127] The court concluded that the *Hot-N-Ready litigation* was a substantial default of the franchise agreement justifying non-renewal based on the standard definition of "substantial" (where the franchise agreement did not define the term).[128] The court found the *Hot–N–Ready litigation* was "a default under the franchise agreements that Sioux Falls Pizza 'expressly' promised to avoid and that had the potential to deprive Little Caesar of the "Hot–N–Ready" trademark and concept, fits within the plain meaning of 'substantial'" based on the dictionary definition of substantial as "important, essential, [and] . . . significantly great."[129]

In *McDonald's*, the court found that a prerequisite to finding likelihood of success on the merits for a grant of injunctive relief relied on finding a legitimate termination of the franchise agreement.[130] The court found franchisee's "failure to comply with McDonald's QSC and food safety standards constituted a material breach of the franchise agreement sufficient to justify termination."[131] Said another way, "[t]he QSC and food safety standards produced by McDonald's constitute some of the 'standards and policies' with

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[124] *Id.* Note that this language reflects the version of the franchise agreement as amended by the Hotchkiss settlement agreement, which the parties agreed controlled the franchise relationship at the time of the suit. *See id.*
[125] *Id.*
[126] *See id.* at 1061–62.
[127] Note that there is another version of the franchise agreement which alleged a "substantial default" which the *Hot-N-Ready litigation* also would have violated accordingly. *See id.*
[128] *Id.* at 1062.
[129] *Id.* (quoting Merriam–Webster's Collegiate Dictionary, 1170 (10th ed. 2000)).
[130] *McDonald's Corp. v. Robertson*, 147 F.3d 1301, 1309 (11th Cir. 1998).
[131] *See id.*

which McDonald's franchisees must comply.[132] Thus, continued violation of these standards appears to constitute a material breach of the franchise agreement."[133]

The court in *IHOP* applied this same reasoning where the franchise agreement defined material breach.[134]

> According to the terms of the Franchise Agreements, when a material breach occurs, IHOP has the right to terminate the Franchise Agreements if, after notice and an opportunity to cure, Moeini Corporation fails to timely cure the material breach. In relevant part, as defined and applied in the Franchise Agreements, "material breach" includes the "failure of Franchisee to comply with any other material obligation of Franchisee under the agreements, including failure to comply with Franchisor's Operations Bulletins as described in paragraph 10.05." [Franchise Agreement] Section 10.05 states that the franchisee Moeini Corporation "shall operate the Franchised Restaurants in strict compliance with all Applicable Laws and with the standard procedures, policies, rules and regulations established by Franchisor and incorporated herein, or in Franchisor's Operations Bulletins." The IHOP policy manuals and operations bulletins include the policies and procedures for operating an IHOP restaurant including the policies and procedures for maintaining IHOP's standards of food safety, food preparation, sanitation and cleanliness at the restaurants. The OEs, OARs, and the customer complaints significantly support IHOP's position that Moeini Corporation failed to strictly comply with IHOP's operations bulletins, as defined in § 1.02, and thus committed a material breach of the Franchise Agreements. Moreover, and importantly, repeated violations of food safety standards constitute a material breach of a restaurant franchise agreement.[135]

IHOP and *McDonald's* together show that failure to meet standards of quality, health, and safety as described in the franchise agreement are likely always going to be violations of the franchise agreement under a materiality standard.

In *Bar Method*, franchisor brought an enforcement action against a former franchisee who was subject to a non-compete and post termination covenant of non-use of proprietary information under the franchise agreement and settlement agreement.[136] The settlement agreement between the parties maintained the non-compete but narrowed the radius and reconfirmed the terms of the franchise agreement, stating that franchisee may not offer "bar classes" at their new studio.[137] The court found that "the

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[132] *Id.*
[133] *Id.* (quoted by *Dunkin' Donuts Franchised Restaurants LLC v. D & D Donuts, Inc.*, 566 F. Supp. 2d 1350, 1359 (M.D. Fla. 2008)).
[134] *IHOP Restaurants LLC v. Moeini Corp.*, No. CV 17–00570–KD-M, 2018 WL 762343, at *5 (S.D. Ala. Feb. 7, 2018).
[135] *Id*. at *6; *see McDonalds Corp.*, 147 F. 3d at 1309 (internal citations removed).
[136] *Bar Method Franchisor LLC v. Henderhiser LLC*, 580 F. Supp. 3d 979 (D. Colo. 2022).
[137] *Id.*

noncompete obligation constituted *material* terms of the contract because the provision was "important to The Bar Method to maintain the integrity of its franchise system."[138]

Repeated breaches of a franchise agreement have also supported a termination for material breach. In *7-Eleven v. KRSM*, the New Jersey District Court granted a preliminary injunction against franchisee based on 7-Eleven's likelihood of success on the merits where the franchise agreement specifically allowed for termination based "on four or more separate occasions within two years" and 7-Eleven had sent seventeen notices of material breach over the course of a just under two years.[139] Importantly, the standard is not the materiality of each individual breach, but the consistent breach and notice from the franchisor that rises to the level of material breach.

Another important consideration is not just when to use words like material, but also when to use words like significant, and when to not use them. Specifically, courts generally consider that "the use of different language in different contractual provisions strongly implies that a different meaning was intended."[140] Thus, while the above discusses where you might use or not use material in a certain instance, that decision also affects other clauses in the same section or even contract.[141]

C. MATERIALITY CONCLUSION

Not every provision can be properly or credibly expressed as material or constitute a provision the violation of which would render it material under analyses of most courts. Not using materiality to describe conditions, representations, or events in a franchise agreement does not eliminate disputes about whether the provision is material, as if it is challenged, state law will address under what circumstances and how one can respond to a breach or a failure of a condition. It would be advisable to use the term "material" in situations where you also give some backdrop showing why the standards that courts apply to the analysis of materiality are met including: 1) that it is foundational to why the parties entered into the agreement in the first place; 2) that had the parties known of the failure to provide information or perform, such information or failure to perform would have affected the decision of the parties to enter into the agreement, make modifications, amendments, etc. (including renewal or in reviewing a request for approval of a transfer) and 3) it constitutes a term for which disapproval or termination is a remedy. For example,

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[138] *Id.* at 993 (second quote from testimony used at trial) (emphasis added).

[139] *7-Eleven, Inc. v. KRSM Inc.*, No. 22 Civ. 7220 (ZNQ) (LHG), 2023 U.S. Dist. LEXIS 39722, at *28 (D.N.J. Mar. 9, 2023); *see also Cici Enterprises, LP v. Fogel Enterprises, Inc.*, No. 22 Civ. 1202, 2023 U.S. Dist. LEXIS 54768, at *5, *18–*20 (N.D. Tex. Mar. 30, 2023) (finding CiCi's likelihood of success on the merits and granting CiCi's preliminary injunction where material default specifically included franchisee "repeatedly commits a material breach" where CiCi's sent two separate notices of material breach for using unauthorized products from unauthorized suppliers); *Sasoro 13, LLC v. 7-Eleven, Inc.*, No. 3:22–cv–2313, 2023 WL 2290788 (N.D. Tex. Feb. 27, 2023).

[140] *Peterbrooke*, 2022 WL 6635136, at *5 (quoting *Aleman v. Gervas*, 314 So. 3d 350 (Fla. Dist. Ct. App. 2020)).

[141] While outside the scope of this paper, no state franchise relationship laws provide a specific definition of "material breach" of a franchise agreement, but many franchise agreements themselves self-define breach or provide that the franchise agreement may not be terminated except for good cause. *See* David Hartford ET AL., *W-4: The Importance of Materiality in Franchise Disputes*, AM. BAR ASS'N 46TH ANNUAL FORUM ON FRANCHISING, Nov. 1, 2023, at 3 ("For the most part, state franchise relationship laws appear to graft a version of the common law understanding of a material breach into the franchise relationship.") There is likely to be significant overlap between materiality and good cause.

describing events like installation of certain computer systems, remodels, inspections, or other conduct required by the franchise system standards as material because they are critical benchmarks for operation of the franchised business would bolster enforcement. The same would be true of compliance provisions including with respect to applicable law, permitting, certifications, and training requirements. Regular and uniform enforcement of these critical provisions is also important as course of dealing including conduct of a franchisor amounting to waiver of a material term is a critical consideration. For example, in *Peterbrooke*, the Eleventh Circuit pointed to the franchisor's failure to require all other franchisees to install the new system.[142] To combat this result, most franchise agreements contain anti-waiver provisions which can also unfortunately be waived by course of conduct.[143]

If the use of the term "material" was sufficient there would not be cases asking a court to decide what it means, and use of language derived from cases is likely to continue the conflict over meaning. Adams makes the argument that the term "non- trivial" is more accurate and understandable. Non-trivial would exclude "small, *de minimus* and nitpicky issues" and is supported by both the *TSC* and *Akorn* opinions.[144] Adams also advocates for a provision like "dealbreaker" be used in contracts to signify an event meriting termination of a contract as well as a transaction.[145]

For example, in an agreement the franchisor and franchisee may state that neither has any non- trivial litigation pending against them. Or said another way the franchisor and franchisee only have trivial litigation pending against them. Another substituting use would be saying that the franchisee will not more than trivially fail to comply with standards instead of requiring material compliance. In the franchise agreements this could be a legitimate change in use of terms. Use of the term "dealbreaker" is possible but a drafter would want to encompass within the dealbreaker standard any uncured breach of provisions in a non-trivial manner.

III. EFFORTS STANDARDS

Franchise agreements, like most contracts, often feature obligations expressed using "*efforts*" standards such as best *efforts, reasonable efforts, commercially reasonable efforts, good faith efforts* and even *reasonable best efforts* and other variants. Contracting parties typically use *efforts* standards when wanting better to ensure the completion of an action or satisfaction of a condition. An example would be ensuring that

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[142] *See Peterbrooke*, 2022 WL 6635136, at *5; *see also RBC Nice Bearings, Inc. v. SKF USA, Inc.*, 318 Conn. 737, 768–69 (2015) (finding plaintiff waived minimum purchase requirement under the distribution contract for years three through six, despite their desire to only waive year three for failure to expressly reserve their rights); *see also Burger King Corp. v. Fam. Dining, Inc.*, 426 F. Supp. 485, 493 (E.D. Pa.), *aff'd*, 566 F.2d 1168 (3d Cir. 1977) (finding Burger King's earlier failure to demand strict performance of development schedule supported the court's finding of no automatic termination where the franchisee's nineteen month delay was substantial compliance with the development schedule).

[143] *Cf. Auntie Anne's, Inc. v. Wang*, No. CV 14–01049 MMM (EX), 2014 WL 11728722 (C.D. Cal. July 16, 2014) (finding that while anti-waiver provisions can be waived, defendant "failed to carry their burden of demonstrating that plaintiff waived the non-waiver clause and its right to terminate the agreements due to underreporting of sales").

[144] Ken Adams, *The Word Material is Ambiguous in Contracts, Why That's a Problem and How to Fix It*, SCRIBES J. OF L. WRITING 84, 89–90 (2023) (quoting *Akorn*, 2018 WL 4719347, at *86).

[145] *Id.* at 94.

a contracting party exerts appropriate effort to achieve a goal like satisfaction of a development quota under a development agreement or promotion of the franchise brand in the franchisee's market.

Different efforts standards are typically used or insisted upon by drafters depending on context, sometimes called a hierarchy of efforts when trying to reflect a specific level of desired effort to accomplish a goal or ensure an action takes place. [146] A contracting party is often appropriately reluctant to assume an unqualified obligation to accomplish the goal, satisfy a condition, or ensure performance of an obligation, as doing so would expose the contracting party to liability regardless of the degree of effort exercised. But it is important to understand what the differing levels of effort mean and whether specifying different levels of efforts will be interpreted in the way the drafter intends. By examining caselaw on efforts standards and evaluating whether differentiating among such standards makes a difference, that in turn provides guidance on how to draft to minimize confusion on the meaning of the efforts standards. This section focuses on express *efforts* standards, as opposed to *efforts* standards that courts imply in the absence of explicit obligations, although the caselaw on the implied duty of good faith is relevant to how courts interpret *efforts* standards.[147]

All provisions featuring *efforts* standards are inherently vague, as complying with an *efforts* obligation is a function of the circumstances.[148] Many practitioners believe that the term *best efforts* includes the obligation to make every possible effort, and to use all possible financial resources, to achieve the goal.[149] This would mean *best efforts "*imposes extraordinary duties of assiduity: a very high standard of care, regardless of whether the required efforts might be commercially reasonable."[150] Most practitioners treat 'reasonable efforts,' commercially reasonable efforts' and 'reasonable best efforts' as all different from, and as imposing less of an obligation than, 'best efforts.'[151] There is no understanding or agreement however, as to whether these standards are, as a practical matter, any different from each other, notwithstanding the fact that 'reasonable best efforts' sounds as if it imposes more of an obligation than 'commercially reasonable efforts.[152]

Although commentators generally accept the idea of a hierarchy of *efforts* standards, the caselaw varies depending on the jurisdiction. In the United States, courts (and the Uniform Commercial Code drafters as well) have declined to recognize a hierarchy of *efforts* standards, whereas courts in England and Canada have endorsed the notion.[153]

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[146] *See* Kenneth A. Adams, Interpreting and Drafting Efforts Provisions: From Unreason to Reason, 74 BUS. LAW. 677 (2019).
[147] *See Id.*
[148] *See Id.*
[149] *See* Charles M. Fox, Working with Contracts 90 (2d ed. 2008).
[150] *See* Bryan A Garner, Garner's Dictionary of Legal Usage 108 (3d ed. 2011).
[151] *See Id.*
[152] *See* Kenneth A. Adams, *Interpreting and Drafting Efforts Provisions: From Unreason to Reason*, 74 BUS. LAW. 677 (2019).
[153] *See Id.*

Courts have articulated in different ways what *best efforts* means. Some have held that the appropriate standard is one of good faith, a standard grounded in honesty and fairness. Some have held that the standard requires something more than good faith. Some have held that it's a function of diligence. Some have invoked reasonableness. And some have acknowledged that *best efforts* and *reasonable efforts* mean the same thing. In interpreting a *good-faith efforts* provision, courts are likely to use whatever standard they would use in applying the implied duty of good faith. That standard might require bad faith—equated with dishonesty—for breach, or it might be grounded in reasonableness. Similarly using *commercially* or *all* in *efforts* standards is viewed as redundant.[154]

For example, in a Sixth Circuit decision one judge noted that the term "best efforts . . . [h]as properly be[en] termed an 'extravagant' phrase" and "[a] more accurate description of the obligation owed would be the exercise of . . . 'reasonable efforts.'"[155] Another district court stated that the distinction between the two standards is "merely an issue of semantics".[156] Similarly, courts have equated "best efforts" and "commercially reasonable efforts" obligations.[157] "Notably, case law in New York and Delaware—states that maintain importance in corporate law—blend the meaning of 'best efforts,' 'reasonable efforts' and 'commercially reasonable efforts.'"[158] One common thread exists among courts seeking to define "commercially reasonable efforts"—the clause does not require a party to act against its own business interests.[159] This is also how New York courts have described a party's obligations under a 'best efforts' and 'reasonable efforts standards.'[160] As noted the same has been true under Delaware law.[161]

This is seen in the case, *Alto v. Sun Pharmaceuticals*, where the Southern District of New York reviewed an acquisition contract between the parties, which required that the parties use "commercially reasonable efforts to take all action and to do all things necessary, proper, or advisable in order to consummate and make effective the transaction. . . ."[162] Sun declined to restart development of the Tetrofosmin Products. The court used an objective standard to evaluate whether Sun's decision breached its obligation to make commercially reasonable efforts: "[a]t a minimum, however, 'compliance with a 'commercially reasonable efforts' clause requires at the very least some conscious exertion to accomplish the agreed goal.'"[163] The court found abandoning development of the Tetrofosmin Products was commercially reasonable and not a breach

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[154] *See Id.*
[155] *Permanence Corp v. Kennametal, Inc.*, 908 F.2d 98, 100 n.2 (6th Cir. 1990).
[156] *Trecom Bus. Sys. Inc. v. Prasad*, 980 F Supp 770, 774 n.1 (D.N.J 1997)
[157] Charles Thau, *Is This Really the Best We Can Do? American Courts' Irrational Efforts Clause Jurisprudence and How We Can Start to Fix It*, 109 Georgetown L. J. 665 (2021).
[158] *Id.* at 680.
[159] *See MBIA Ins. Corp. v. Patriarch Partners VIII, LLC*, 950 F. Supp. 2d 568, 618 (S.D.N.Y. 2013) ("A contractual requirement to act in a commercially reasonable matter does not require a party to act against its own business interests, which it has a legal privilege to protect.").
[160] Charles Thau, *Is This Really the Best We Can Do? American Courts' Irrational Efforts Clause Jurisprudence and How We Can Start to Fix It*, at 665.
[161] *Id.* at 681.
[162] *Alto v. Sun Pharm. Indus., Inc.*, No. 1:19-CV-09758-GHW, 2021 WL 4803582 (S.D.N.Y. Oct. 13, 2021), *judgment entered*, No. 19 CIVIL 9758 (GHW), 2021 WL 4805430 (S.D.N.Y. Oct. 14, 2021).
[163] *Id.* at *41 (quoting *Holland Loader Co., LLC v. FLSmidth A/S*, 313 F. Supp. 3d 447, 473 (S.D.N.Y. 2018), *aff'd*, 769 F. App'x 40 (2d Cir. 2019)).

of the contract because "faced with higher costs, uncertain markets, uncertain supply, and risks of cost-prohibitive capital expenditures . . . [d]oing more would have subjected Sun's business to significant risk of loss to its commercial interests" which would have been against Sun's business interests.[164]

A. Specific Cases

1. Best Efforts

The court in *Samica Enterprises, LLC v. Mail Boxes Etc. USA, Inc.* attempted to define "best efforts" stating that "best efforts" requires a party to make such efforts as are reasonable in light of that party's ability and the means at its disposal and the other party's justifiable expectations.[165] This court also went on to cite a law review article stating: "Best efforts is a standard that has diligence as its essence and is imposed only on those contracting parties that have undertaken such performance."[166]

Plaintiffs, as franchisees, had entered into franchise agreements to operate UPS Stores with Defendant, as franchisor.[167] The franchise agreements contained a "best efforts" provision pursuant to which "[Defendant] agree[d] to use best efforts to ensure that its affiliate [UPS] gives Franchisee discounts and incentives on Franchisee's wholesale cost of UPS services."[168] Plaintiffs alleged that Defendant failed to use best efforts in this regard.[169]

The court considered the evidence regarding Defendants efforts and found that the following undertakings satisfied the standard: (1) Defendant had several discussions with UPS about improving "incentives, pricing, and retail rates;" (2) Defendant made "numerous requests to UPS to increase [franchisees'] margins and incentives;" and (3) Defendant suggested that UPS simplify the rate structure, providing for "incentives [on the] retail rate.[170] The court also noted that UPS had, itself, reserved the right to modify Plaintiffs' incentives.[171] This fact, which limited Defendant's abilities and tempered Plaintiff's justifiable expectations, coupled with Defendant's undisputed efforts, led the court to conclude that Defendant fulfilled its obligations.[172]

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[164] *Id.* at *43.
[165] *Samica Enterprises, LLC v. Mail Boxes Etc. USA, Inc.*, 637 F. Supp. 2d 712, 717 (C.D. Cal. 2008) (citing 2 Farnsworth on Contracts § 7.17 at 350 (2d ed. 1998)).
[166] *Id.* (citing On Trying to Keep One's Promises: The Duty of Best Efforts in Contract Law, 46 U. Pitt. L. Rev. 1, 8 (1984)). In *DaimlerChrysler Motors Co., LLC v. Manuel*, the court stated that, "Courts construing a best efforts provision that does not specify the performance to be required commonly hold the promisor to the standard of the diligence a reasonable person would use under the circumstances." 362 S.W.3d 160, 171 (Tex. App. 2012).
[167] *Id.* at 716.
[168] *Id.*
[169] *Id.* at 717.
[170] *Id.*
[171] *Id.* at 718.
[172] *Id.*

Another example of a court grappling with the meaning of "best efforts" is found in *Paccar Inc. v. Elliot Wilson Capitol Trucks LLC*.[173] The relevant franchise agreement provided that:

> DEALER shall give [Plaintiff] notice in writing before undertaking any efforts to sell the dealership. The notice will contain a description of the assets to be sold, the proposed selling price, and other terms relevant to the sale. Upon request, [Plaintiff] agrees to provide assistance to DEALER in locating BUYER candidates acceptable to both [Plaintiff] and DEALER, although DEALER shall independently negotiate any buy/sell agreement. *[Plaintiff] also agrees to make best efforts to conditionally approve potential buyers to facilitate DEALER's negotiations.* Upon conditionally approving a specific buyer, Peterbilt will waive its right of first refusal to that buyer.[174]

Plaintiff asserted the argument that the "best efforts" clause was without meaning and that it could approve or disprove of a potential buyer as it pleased.[175] The Defendant Dealer disagreed.[176]

The court analyzed the term by reviewing the context. It stated, like the court in *Mail Boxes*, that a "best efforts" standard has diligence as its essence.[177] The court rejected Plaintiff's position and reasoned that, at the least, the "best efforts" provision must be interpreted to require that Plaintiff exercise some diligence in considering a potential buyer–the level of diligence to be determined by the circumstances.[178]

The court then concluded that considering the relevant statutory background, pursuant to which consent to a transfer may not be unreasonably withheld, the necessary diligence to satisfy best efforts "must include an obligation to make reasonable efforts to approve a transfer, or, conversely, to not unreasonably reject a transfer."[179] The court went on to reason that reasonable efforts implies good faith and reasonable efforts.[180] The court further stated:

> [Plaintiff] must view the proposed transfer in the most favorable light possible to the dealer. It can be said that [Plaintiff] is to "extend itself" to conditionally approve a potential buyer, to "facilitate" or assist the dealer in

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[173] *Paccar Inc. v. Elliot Wilson Capitol Trucks LLC*, 905 F. Supp. 2d 675 (D. Md. 2012).
[174] *Id.* at 688 (emphasis added).
[175] *Id.*
[176] *Id.*
[177] *Id. (*citing *First Union Nat'l Bank v. Steele Software Sys. Corp.*, 838 A.2d 404 (Md. Ct. Spec. App. 2003)).
[178] *Id.* at 689.
[179] *Id.* Defendant referenced Maryland Transportation code section 15-211(e) to argue that "best efforts" included Plaintiff not unreasonably withhold transfer. *See id.* The statute stated that '"a manufacturer's consent to a transfer may not be 'unreasonably withheld.'" Md. Code Ann., Transp. § 15-211(e) (West)
[180] *See id.* (relying on Randolph Stuart Sergent, Do Your Best with "Best Efforts:" Using Open Contract Terms, Md. B.J., March/April 2007, at 49 ("In terms of content, the Maryland courts have found that a promise to exercise best or reasonable efforts, whether express or implied, contains two separate requirements of "good faith" and "reasonable diligence" in pursuing the stated goal.")).

> its negotiations. If the transfer is deemed unacceptable as a rational business matter even in this light, [Plaintiff] may reject the proposal. . . ."[181]

Based on allegations that Plaintiff consistently attempted to discourage and frustrate the transaction and informed the Dealer that it would only accept a specific other buyer, the court held that the Dealer had made out a claim sufficient to survive Plaintiff's motion to dismiss.[182]

Additionally, in *Maestro West Chelsea SPE LLC v. Pradera Realty Inc.*, parties entered into a contract for the sale of certain air rights from Defendant to Plaintiff.[183] As part of that contract, Defendant was required to use its best efforts to obtain a waiver and subordination from JPMorgan Chase, which held the mortgage on Defendant's property.[184] Defendant failed to obtain the waiver and Plaintiff brought this action, in part, for breach of contract based on Defendant's failure.[185] Defendant argued that the "best efforts" clause was void because it contained no objective criteria or guidelines against which Defendant's efforts could be measured.[186] The court rejected Defendant's argument reasoning that: A court must interpret and give effect to an express best efforts clause just as it would any other contractual provision.[187] The court repeated the well-established rules for contract interpretation: that the court is to ascertain the intention of the parties at the time they entered into the contract.[188] And if that intent is discernible from the plain meaning of the language of the contract, there is no need to look further.[189]

The court further provided that:

> A best efforts clause imposes an obligation to act with good faith in light of one's own capabilities. Best efforts requires that plaintiffs pursue all reasonable methods . . . and whether such obligation has been fulfilled will almost invariably . . . involve a question of fact. Accordingly, the precise meaning of a best efforts provision and whether the provision is breached are factual issues that cannot be resolved on the face of the complaint.[190]

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[181] *Id.*
[182] *See id.*
[183] *Maestro West Chelsea SPE LLC v. Pradera Realty Inc.*, 38 Misc. 3d 522, 525 (N.Y. Sup. Ct. 2012). Defendant owned the unused air right above his own property, and Plaintiff owned air rights above their own property (adjacent to Defendant's property), but Plaintiff needed additional air rights to complete their development project and get approval from the New York City zoning regulation authority. *Id.*
[184] *Id.*
[185] *Id.* at 526–27.
[186] *Id.* at 527–28.
[187] *Id.*
[188] *See id.*
[189] *Id.* at 530 (internal quotation marks omitted).
[190] *Id.* (quoting *Robin Bay Assoc., LLC v. Merrill Lynch & Co.,* No. 07 Civ. 376, 2008 WL 2275902, *7, at *19–20 (S.D.N.Y. June 3, 2008)).

As a result, the court denied Defendant's motion to dismiss.[191] It should, however, be noted that certain courts have also regarded the phrase "best efforts" with a degree of hostility because the standards applied to the term make compliance "murky."[192]

2. COMMERCIALLY REASONABLE EFFORTS

In *Takiedine v. 7-Eleven, Inc.* the court noted that "the term 'commercially reasonable effort' does not have one set of definitions in this jurisdiction; rather it is a standard of reasonableness."[193] The court further noted that the determination of reasonableness is a factual determination based on the totality of the circumstances and includes factors such as economic interests and diligence, among others.[194] In this matter, the court determined that plaintiff had not presented facts to support a finding that franchisor failed to make a commercially reasonable effort to obtain the lowest cost for products and services, as was required by the relevant franchise agreements.[195] In large part, franchisee's complaint was that franchisor was not actually achieving the lowest price on certain products.[196] The court noted that commercially reasonable efforts does not require that franchisor succeed in obtaining the lowest cost on each product.[197]

In *Russell v. Zimmer*, an inventor sued his distributor for breach of contract[198] alleging the distributor, Zimmer, failed to use the required commercially reasonable efforts. Specifically, plaintiff alleged that "Zimmer agreed that it would use 'Commercially

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[191] *See id.* at 532.

[192] *Advanced Water Techs., Inc. v. Amiad U.S.A., Inc.*, 457 F. Supp. 3d 313, 322 (S.D.N.Y. 2020) (finding that distributor's admission to suppressing manufacturer's sales could be a violation of the "best efforts" obligation to supply and promote manufacturer's goods in their distribution contract and the court granted manufacturer's motion to amend their answer); *see e.g., Bloor v. Falstaff Brewing Corp.*, 601 F.2d 609, 613 n.7 (2d Cir. 1979) (stating that "the New York law [regarding 'best efforts'] is far from clear and it is unfortunate that a federal court must have to apply it). In *Bloor*, the court found that where purchaser failed to perform their best efforts to maintain high volume of sales as a result of buyer closing distribution depots, prioritizing selling its own brands at higher prices, discontinuing salesmen, and passing on key distribution opportunities all amounted to a violation of the acquisition agreement's "best efforts" clause. *Id.* at 610, 614.

[193] *Takiedine v. 7-Eleven, Inc.*, No. CV 17–4518, 2022 WL 837181, at *2 (E.D. Pa. Mar. 18, 2022), citing *Paramount Fin. Commc'ns, Inc. v. Broadridge Inv'r Commc'n Sols., Inc.*, No. 15–cv–405, 2019 WL 3022346, at *7 (E.D. Pa. May 23, 2019). Similarly, another court noted that "[c]ommercial reasonableness . . . has been defined . . . to include commonly accepted commercial practices of responsible businesses which afford all parties fair treatment." *Gifford v. J & A Holdings,* 54 Cal. App. 4th 996, 1005 (1997). A third court rejected the argument that the phrase "all commercially reasonable efforts" was ambiguous stating: "Although no Ohio court has previously defined the phrase 'all commercially reasonable efforts,' it does not follow that the phrase itself is ambiguous. The phrase has ordinary meaning which is not contradicted by the terms of the agreement and which does not result in absurdity. It appears that the language used is capable of only one reasonable construction, that Lowe's [the purchaser] was required to make every effort to obtain the required zoning that a reasonable business entity would have made under similar circumstances." *Castle Properties v. Lowe's Home Centers, Inc.,* No. 98 CA 185, 2000 WL 309395, *3 (Ohio Ct. App. Mar. 20, 2000).

[194] *Id. at *3*, citing *In re Am. Mortg. Holdings, Inc.*, 637 F.3d 246, 259 (3d Cir. 2011) (Rendell, J., concurring).

[195] *Id.* at *1–6.

[196] *Id.* at *4.

[197] *Id.*

[198] *See Russell v. Zimmer*, 82 F.4th 564 (7th Cir. 2023).

Reasonable Efforts' as defined in the agreement to sell the earnout products" but failed to do so.[199] The contract itself defined 'Commercially Reasonable Efforts' as:

> the level of efforts, expertise and resources that it would apply in the ordinary and usual course of business to satisfaction of a comparable obligation with respect to another product or technology that is similar to the Earnout Products in terms of commercial potential, development stage and product life. This evaluation is done holistically, looking at the entire business, financial, commercial, scientific, clinical and regulatory context . . . including issues such as product safety and efficacy, the competitive environment, market conditions, the product's proprietary position, the extent to which health care providers would be expected to embrace the product as a desirable and competitive solution, regulatory hurdles, the product's pricing and potential profitability, and similar factors.[200]

The Seventh Circuit affirmed the District Court's grant of the distributor's motion to dismiss for failure to state a claim. The court found that each of the twenty-one separate actions plaintiff alleged distributor had failed to take failed to state facts sufficient to support even a plausible claim that the distributor did not meet commercially reasonable efforts as defined in the agreement.[201] For example, Plaintiff alleged distributor did not fulfil orders, terminated supplier agreements, maintain trademark registrations, and failed to schedule internal team meetings.[202] The Court found that because Plaintiff did not plead how these failures deviated from distributor's usual or expected standard of conduct and did not present the alleged failures in the context of the entire business, but only a one-off-basis, Plaintiff did not meet the pleading requirements.[203] The Court further found that most of the twenty-one bases were either aspirational, meaning expectations that the inventors wanted distributor to accomplish, or based on distributor's alleged broken promises made outside of the four corners of the agreement, all of which did not breach the agreement's own definition of 'Commercially Reasonable Standards.'[204]

Conversely, *Akorn, Inc. v. Fresenius Kabi AG* provides an example of a court finding a party had failed to use commercially reasonable efforts.[205] The court held that Plaintiff pharmaceutical company's contractual obligation to use commercially reasonable

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[199] *Id.* at 567.
[200] *Id.* at 566-67 (internal quotes omitted). At the District Court level there was extensive discussion if the standard should come from an "outward facing" or "inward facing" definition of 'Commercially Reasonable Efforts' with inward being the inventor's (and contract drafter's) definition of the term versus one compared to industry standards. *Id.* at 569–570 (referring D. Ct. Op. at 8 (citing Kristian Werling et al., *"Commercially Reasonable Efforts" Diligence Obligations in Life Science M&A*, 18 No. 6 M & A Lawyer 16 (2014); *Banas v. Volcano Corp.*, 47 F. Supp. 3d 941, 946–47 (N.D. Cal. 2014); *Neurvana Med., LLC v. Balt USA, LLC.,* No. 2019-0034, 2020 WL 949917, at *16 (Del. Ch. Feb. 27, 2020)).
[201] *Id*. at 571.
[202] *Id.* at 567–78.
[203] *Id.* at 571.
[204] *Id.* at 571.
[205] *Akorn, Inc. v. Fresenius Kabi AG,* No. CV 2018–0300–JTL, 2018 WL 4719347 (Del. Ch. Oct. 1, 2018), aff'd, 198 A.3d 724 (Del. 2018).

efforts to operate in the ordinary course of business meant that Plaintiff was required *to take all reasonable steps* to maintain operations in the ordinary course of business.[206] The court found that Plaintiff failed to meet this obligation by, among other things, cancelling regular audits, failing to maintain a data integrity system, and submitting regulatory filings to the FDA based on fabricated data.[207]

IV. EFFORTS CONCLUSION

While there is a variety of caselaw across multiple jurisdictions, which, to varying degrees, attempts either to create or divine objective definitions of phrases such "best efforts," and "commercially reasonable efforts" the one constant is that courts interpreting these phrases look to the context—often the accompanying language in the relevant agreement. Accordingly, it is a potentially impossible task to attempt to determine what such terms mean in a vacuum. At best there are guidelines. However, this reality does not leave practitioners without options. What can be taken from this caselaw is that if these terms are to be used, one should either expressly define them or provide the conditions to be met to satisfy the standard intended.

For example, to reduce the vagueness inherent in a *reasonable efforts* obligation, make it an unqualified obligation of the party in question to perform in addition any tasks that are related to the desired goal and that the party does have control over. For example, you could supplement an obligation that a franchisee uses reasonable efforts to obtain permits by requiring that by a specified date (90 days prior to opening date), the franchisee would apply for the permit.

Caselaw offers other examples of this. In *Kevin M. Ehringer* Enterprises, *Inc. v. McData Services Corp.,* the U.S. Court of Appeals for the Fifth Circuit, applying Texas law, held that McData's promise to use "best efforts" to promote, market, and sell products during the three-year term was not an enforceable promise and so could not support a fraudulent-inducement claim.[208] According to the court, that's because "a best efforts contract must set some kind of goal or guideline against which best efforts may be measured."[209]

Another Fifth Circuit case applying Texas Law, *Herrmann Holdings Ltd. v.* Lucent *Technologies Inc.,* involved "best efforts" provisions that required the defendant to file a registration statement and cause it to become effective "as promptly as practicable" and "in the most expeditious manner practicable."[210] The court held that the latter two phrases established an objective goal, rendering the "best efforts" provision enforceable.[211]

But courts can be unrealistic in what they expect by way of guidelines for *efforts* provisions. For example, New York caselaw refers to the need for "a clear set of guidelines against which to measure a party's best efforts" to enforce such a provision.[212]

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[206] *Id.* at 88.
[207] *Id.*
[208] *Kevin M. Ehringer Enterprises, Inc. v. McData Servs. Corp.*, 646 F.3d 321 (5th Cir. 2011).
[209] *Id.* at 326.
[210] *Herrmann Holdings Ltd. v. Lucent Techs. Inc.*, 302 F.3d 552 (5th Cir. 2002)
[211] *Id.* at 559-61.
[212] *See* Kenneth A. Adams, Interpreting and Drafting Efforts Provisions: From Unreason to Reason, 74 BUS. LAW. 677 (2019).

This sees to run contrary as to expect drafters to offer much in the way of guidelines for interpreting *reasonable efforts* provisions may undercut the point of using the term in the first place.

V. "NOT TO BE UNREASONABLY WITHHELD" CLAUSES

An example of a frequently used standard in franchise agreements without clear uniform definition or consistent judicial interpretation includes the "not to be unreasonably withheld standard". This phrase is typically used when a franchise agreement lists conditions that must be satisfied before obtaining a franchisor's consent to renewal of a franchise agreement or approval of a transfer of franchise rights under a franchise agreement.

As it will be become apparent with each of the phrases discussed herein, the meaning of "not to be unreasonably withheld" will largely depend on context. The court in *In re Van Ness Auto Plaza, Inc.* attempted to set forth certain guidelines for the analysis.[213] That court provided that the withholding of consent to a dealership assignment would be considered reasonable only if it was "based on factors closely related to the proposed assignee's likelihood of successful performance under the franchise agreement."[214] The court went on to list relevant factors to be considered: (1) whether the proposed dealer had adequate working capital; (2) the extent of prior experience of the proposed dealer; (3) whether the proposed dealer had been profitable in the past; (4) the location of the proposed dealer; (5) the prior sales performance of the proposed dealer; (6) the business acumen of the proposed dealer; (7) the suitability of combining the franchise in question with other franchises at the same location; and (8) whether the proposed dealer provided the manufacturer sufficient information regarding its qualifications.[215]

Burger King Corporation v. H & H Restaurants, LLC provides an example of how a requirement that consent not be "unreasonably withheld" is interpreted in the context of other language contained in a franchise agreement.[216] In that matter, Plaintiff and Defendant were parties to a franchise agreement as franchisor and franchisee, respectively.[217] The dispute arose out of Plaintiff's refusal to approve Defendant's sale of the franchised restaurants to a potential buyer.[218] The relevant franchise agreement provided:

> Except with prior written consent of an authorized officer of [Plaintiff], FRANCHISEE shall not (1) assign or pledge this Agreement or assign any of FRANCHISEE'S rights or delegate any of its duties hereunder; or (2) sell, assign, transfer, convey, give away, pledge, mortgage, or otherwise encumber any equity securities of FRANCHISEE; or (3) sell, assign,

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[213] *In re Van Ness Auto Plaza, Inc.* 120 B.R. 545, 547 (Bankr. N.D. Ca. 1990) (discussing California's automobile dealership statute, which provided that a dealership could only be assigned with the consent of the manufacturer, but that such consent could not be unreasonably withheld).
[214] *Id.* at 547.
[215] *Id.*
[216] *Burger King Corporation v. H & H Restaurants, LLC*, No. 99-2855, 2001 WL 1850888 (S.D. Fla. Nov. 30, 2001).
[217] *Id.* at *1.
[218] *Id.* at *3–4.

> transfer, convey or give away, substantially all of the assets of the Franchised Restaurant. [Plaintiff] may condition its consent to the proposed transfer of an interest ... on satisfaction of any or all of the following requirements: . . . (3) That the transferee . . . in [Plaintiff's] sole judgment, satisfies all of [Plaintiff's] business standards and requirements; has the ability to operate the Franchised Restaurant; and has adequate financial resources and capital to do so; and that transferee complete and be approved through [Plaintiff's] selection process including satisfactorily demonstrating to [Plaintiff] that transferee meets the financial, character, managerial, ownership, and such other criteria and conditions as [Plaintiff] shall then be applying in considering applications for new franchises, including transferee, and/or if applicable, Managing Owner and Managing Director satisfactorily completing all [Plaintiff's] training requirements.[219]

The franchise agreement added that consent "will not be unreasonably withheld upon compliance with the conditions imposed by [Plaintiff] on such assignment or sales."[220]

The court held that even though the franchise agreement provided that Plaintiff was not permitted to unreasonably withhold its consent, Plaintiff did not breach the franchise agreement by failing to provide consent because the franchise agreement also provided Plaintiff "sole judgement" to determine whether the potential buyer satisfied all standards and requirements and to condition the sale on these grounds.[221] Accordingly, the language regarding consent not to be unreasonably withheld appears to be of little objective value when the accompanied with sole discretion language.[222]

Similarly, in *Burger King Corp. v. Ashland Equities, Inc.*, the court found that the franchisor did not unreasonably withhold consent to a sale of restaurants by franchisee because franchisee failed to demonstrate that the prospective purchaser satisfied all of franchisor's relevant criteria.[223] The franchise agreement provided that franchisee "may conclude the sale to the purchaser who made the offer *provided that [franchisor's] consent to the assignment be first obtained, which consent will not be unreasonably withheld upon compliance with the conditions imposed by [franchisor] on the assignment."*[224]

The agreement expressly listed the following conditions that may be imposed*:* (1) that the franchisee must satisfy all obligations under the franchise agreement at time of transfer; (2) the prospective purchaser has satisfactorily completed franchisor's training for new franchisees; and (3) the prospective purchaser "must complete and be approved through [franchisor's] standard franchisee selection process including satisfactorily demonstrating to [franchisor] that he meets the financial, character, managerial, equity ownership and such other criteria and conditions as [franchisor] shall then be applying in considering applications for new licenses."[225] The court determined that, based on the

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[219] *Id.* at *3.
[220] *Id.*
[221] *See id.* at *5–6.
[222] *See id.*; *see also Perez v. McDonald's Corp.*, 60 F. Supp. 2d 1030 (E.D. Cal. 1998).
[223] *See Burger King Corp. v. Ashland Equities, Inc.*, 217 F. Supp. 2d 1266 (S.D. Fla. 2002).
[224] *See id.* at 1275 (emphasis added).
[225] *Id.*

foregoing, if a prospective purchaser had not complied with the conditions imposed by franchisor, consent could reasonably be withheld, as was the case in this matter.[226] The court placed the burden of proof on Defendant (pursuant to Defendant's counterclaim for breach of contract) to show that the buyer satisfied the criteria and found defendant did not carry the burden and that Burger King's decision buyer did not have satisfactory operational experience was sufficient as a decision made in their sole discretion. [227]

These cases strongly suggest that courts will look to additional language of a franchise agreement in order to determine what is reasonable. If a party has "sole discretion" the scope of reasonableness will likely be broad, if however, the agreement provides for explicit conditions, it seems likely that reasonableness will be interpreted largely as evaluating compliance with those conditions.

The phrase "not to be unreasonably withheld" may also be interpreted in light of common practice. For example, in *De Walshe v. Togo's Eateries, Inc.*, plaintiff franchisee contended that defendant franchisor breached the franchise agreement by unreasonably withholding its consent to a potential sale by franchisee.[228] Franchisee argued that franchisor's requirement that the buyer pass franchisor's English language proficiency assessment was unreasonable.[229] Based on substantial evidence that franchisor reasonably required its franchisee to be proficient in English in order to complete training, communicate with suppliers, and interact with customers, the court held that franchisor's withholding of approval was not unreasonable.[230]

Additionally, the case *H-D Michigan, LLC v. Sovie's Cycle Shop, Inc.* concerned a statute providing that a franchisor may not unreasonably withhold consent to a transfer of the franchise.[231] The relevant contract provided that "[d]ealer shall give Seller prior written notice and complete explanation of any proposed transfer, sale or other change in ownership. . . no matter what the share or relationship between the parties. . . ."[232] The court held that because no written request was made withholding consent was not unreasonable.[233] The court in *Quality Oil, Inc. v. Kelley Partners, Inc.* reached a similar conclusion.[234]

VI. "REASONABLE BUSINESS JUDGMENT" PROVISIONS

For over two decades, franchise attorneys have debated whether the business judgment rule, established in the corporate law context, should or can be applied to the franchise relationship. In an article published in 2000,[235] Jeffrey C. Selman argued that the business judgment rule could more predictably determine franchisor liability to franchisees than the implied covenant of good faith and fair dealing. The business

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[226] *Id.* at 1274–77.
[227] *See id.* at 1276-77.
[228] *De Walshe v. Togo's Eateries, Inc.*, 567 F.Supp. 2d 1198, 1201–02 (C.D. Cal. 2008).
[229] *Id.* at 1202.
[230] *Id.*
[231] *H-D Michigan, LLC v. Sovie's Cycle Shop, Inc.*, 626 F.Supp. 2d 274, 279 (N.D.N.Y. 2009).
[232] *Id.*
[233] *Id.*
[234] *See Quality Oil, Inc. v. Kelley Partners, Inc.*, 657 F.3d 609, 615 (7th Cir. 2011).
[235] J. C. Selman, *Applying the Business Judgment Rule to the Franchise Relationship*, 19 AM. BAR ASS'N FORUM ON FRANCHISING FRANCHISE L. J. 111 (2000) (Issue 3).

judgment rule, in brief, is "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[236] Thus, Selman argued, by "substituting the franchisor for the director" and "substituting the franchise system for the corporation," "there should be a presumption that a franchisor" has exercised its discretion properly; the burden then would fall on the franchisee to rebut that presumption. The duty of good faith and fair dealing would not otherwise apply.[237]

Selman's arguments, however, did not take account of the critical fact that franchisees' interests are different from those of shareholders: their investments are not in the franchisor or the "system" but in their own assets; franchisees, unlike shareholders, cannot vote to replace their franchisors; and shareholders usually can sell their shares quickly at a market price while franchisees at best have a limited, cumbersome and time-consuming market if they wish to sell their businesses. Further, franchisees have other contractual constraints, including restrictions on transfer, non-competes and the rules of the "system" that may weigh heavily in a contractual dispute.

Despite these fundamental differences between shareholders and franchisees, franchisors have adopted provisions in their agreements stating that where the franchisor has discretion to act, it will be deemed to have acted with "reasonable business judgment," and that such "reasonable business judgment" "will prevail." For example:

> Reasonable Business Judgment (as defined herein) applies in all circumstances involving or requiring [Franchisor's] approval or consent . . . Reasonable Business Judgment means that [Franchisor's] determinations or choices will prevail, even if other alternatives are also reasonable or arguably preferable, if [Franchisor] intends to benefit or is acting in a way that could benefit the . . . System. . . ." [238]

Fifteen years after Selman's article, Ronald Gardner and Brian Schnell, attorneys for franchisees and franchisors respectively, revisited the applicability of the business judgment rule to franchising in light of such provisions.[239] Observing that there was a "notable dearth of case law discussing this particular standard in the franchise context," they nonetheless argued from their clients' perspectives that, on the one hand, the duty of good faith "means different things to different people" and yields unpredictable results that would be rendered predictable with a business judgment rule (Schnell), while on the other hand, franchisor decisions need to be checked, and the "implied covenant provides such a check" with its flexibility.[240]

Now, nearly 10 years after the Schnell and Gardner article, and nearly a quarter of a century after the Selman article, there are still outstanding questions:

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[236] *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984).
[237] Selman, 19 AM. BAR ASS'N FORUM ON FRANCHISING FRANCHISE L. J., at *112.
[238] *See Armstrong v. Curves International, Inc.*, Civ. Action 15-294, 2017 WL 5256997 at *2 (W.D. Tex. Nov. 2, 2017).
[239] Brian B. Schnell and Ronald K. Gardner, *Battle Over the Franchisor Business Judgment Rule and the Path to Peace*, 35 . Bar Ass'n Forum on Franchising Franchise L. J. 167 (2015) (Issue 2).
[240] *Id.*

- Do "reasonable business judgment" provisions in fact graft the business judgment rule onto the franchise relationship so as to "insulate" franchisors from second guessing?
- Does a "reasonable business judgment" provision oust the doctrine of good faith and fair dealing so as to have greater predictability in franchise relations?

In short, does your "reasonable business judgment" provision mean what you think it means and do what you think it does? Even though there is still a "dearth of case law," the little that has come down fails to provide clear guidance.

A. DOES A "REASONABLE BUSINESS JUDGMENT" PROVISION EFFECTIVELY APPLY THE BUSINESS JUDGMENT RULE TO THE FRANCHISE RELATIONSHIP?

At the outset, there is, and has been, considerable confusion and debate over the meaning of "business judgment" in franchise law. Cases in the automotive arena have frequently upheld and applied contractual provisions granting the manufacturer the right to make decisions in its "reasonable business judgment," without any specific reference to the business judgment rule or to any presumption. For example, in *General Motors Corp. v. Dealmaker, LLC*,[241] the court upheld a manufacturer's disapproval of a dealer's relocation request "pursuant to its business judgment," as provided in the contract. But far from invoking either the business judgment rule or the implied covenant of good faith, the court's analysis was refreshingly straightforward: Did the manufacturer provide evidence that it had in fact exercised reasonable business judgment? And the answer was yes – the court relied upon the manufacturer's proof that it had engaged an outside vendor to study the relocation issue and had had an internal group make an independent assessment. Thus, the dealer failed to show "sufficient grounds upon which a fair-minded trier of fact could conclude that GM failed to use reasonable business judgment. Other courts have followed this reasoning.[242]

Thus, the automobile cases stand for the proposition that a simple provision stating that the franchisor has discretion to exercise "reasonable business judgment" will likely insulate a franchisor from attack if there is evidence that the franchisor in fact exercised reasonable business judgment. They do not, however, eliminate the implied covenant of good faith, and it is possible that a franchisee could prevail by showing actual bad faith, malice or improper motive. Nor do these cases answer the question whether a provision stating that the franchisor's judgment will "prevail" is enforceable.

In business format franchising, there appear to have been only two decisions, both from the same case, that have specifically discussed a "reasonable business judgment" provision in a franchise agreement.

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[241] *General Motors Corp. v. Dealmaker, LLC*, No. 09–CV–141, 2009 WL 1310616 (N.D.N.Y. May 8, 2009).
[242] *Love Pontiac, Cadillac, Buick, GMC Truck, Inc. v. General Motors Corp.*, 173 F.3d 851 (4th Cir. 1999) (denying a request for a satellite dealership) ("contract leaves no ambiguities as to defendants' discretion"); *Clair Int'l., v. Mercedes-Benz of N. America*, 124 F.3d 314, 317 (1st Cir. 1997) (decision made by manufacturer pursuant to business judgment did not require dealer's consent); *Olympic Chevrolet, Inc. v. Gen'l Motors Corp.*, 959 F. Supp. 918, 923 (N.D. Ill. 1997).

In *Armstrong v. Curves International, Inc.*,[243] a franchisor sought summary judgment on franchisees' claims of breach for failure to provide certain promised services. The franchisor argued that the "reasonable business judgment" provision of the franchise agreement – substantially the same as that provided above – "provides [Franchisor] sole discretion over certain decisions."[244] Specifically, the Court held that a provision in which the franchisor agreed to "make available certain services" to the franchisee, "within [the Franchisor's] sole reasonable discretion and right," required a determination whether the franchisor's decision not to provide certain services was reasonable—and reasonableness was a question of fact.[245]

More specifically, the franchisor argued that the "reasonable business judgment" provision of the franchise agreement allowed it "discretion to provide services and support." The court first observed that by its terms, the provision applied only where the franchisor's approval or consent was required; it did not apply obligations that were mandatory. More importantly, the Court stated:

> Second, simply because the "Reasonable Business Judgment" clause provides Curves latitude in making certain decisions does not foreclose altogether the possibility that it could be held liable for its decisions. The concept of reasonable business judgment comes from the realm of corporate governance. For example, in Texas, corporate officers and directors, who owe fiduciary duties to a corporation, are protected 'from liability for acts that are within the honest exercise of their business judgment and discretion." This rule does not, however, protect corporate officers and directors from all liability for breaches of their fiduciary duties or transactions that improperly benefit the officers.[246]

Thus, the Court concluded the "Reasonable Business Judgment" provision did not protect the franchisor from acts that were unreasonable or that were not intended to benefit the system. Thus, where the franchisees had alleged that the franchisor had offered "virtually no support" after franchisees entered the system, the court noted, "a reasonable jury could very well conclude that these actions were unreasonable and not intended to benefit the Curves system."[247]

What is striking about the decision is that it did not treat the "reasonable business judgment" provision as creating a presumption, even though the contractual provision stated that the franchisor's "determinations or choices will prevail." The Court's disregard of this provision was underscored by the fact that on summary judgment, it ruled that the franchisor had failed to carry its burden of showing that there was no disputed material issue of fact as to whether the franchisor had exercised reasonable business judgment.[248] Had he enforced the portion of the provision stating that the franchisor's judgment would

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[243] *Armstrong v. Curves International, Inc.*, No. 6:17–cv–294-RP, 2017 WL 894437 (W.D. Tex. March 6, 2017).
[244] *Id. at * 3.*
[245] *Id.* at *5.
[246] *Id.* at *6 (citing *Sneed v. Webre*, 465 S.W.3d 169, 173 (Tex. 2015) & *Ritchie v. Rupe*, 443 S.W.3d 856, 876 n.47 (Tex. 2014)).
[247] *Id.*
[248] *Id.* at *7.

"prevail," it is logical that the franchisor could have carried its burden with a minimal showing of reasonableness.

The Curves franchisees won at trial and Curves made a post-trial motion for judgment as a matter of law. The Court, by a new judge, made short work of it: He held that the court's decision that the franchisees could show, at trial, that the franchisor's actions had been unreasonable and were not intended to benefit the system, was law of the case and would not be revisited; and that there was sufficient evidence of facts to support the verdict.[249]

It certainly can be argued, persuasively, that the *Curves* decisions turn the "reasonable business judgment" provision on its head by opening the door to a factual examination of the franchisor's "reasonableness." The decisions did not invoke a presumption of reasonableness, and in fact the test applied by the court may well have been lower than that required by the covenant of good faith. Thus, franchisors can't rely upon a "reasonable business judgment" clause such as that quoted above to insulate them from "second guessing" by the courts.

B. DOES A "REASONABLE BUSINESS JUDGMENT" PROVISION OUST THE IMPLIED COVENANT OF GOOD FAITH?

A provision stating that the franchisor's "reasonable business judgment" will "prevail" will not necessarily oust or supplant the implied covenant of good faith and fair dealing in the absence of an express waiver.

First, the elements of the implied covenant vary among jurisdictions, and many require a showing of bad faith.[250] That element falls outside the terms of the reasonable business judgment provision; therefore, a franchisee could well show a violation of good faith if there were some evidence that the franchisor acted in "bad faith" or with an improper motive even if there were some "reasonable" grounds to support the decision. And "bad faith" can range from subjective bad faith to conduct that exploits changing economic conditions to capture gains that were not expected at the time of contracting.[251]

Second, even in the absence of bad faith, some jurisdictions will uphold a good faith claim upon proof that a franchisor's decision was commercially unreasonable even if it was within the contractual bounds of the franchisor's discretion. Thus, in *Carvel Corp. v. Diversified Management Group, Inc.*,[252] a development agreement gave the franchisor wide discretion to accept or reject the developer's plans for development of a territory. The developer alleged that the franchisor had unreasonably refused to approve any of its build-out plans in violation of the duty of good faith, even though the franchisor had the contractual discretion to do so. The Second Circuit agreed, noting that "even if it acted

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[249] *Armstrong v. Curves International, Inc.*, Civ. Action 15–294, 2017 WL 5256997 (W.D. Tex. Nov. 2, 2017).
[250] *See, e.g., Grahek v. Voluntary Hospital Cooperative Assoc. of Iowa, Inc.,* 473 N.W.2d 31, 34 (Iowa 1991) ('there must be . . . an act of bad faith. Mere breach of contract is not enough."); *JRT, Inc. v. TCBY Systems, Inc.,* 52 F.3d 734 (8th Cir. 1995) (despite extensive allegations of bad-faith breach, in absence of an allegation of bad motive, claim was dismissed); *Wilson v. Amerada Hess Corp.,* 773 A.2d 1121, 1130–31 (N.J. 2001) ("[b]ad motive is essential").
[251] *Allapattah Services, Inc. v. Exxon Corp.*, 188 F.R.D. 667 (S.D. Fla. 1999), *aff'd*, 333 F.3d 1248 (11th Cir. 2003), *aff'd*, 545 U.S. 546 (2005).
[252] *Carvel Corp. v. Diversified Mgmt. Group, Inc*., 930 F.2d 228 (2d Cir. 1991).

within the bounds of its discretion Carvel would be in breach if it acted unreasonably."[253] It is, effectively, the same test that the *Curves* court used.

Finally, in some, but not all, jurisdictions, the implied duty can be waived.[254] But such a waiver carries the message, intended or not, that the franchisor will not act in good faith, which will be an impediment to franchise sales.

C. REASONABLE BUSINESS JUDGMENT CONCLUSION

The limited case law points to a conclusion that "reasonable business judgment" provisions neither invoke the business judgment rule in a way that protects franchisors from "second guessing" nor do they oust the implied covenant of good faith and fair dealing. Indeed, they may lead to greater liability if courts follow the *Curves* precedent of treating reasonableness as an issue of fact. This is not surprising in light of the fact that the interests of parties to the franchise relationship are completely different from those to the director-shareholder relationship.

VII. OFFICERS, DIRECTORS, AND OTHERS: DO WAIVERS OF LIABILITY ACTUALLY ADD ANYTHING? SUBJECT TO LIABILITY, AND, IF SO, WHERE?

Franchisors have long wrestled with how to manage the rights of individuals who are involved in the franchise: for example, individual owners of a corporate franchisee typically sign personal guarantees, and bound by the agreement's non-competes; similarly, many franchisors now require a franchisee's principal's spouse to sign a spousal guarantee. In almost all of these instances, the franchise agreements call for the individuals to sign in their own capacities. In contrast, franchise agreements virtually never expose franchisor officers, directors or other agents to individual liability. To the contrary, franchise agreements sometimes seek to either insulate franchisor officers and agents from liability, or to make sure that if there is a dispute that individuals will be included, particularly in arbitration. For example:

> Franchisee hereby waives the right to bring any action against any individual owner, officer, director or employee of the Franchisor entity or of the Franchisor's Affiliates.

Another formulation of this provision states:

> No past, present or future director, officers, employee, incorporator, member, partner stockholder, subsidiary, controlling party, or representative of ours will have any liability for any obligation we have relating to or arising from this Agreement, or any claim against us based on the transaction contemplated by this agreement.

The individual officers or agents of the franchisor ("Officers"), however, do not sign the agreement.

Two key questions arise about individual liability: First, do these waivers of individual liability actually mean what they say and add a layer of protection, or are they merely window dressing? Second, what happens if the franchise agreement calls for

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[253] *Id*. at 232.

[254] *See Northwest, Inc. v. Ginsberg*, 572 U.S. 273, 286, n.2 (2014) (citing and discussing cases on waiver.)

arbitration of all disputes, and the franchisee wants to file against the franchisor's officers, but they are not signatories to the franchise agreement?

A. DO WAIVERS OF PERSONAL LIABILITY ADD ANYTHING TO THE AGREEMENT?

Absent statutory anti-waiver protections, waivers of individual liability can be of limited effectiveness in certain circumstances if drafted properly.

Although we have been unable to find any cases discussing these waivers in franchise agreements, they have existed in other industries for decades. For example, in *Bates & Rogers Const. Corp. v. Greeley & Hansen*,[255] the construction agreement at issue contained a provision in which the plaintiff agreed not to make claims against any of the defendant's officers, agents, and employees. The plaintiff sued the defendant and an individual, third-party engineer after the engineer's actions caused a delay.[256] The court dismissed the claim against the engineer on the ground that the waiver applied to him as an "agent" of the defendant.[257]

Although courts are generally willing to enforce these waivers as written the individuals cannot claim the benefits of them unless they are third-party beneficiaries of the franchise agreement.[258] As many franchise agreements contain provisions stating that there are no intended third-party beneficiaries to the agreement, franchisees may be able to preclude individual officers, agents, or employees from invoking the personal liability waiver by pointing out that they are not third party beneficiaries. For the lawyer drafting the agreement, the lesson is to make sure that the waiver clauses and any provisions discussing third-party beneficiaries are aligned.Also, personal liability waiver provisions serve as exculpatory clauses, which are subject to a stricter standard of review, are construed against the drafter, and generally can only waive liability for negligence or strict liability and not willful or intentional misconduct. In general, courts will not enforce exculpatory or limiting provisions if they are unconscionable, if they result from unreasonable bargaining power, or if they purport to relieve parties from their own willful, wanton, reckless, or intentional wrongdoing.[259] This result may be avoided if the provision explicitly states that it is to be construed so as to give maximum effect to its intent without being construed as unconscionable.

Thus, if personal liability waivers only protect a franchisor's officers or agents from liability for negligence or strict liability, then it is doubtful whether they add anything to the franchise agreement. Since the common law already protects a corporation's owners and agents from personal liability for negligence committed within the scope of their job duties.[260]

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[255] 109 Ill. 2d 225, 232–34, 486 N.E.2d 902, 906–07 (1985).
[256] *Id.* at 228–29.
[257] *Id.*
[258] *Burnett v. Chimney Sweep*, 20 Cal. Rptr. 3d 562, 572–73 (2004) (holding that a property manager could not invoke an exculpatory clause in a lease because it was not a signatory to or a third-party beneficiary of the lease).
[259] *Rhino Fund, LLLP v. Hutchins*, 215 P.3d 1186, 1191 (Colo. App. 2008), as modified on denial of reh'g (Dec. 24, 2008).
[260] *See e.g., Union Mutual Life Insurance Co. v. Chrysler Corp.,* 793 F.2d 1, 11–12 (1st Cir. 1986).

B. ARE NON-SIGNATORY OFFICERS OR AGENTS SUBJECT TO ARBITRATION?

A thorny problem may arise with arbitration. In the last few decades, franchisors have embraced arbitration, often with the thought that the ability to shape, by agreement the scope of dispute resolution would put an end to lengthy court litigation with multiple parties. Franchise agreements frequently contain a straightforward arbitration provision requiring the "parties" to arbitrate their disputes:

> All disputes and claims arising out of or relating to this agreement, or to the breach thereof, or to any of our standards or operating procedures, or other obligation of either yours or ours, or to the breach thereof, or any aspect of the relationship between you and us (even if additional persons are named as parties to such action) must be resolved by arbitration

While the provision is clear that the franchisor and franchisee entities must arbitrate, it is not clear about the status of corporate officers. Thus, If the franchisee has a claim that the franchisor's officers made unlawful earnings claims or committed common law fraud, do those claims have to be arbitrated, assuming that the agreement defines "we," "us" and "you" as corporate entities? Or can the franchisee sue the individuals in court? In contrast, individual franchisees are generally bound by a personal guarantee to arbitration provisions.[261]

In order to compel arbitration, there must be a "written agreement for arbitration" between the parties.[262] Arbitration is "a matter of contract and a party cannot be required to submit to arbitration any dispute which he has not agreed to so submit."[263] The franchise agreement is not an agreement between the franchisee and the franchisor's officers, and thus, claims against the officers would not have to be arbitrated under the clause above. A franchisee could sue the individual officers in court, even though a parallel arbitration was pending against the franchisor.[264]

In such a situation, the franchisor and officers might be able to compel the franchisee to arbitrate the claims against the officers, if state law provides a contractual or quasi-contractual basis for subjecting them to the arbitration provision. For example, in California, a non-signatory may be bound to arbitrate under theories of (1) incorporation by reference; (2) assumption of liability; (3) agency; (4) veil-piercing or alter ego; (5) estoppel; or (6) third-party beneficiary.[265] All of these theories, however, are fact-specific. Further, state law – usually that chosen by the franchisor – will govern what theories are available and the elements of each. They vary considerably from state to state. All of this potentially makes administration of the arbitration a procedural quagmire: the parties will be tied up in disputing the proper forum instead of resolving the dispute.

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[261] *Gingiss Int'l, Inc. v. Bormet*, 58 F.3d 328 (7th Cir. 1995).
[262] 9 U.S.C. § 4.
[263] *United Steelworkers v. Warrior & Gulf Navigation Co.*, 363 U.S. 574, 582 (1960).
[264] *Janmort Leasing, Inc. v. Econo-Car Int'l, Inc.*, 475 F. Supp. 1282 (E.D.N.Y. 1979) (court action stayed pending arbitration). *Cf. World Rentals and Sales, LLC v. Volvo Const. Equipment Rents, Inc.,* 517 F.3d 1240 (11th Cir. 2008).
[265] *Martinez-Gonzales v. Elkhorn Packing Co., LLC,* 635 F. Supp. 3d 883 (N.D. Cal. 2022).

Can the problem be fixed by amending the contractual provision to state that any claims between the franchisee and the franchisor, *including its "officers, directors and agents"* will be arbitrated – even if the officers do not sign? The franchisee will still have the argument that it does not have a "written agreement" to arbitrate with the franchisor's officers, but in many jurisdictions, the inclusion of these positions – if not the named individuals – may support an argument that the franchisee is estopped from opposing arbitration.

In actual practice, there is not a clear fit between arbitration provisions and resolution of individual liability of franchisor officers. Franchisees have to sign personally on everything; franchisor officers do not, and their lawyers, have a powerful argument that a franchisor who insists on individual franchisee owners signing personal guarantees, has no reason to complain if individual franchisor officers are not covered by those agreements.

There are steps that franchisors can take to ensure officers are covered by arbitration. These will be discussed in the live presentation.

C. OFFICERS AND DIRECTORS CONCLUSION

There is good news and bad news for provisions in franchise agreements that relieve franchisor officers and agents of personal liability to franchisees. On one hand, they are probably effective to relieve the individuals of liability for negligence or strict liability; but on the other hand, they do reach intentional wrongdoing and may not reach reckless conduct. For those reasons, these provisions really do not deliver what they promise on their face, and a good argument can be made that they are surplusage.

Franchisor officers and agents who may subject to claims of individual liability, either at common law or under a franchise statute, face uncertainty in whether they must arbitrate when the franchise agreement calls for arbitration, but they are not signatories to that agreement. The only truly effective way to resolve this issue is to spell it out in the agreement, and have the officers or agents sign, at least as to the agreement to arbitrate. It's awkward, but it's what franchisors demand of franchisees.

VIII. CHOICE OF LAW

Franchisors love choice of law provisions, and largely for good reason: they support predictability in dispute resolution; they help to establish jurisdiction over franchisees in the franchisor's home state; they provide uniformity; and they are reputed to lead to a line of decisions in the franchisor's favor. But do they really live up to these promises? In the absence of a state law to the contrary, the effectiveness of choice of law provisions may well turn on the drafter's choice of words: the difference between a choice of law to "construe and interpret" a contract, or one that "governs" the parties' relationship.

For example, a lot of agreements contain a short and simple choice of law: "This Agreement shall . . . be interpreted and construed under the laws of the state in which the Franchisor's principal place of business is located." The problem? It only applies the franchisor's chosen law to interpretation and construction of the franchise agreement, not to the entire relationship. Thus, the franchisee may be able to prosecute tort or fraud

claims or claims for violation of state franchise or unfair trade practice laws.[266] A change in the language to state that the parties' relationship will be governed by the chosen state's law and that all disputes will be decided under it changes the result.

A. LIMITATIONS: THE HIDDEN, AWKWARD EXCEPTION

A key reason to choose any state's law is for its statute of limitations. Once chosen, a franchisor can plan dispute management accordingly; for example, a Minnesota franchisee has a three-year limitations period for disclosure violations under the Minnesota Franchise Act.[267] Its New York franchisor has a six-year limitations period for contract breaches under New York law.[268] The franchisor may well choose to wait until the MFA limitations period expires before suing on a breach of contract claim.

But courts do not always treat limitations in the same way they treat other provisions of law when considering choice of law. Some jurisdictions consider limitations to be "procedural" rather than "substantive," and therefore outside of a contractual choice of law. Other states have borrowing statutes that potentially cut off claims.

In *Belleville Toyota, Inc. v. Toyota Motor Sales, U.S.A., Inc.*,[269] the Illinois Supreme Court held that even though an automobile dealer agreement provided that California law would govern, the limitations period would be determined by Illinois law, because limitations were "procedural."[270] However, the court also held that the auto dealership agreement was one primarily for the sale of goods and thus governed by the UCC's four-year statute of limitations. As a result, the trial court's admission of evidence preceding the four-year limitations period had been in error. But if the plaintiff had been a business format franchisee, there would not have been a contract for the sale of goods, and the claim would have been governed by Illinois' 10-year limitations period for breach of contract.

States with "borrowing statutes" or common law borrowing doctrines typically provide that if a cause of action that arises outside of the forum has a shorter statute of limitations than the forum state, that shorter period will be applied to bar the suit.[271] And in *Ramada Franchise Systems, Inc. v. Capitol View II Ltd Partnership Venture*,[272] the Court held that even though the parties had chosen Arizona law to govern their dispute, "New Jersey's statute of limitations will apply because Ramada is a resident of New Jersey."[273]

Drafting strategies may mitigate these risks. A contractual statute of limitations, or a provision expressly adopting a given state's limitations periods, would likely be enforceable and would obviate the risk of a "hidden" limitations period.

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[266] *Vino 100, LLC v. Smoke on the Water, LLC*, Civ. Action No. 09-4983, 2011 WL 2604338 (E.D. Pa. 2011).
[267] Minn. Stat. § 80C.17(5).
[268] N.Y. C.P.L.R. 213(2).
[269] 199 Ill. 2d 325, 770 N.E.2d 177 (Ill. 2002).
[270] *Id.* at 194, 351.
[271] *See Dent v. Cunningham*, 786 F.2d 173 (3rd Cir. 1986).
[272] 132 F.Supp. 2d 358 (D. Md. 2001).
[273] *Id.* at 362.

IX. DAMAGES

Franchise agreements, like other contracts, seek to clarify each party's obligations, duties, and risk. When drafting a franchise agreement, the parties are seeking to balance the economic terms, obligations and duties of each party while also allocating and managing the corresponding risk. If the parties cannot reasonably predict the scope of damages that it can be be exposed too, it is difficult to evaluate the contract terms to ascertain whether the consideration being received is sufficient and adequate and if the attendant risk is being properly managed.

A court will generally not enforce any limitations on a party's remedies for the other party's breach unless such limitations are specifically agreed upon[274]. In *Bank United, NA v. GC of Vineland, LLC*[275], a Golden Corral franchisee ceased operating its franchised business. The Franchisor filed an action seeking lost profits. The franchisee argued that the franchise agreement did not expressly provide for lost profits[276]. In rejecting this argument, the court noted that the franchise agreement, provided:

> In the event of termination for any default of Franchisee, [Franchisee shall promptly pay] all damages, costs, and expenses, including reasonable attorneys' fees, incurred by Franchisor as a result of the default . . . .")[277]. (*Emphasis added*).

The court held that the term "all damages" includes consequential damages and affirmed that it does not clearly exclude lost future royalty payments simply because it does not expressly include that precise language[278].

To avoid having a court interpret the term "damages" broadly, many franchise agreements require the parties (or in some cases, the franchisee) to waive different types of claims through limitation of damages provisions. These provisions generally exclude recovery for indirect or consequential damages (such as lost profits, additional operating expenses incurred, additional costs and expenses incurred as a result of a delay, increased insurance premium payments, etc.). The intent is to limit the parties' recovery to just "actual" damages. An example of this type of provision can provide:

> *FRANCHISOR AND FRANCHISEE HEREBY WAIVE TO THE FULLEST EXTENT PERMITTED BY LAW ANY RIGHT TO OR CLAIM OF ANY CONSEQUENTIAL, PUNITIVE, OR EXEMPLARY DAMAGES AGAINST THE OTHER, AND AGREE THAT IN THE EVENT OF A DISPUTE BETWEEN THEM EACH SHALL BE LIMITED TO THE RECOVERY OF ANY ACTUAL DAMAGES SUSTAINED BY IT.*

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[274] See, for example, *Transp. Ins. Co. v. Am. Harvest Baking Co*., 2018 U.S. Dist. LEXIS 81451, 2018 WL 2215514, at *4 (D.N.J. May 15, 2018)

[275] *Bank United, NA v. GC of Vineland, LLC,* No. 18-12879, 2024 U.S. Dist. LEXIS 55555; 2024 WL 1299024 (D.N.J March 27, 2024)

[276] *Id.* at *26.

[277] *Id*. at *28

[278] *Id.* at *35

There are also examples where the limitation of damages provision is not mutual and only applies to the Franchisee.

> *FRANCHISEE HEREBY WAIVES TO THE FULLEST EXTENT PERMITTED BY LAW, ANY RIGHT TO OR CLAIM FOR ANY PUNITIVE, EXEMPLARY, INCIDENTAL, INDIRECT, SPECIAL OR CONSEQUENTIAL DAMAGES (INCLUDING, WITHOUT LIMITATION, LOST PROFITS) AGAINST FRANCHISOR ARISING OUT OF ANY CAUSE WHATSOEVER (WHETHER SUCH CAUSE BE BASED IN CONTRACT, NEGLIGENCE, STRICT LIABILITY, OTHER TORT OR OTHERWISE) AND AGREES THAT IN THE EVENT OF A DISPUTE, THAT FRANCHISEE'S RECOVERY IS LIMITED TO ACTUAL DAMAGES.*

The rational driving these limitations of damages provisions is that the parties are excluding certain types of damages that are not foreseeable, difficult to quantify and speculative. In contrast, direct or actual damages, are reasonably foreseeable and more easily predicted.

As a starting point, it is important for the practitioner to understand what each of these types of damages entail and what is actually being waived.

A. ACTUAL DAMAGES

The priority of most limitation of damages provisions appear to focus on requiring the franchisee or both parties to waive punitive (or other types of exemplary damages) as well as consequential damages. In an effort to limit such damages, it is common for a practitioner to specifically state that the franchisee's (or each parties') damages are limited to "actual damages" incurred by such party.

While it is relatively common for a practitioner to seek to limit recovery to "actual damages" it is not common for such term to be defined in the franchise agreement. In the absence of the franchise agreement defining the term "actual" damages, a court will interpret the definition in the context the applicable state law.

In the context of tort law, the United States Supreme court noted that actual damages are also referred to as compensatory damages[279]. In contract law, compensatory damages aim to restore the non-breaching party to its original position by covering any losses they have incurred. Unlike punitive damages, compensatory damages are not meant to punish the breaching party, but rather to make the non-breaching party whole again.

In this context, a court's interpretation of actual damages may be broader than the practitioner may have intended when crafting a damages waiver. For example, in the unreported decision of *Bonanza Rest. Co. v. Wink*, the franchise agreement contained the following limitation of damages provision:

> WAIVER OF PUNITIVE DAMAGES. FRANCHISOR AND FRANCHISEE HEREBY WAIVE TO THE FULLEST EXTENT PERMITTED BY LAW, ANY PUNITIVE, EXEMPLARY, CONSEQUENTIAL OR SPECULATIVE

[279] See Birdsall v. Coolidge, 93 U.S. 64, 71 (1876) (holding that the phrases "compensatory damages" and "actual damages" are identical.)

DAMAGES AGAINST THE OTHER AND AGREE THAT IN THE EVENT OF A DISPUTE BETWEEN THEM, EXCEPT AS OTHERWISE PROVIDED HEREIN, EACH SHALL BE LIMITED TO THE RECOVERY OF ACTUAL DAMAGES SUSTAINED BY IT.[280]

The *Wink* court[281] noted that the franchise agreement did not define the term "actual damages" and interpreted "actual damages" to include both "direct" damages and "consequential" damages.[282] For this reason, practitioners should either limit recovery to "direct damages" or include a definition for "actual damages".

B. DIRECT VS. INDIRECT DAMAGES

There are two primary categories of damages: Direct and Indirect. Direct damages are real, substantial and just damages, or the amount awarded to a complainant in compensation for his or her actual and real loss or injury, as opposed to "exemplary" or "punitive" damages.[283]

In *Wink,* the court noted that direct damages include damages that are inherent in the breach, are the necessary and usual result of the breaching parties' wrongful act and were foreseeable and contemplated by the parties[284]. These direct damages are generally not within the scope of the limitation of damages provisions. In contrast, indirect damages include:

- Exemplary
- Punitive
- Consequential damages
- Incidental
- Special
- Loss of profits (indirectly)

1. EXEMPLARY/ PUNITIVE DAMAGES

Exemplary Damages and Punitive Damages refer to damages awarded which are beyond the damages actually incurred by a party. They are considered punishment or

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[280] Bonanza Rest. Co. v. Wink, 2012 Del. Super. LEXIS 167, at *7–*8, 2012 WL 1415512 (Del. Super Apr. 17, 2012), *aff'd, Bonanza Rest. Co. v. Wink*, 65 A.3d 616 (Del. 2013).

[281] *See Wink,* 2012 Del. Super. LEXIS 167, at *7 (the *Wink* franchise agreement contained a Texas choice of law provision).

[282] *Id*. (citing *Arthur Andersen & Co. v. Perry Equip. Corp.*, 945 S.W.2d 812, 816 (Tex. 1997); *Henry S. Miller Co. v. Bynum*, 836 S.W.2d 160, 163 (Tex. 1992)). *See also Gebhart v. Martin*, No. 89C–MY13, 1992 Del. Super. LEXIS 569, at *1 (Del. Super. Ct. Feb. 26,1992); *ITSI Del., Inc. v. Townsend*, No. CIV. A. 91C–08-017, 1993 WL 189467, at *4 (Del. Super. Ct. Mar. 31,1993).

[283] *Ross v. Leggett*, 61 Mich. 445, 450 (Mich. 1886); *Gatzow v. Buening,* 106 Wis. 1, 19-20 (Wis. 1900); *Oliver v. Columbia*, 65 S.C. 1, 18 (S.C. 1902); *Lord v. Wood*, 120 Iowa 303, 309-310 (Iowa 1903); *Western Union Tel. Co. v. Lawson*, 66 Kan. 660, 662-663 (Kan. 1903); *Field v. Munster*, 11 Tex. Civ. App. 341, 343 (Tex. Civ. App. 1895).

[284] *See Wink*, 2012 Del. Super. LEXIS 167, at *8 (citing *Arthur Andersen & Co. v. Perry Equip. Corp*., 945 S.W.2d 812, 816 (Tex.1997); *Mass. Mut. Life Ins. Co. v. Certain Underwriters at Lloyd's of London*, 2010 Del. Ch. LEXIS 156, at *74, 2010 WL 2929552 (Del. Ch. 2010) (observing that direct damages follow immediately from the breach).

damages intended to dissuade and are typically awarded at the court's discretion when the defendant's behavior is found to be especially harmful. Punitive damages are normally not awarded in the context of a breach of contract claim but rather used to punish the defendant for fraud, a deliberate act that caused harm, or gross negligence.

While the award of punitive/exemplary damages are rare, it is much more likely that a court or arbitrator would award such type of damages against a Franchisor, which is why many franchise agreements do not make this type of damages waiver mutual.

2. SPECIAL/ CONSEQUENTIAL DAMAGES

Special or Consequential Damages are foreseeable secondary or derivative losses incurred by the damaged party. The pivotal analysis by a court is whether such secondary damages were foreseeable. For example, in a franchise system where the Franchisor is also the supplier of equipment that is essential for the Franchisee to perform or deliver services its customers, if such equipment is defective, any resulting loss in sales, while the equipment is being repaired or replaced could be deemed consequential damages.

3. INCIDENTAL DAMAGES

Incidental damages are losses incurred by the damaged party to avoid or mitigate the damage created by the breach. For example, in staying with the above example where the Franchisor has supplied a franchisee with defective equipment, the repair costs of such defective equipment or having to rent short-term replacement equipment, could be an example of incidental damages.

C. LOST PROFITS

When distinguishing between direct and consequential damages, the conclusion reached by a court may vary based on the specific facts. Lost profits, in particular, have a unique aspect of potentially being classified as either direct or indirect damages. Although generally viewed as consequential damages, as discussed below, lost profits can also be deemed direct damages if the damaged party bargained for such profits and the damages were the direct result of the contract breach.

When drafting a limitation of liability provision, the drafter should expressly cover both direct lost profits and consequential lost profits. Otherwise, if the provision only generically refers to a waiver of lost profits, a court may only enforce such limitation in relation to consequential damages and not direct damages.

In *Bonanza Rest. Co. v. Wink*, the Franchisor sought damages consisting primarily of lost profits in the form of lost future royalties from franchise agreements.[285] The franchisee argued that the waiver of consequential damages precluded the Franchisor from the recovery of future lost royalties.

In reaching its decision, the court reasoned that the royalty fees due directly under the franchise agreements were direct damages and not consequential damages and therefore the waiver of consequential damages in the franchise agreements did not

[285] *See Wink*, 2012 Del. Super. LEXIS 167, at *7.

preclude the franchisor from its claim of lost royalties[286].

The Delaware court noted that under Texas law (pursuant to the choice of law provision contained in the franchise agreement), direct damages are those inherent in the breach and are the necessary and usual result of the defendant's wrongful act; “they flow naturally and necessarily from the wrong. Direct damages compensate the plaintiff for the loss that is conclusively presumed to have been foreseen by the defendant from his wrongful act. The measure of damages for breach of contract may include reasonably certain lost profits, which are defined as damages for the loss of net income to a business.”[287]

The court further noted that under Texas law, profits lost on other contracts or relationships resulting from the breach may be classified as consequential damages; “That is, if the party's expectation of profit is incidental to the performance of the contract, the loss of that expectancy is consequential. Consequential damages, also known as special damages, are those that result naturally but not necessarily from the wrongful act, because they require the existence of some other contract or relationship. Consequential damages are not recoverable unless they are foreseeable and are traceable to the wrongful act and result from it. The distinction between direct and consequential damages is the degree to which the damages are a foreseeable and highly probable consequence of a breach.”[288]

Therefore, the court held that a contractual restriction on consequential damages, standing alone, does not preclude recovery of direct lost profits. In this case, the court found that the losses were inevitable and flowed necessarily from the closings. The royalty fees, as set forth in the Franchise Agreements, were inherent to the nature of the contracts, and the Court found that they were actual and direct damages.

D. ARE LIMITATION OF DAMAGES PROVISIONS WORTH THE FIGHT?

To the extent that the Franchisor has agreed to negotiate the franchise agreement terms, the question arises as to whether a dispute over a limitation of damages provision is worth fighting for. The answer to this question depends on multiple factors that pertain to the potential impact on the parties’ rights in a subsequent dispute.

1. IMPACT OF STATE LAW

As discussed more fully below, the enforcement of a limitation damages provision will vary by jurisdiction. In addition to understanding how courts have interpreted these limitation of damages waivers, the practitioner also has to be cognizant of the interplay between state disclosure laws, Little FTC Acts, franchise relationship laws and other state laws that may provide for independent causes of action for a franchisee to pursue a claim against a franchisor which may have separate statutory or other damages associated with such laws and which will not be subject to any waiver contained in the franchise agreement.

From a franchisee’s perspective, they may not deem this provision being “worth

[286] *Id*. at *7

[287] *Id.* at *8.

[288] *Id.* at *10.

the fight" if it appears that the State they are in have such statutory protections or other laws that enable them to bring other types of claims against the franchisor and which will supersede any language in the franchise agreement that limits such claims. Similarly, using this same analysis, the franchisor can also determine, based on other potential claims that the franchisee can bring pursuant to their respective state laws (which will not be subject to any limitation of damages), if they are willing to compromise on this issue.

In addition, franchisors have to be mindful to ensure that the applicable state law will not render such limitation of damages clause unconscionable or against public policy. For example, as discussed below, a court may find a limitation of damages clause that is not mutual to be unenforceable. Therefore, if a franchisee has requested that a limitation of damages clause be mutual, in certain states it may not be worth a protracted fight if there is a chance that the clause will only be enforced if it is mutual.

If a franchisor agrees to modify a limitations of damages clause to make it mutual, the practitioner has to evaluate the impact of the types of damages being waived on the franchisor. For example, modifying the waiver on punitive damages to make it mutual will generally not impact the franchisor since punitive damage awards are both rare and more likely to be awarded against the franchisor than the franchisee. In contrast, modifying the waiver on lost profits to make it mutual could have a much broader impact on a franchisor's ability to pursue damages because it could negate a claim for lost royalties.

2. JUDICIAL ENFORCEMENT OF DAMAGES LIMITATIONS

Another crucial factor that each practitioner must examine is whether such limitation of damages claims, if asserted, would be enforced by a court. Again, this varies from jurisdiction to jurisdiction. However, provided that the damage limitation clause is conspicuous, not buried in fine print and the clause in not conflicting with a public policy concern, courts generally appear to enforce these types of provisions.

In *Ingraham v. Planet Beach Franchising Corp.*, the Franchisor filed a motion to preclude the franchisee from eliciting testimony regarding any type of damages other than actual damages at trial.[289] The court affirmed that the limitation of liability clause in the franchise agreement did waive the right to seek consequential damages. In particular, the franchise agreement provided, in relevant part:

> The parties waive to the fullest extent permitted by law, any right to or claim for any punitive, exemplary, incidental, indirect, special or consequential damages (including, without limitation, lost profits) which either party may have against the other arising out of any cause whatsoever (whether such cause be based in contract, negligence, strict liability, other tort or otherwise) and agree that in the event of a dispute, recovery shall be limited to actual damages. If any other term of this Agreement is found or determined to be unconscionable or unenforceable for any reason, the forgoing provision shall continue in full force and effect, including, without limitation, the waiver of any right to claim any consequential damages.[290]

[289] *Ingraham v. Planet Beach Franchising Corp.*, No. 07-3555, 2009 U.S. Dist. LEXIS 38164, at *1 (E.D. La. Apr. 17, 2009).
[290] *Id*.

In enforcing this provision, the court noted in Louisiana, "contracts have the effect of law for the parties."[291] "When the words of a contract are clear and explicit and lead to no absurd consequences, no further interpretation may be made in search of the parties intent."[292]

The franchisee had claimed that a) the contract language was ambiguous because "lost profits" are actual damages and b) that the Franchisor must prove that the waiver was brought to the attention of the Franchisee. The court ruled that the inclusion of lost profits was not ambiguous because a court could determine whether the lost profits claim were the result of a direct breach of the contract (and therefore would be recoverable under this provision) or if they were indirectly caused by the breach of contract (and therefore would be consequential and waived under the provision).[293]

The court also rejected the Franchisee's claim that the damages waiver was not brought to its attention because the limitations of damages clause was highlighted as a separate provision and the franchisee signature was on the bottom of the page.[294]

In *Chin v. Advanced Fresh Concepts Franchise Corp*.[295], the court also upheld an arbitration provision that limited recovery to actual compensatory damages and did not allow for noneconomic and punitive damages[296].

The Franchisee contended that the damages limitation was unconscionable. In rejecting this argument, the court held that a damages limitation may be unconscionable if it contravenes public policy by limiting remedies available in the statute under which a plaintiff proceeds, or if it is one-sided[297]. The franchisee argued that the damages limitation violated certain provisions of the California Franchise Investment Law "CFIL"), but since the Franchisee was not asserting any claims under the CFIL, the court did not find the waiver unconscionable. The court also noted that the damages limitation was mutual[298].

Although the California court enforced the damages limitation, its ruling expressly noted that if the Franchisee had claims under the CFIL, the court could have found the damages limitation, in whole, or in part, against California public policy. The court's decision also implied that if the damages limitation was not mutual, the court may have

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[291] *Id.* at *3-*4

[292] *Id*. at *1. (*quoting* La. Civ.Code art. 1983). Under La. Civ.Code art. 2045: "Interpretation of a contract is the determination of the common intent of the parties." The interpretation of an unambiguous contract is an issue of law or the court to decide. *Amoco Production Co. v. Texas Meridian Resources Exploration Inc*., 180 F.3d 664, 668 (5th Cir.1999).

[293] *Ingraham*, 2009 U.S. Dist. LEXIS 38164, at *3 (*quoting* La. Civ.Code art. 2046).

[294] *Ingraham* at *4.

[295] *Chin v. Advanced Fresh Concepts Franchise Corp*., 194 Cal. App. 4th 704 (2011).

[296] *Id.* at 714.

[297] *Id*. at 713, (*citing Armendariz v. Foundation Health Psychcare Services, Inc.* (2000) 24 Cal.4th 83, *103-104)

[298] *Chin,* 194 Cal. App. at 714.

found it unconscionable and not enforced it.

Similarly, in *Yumilicious Franchise, LLC v. Matthew Barrie, et al.*[299] (2015), the United States Court of Appeals (5th Circuit) upheld the lower courts partial summary judgment ruling that the franchisees waived their right to punitive and consequential damages. The court noted that the provision was in boldface and all capital letters and therefore complied with Texas's requirement that damages waivers be conspicuous[300].

3. FRANCHISE DISCLOSURE LAWS

The sale of franchises is governed by federal disclosure laws[301]. However, the federal disclosure laws provide no private right of action for a franchisee to pursue a Franchisor from a violation of such federal disclosure laws. Fifteen states[302] have enacted franchise disclosure laws, which provide a private right of action for franchisees, and permit franchisees to pursue various remedies including monetary damages, punitive damages, recission, and other costs.

Any damages limitation contained in a franchise agreement will not be applicable for any claims properly brought by a franchisee to the extent such state disclosure law provided for a specific remedy for a franchisor's violation of the state's disclosure laws. Therefore, in terms of each party evaluating whether the limitation of damages provisions are worth the fight, the practitioner should evaluate whether the franchisee will still have an avenue to bring a claim for a violation of state disclosure laws that will not be subject to any damages waiver.

4. "LITTLE FTC" ACTS

Twenty Eight states have enacted "Little FTC" Acts. Beyond the disclosure laws, some of these "Little FTC" Acts expand the scope to provide Franchisees with a cause of action for a Franchisor's unfair acts or practices.[303] While these Little FTC Acts vary from state to state, the damages recoverable from the violation of "Little FTC" Acts range from actual damages, restitution, or equitable relief and the majority of these statutes provide statutory damages, treble damages, and punitive damages[304].

To the extent a claim is properly asserted under a "Little FTC" Act, the limitation of damages provision would be superseded by the language contained in such "Little FTC" Act (for the applicable portion of the claim(s) being asserted.

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[299] Yumilicious Franchise, LLC v. Matthew Barrie, et al., 819 F.3d 170 (5th Cir. 2016).

[300] *Id. (citing Dresser Indus., Inc. v. Page Petroleum, Inc*., 853 S.W.2d 505, 511 (Tex.1993) ("A term or clause is conspicuous when it is so written that a reasonable person against whom it is to operate ought to have noticed it. A printed heading in capitals is conspicuous." (*quoting Tex. Bus. & Com.Code* § 1.201(10).

[301] 16 C.F.R. Part 436.

[302] California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington and Wisconsin.

[303] Alaska, California, Connecticut, Florida, Georgia, Hawaii, Illinois, Iowa, Louisiana, Maine, Maryland, Massachusetts, Mississippi, Missouri, Montana, Nebraska, New Hampshire, North Carolina, Ohio, Oklahoma, Rhode Island, South Carolina, Tennessee, Vermont, Washington, West Virginia, Wisconsin and Wyoming)

[304]

5. RELATIONSHIP LAWS

In addition to "Little FTC" Acts, there are several states that have enacted franchise relationship statutes[305] extending protections to franchisees on issues such as termination, non-renewal, transfers, association with other franchisees and other issues and have self-prescribed damages for franchisors who violate such statutes.

For example, in *Sanchez v. CleanNet USA, Inc*.[306], the court held that "Any condition, stipulation, or provision purporting to bind any person acquiring any franchise to waive compliance with any provision of [the Illinois Franchise Disclosure Act] or any other law of this State is void." (citing 815 ILCS 705/41).

In *Sanchez*, the franchise agreement provided that the franchisee waived its right to collect punitive damages, consequential damages, loss of profits, and attorneys' fees and costs. The franchisee argued that this limitation of damages provision was unconscionable. The court noted that damage limitations are not per se unconscionable[307]. However, the court did note that to the extent the limitation of damages provision attempts to categorically exclude statutorily granted and statutorily unwaivable forms of relief, are void and unenforceable[308].

In O'Quinn, an arbitration provision that prohibited punitive damages "unless the statute under which [the parties] are suing provides otherwise" was deemed unenforceable because the plaintiff brought claims under the Consumer Fraud Act, which authorizes punitive damages.[309] In another Consumer Fraud Act case, Tortoriello v. Gerald Nissan of N. Aurora, Inc[310]., a similar prohibition on punitive damages was deemed unenforceable even though the arbitration agreement did not provide the exception to its limitation on punitive damages limitation that was present in O'Quinn .[311]

The court went on to reason that since the Illinois Franchise Disclosure Act makes franchisors liable to franchisees for damages and attorneys' fees, the remedial limitations in the Franchise Agreement—which includes Sanchez's waiver of punitive damages and recovery of attorneys' fees and costs—are unenforceable.[312]

Similarly, in *Chin v. Advanced Fresh Concepts Franchise Corp, (Supra)* the California court clearly signaled that it would not enforce any limitation of damages provision to the extent that the franchisee had a claim under the California Investment

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[305] Alaska, Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Maryland, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Rhode Island, Virginia, Washington and Wisconsin.

[306] *Sanchez v. CleanNet USA, Inc.*, 78 F. Supp. 3d 747, 757 (N.D. Ill. 2015) (*citing* 815 ILCS 705/41).

[307] *Sanchez*, 78 F. Supp. at 757.

[308] *Id*. at 753.

[309] *Id.* at 756 (*citing O'Quinn v. Comcast Corp.*, 2010 U.S. Dist. LEXIS 125879, 2010 WL 4932665 (N.D. Ill. Nov. 29, 2010).

[310] Id. at 756 (citing O'Quinn v. Comcast Corp., 2010 U.S. Dist. LEXIS 125879, 2010 WL 4932665 (N.D. Ill. Nov. 29, 2010 and see also Tortoriello v. Gerald Nissan of N. Aurora, Inc., 379 Ill. App. 3d 214, 238 (2008).

[311] *Tortoriello,* 379 Ill. App.3d at 239.

[312] Sanchez, 78 F. Supp. 3d 747, 757. The Sanchez court did note that the unconscionable portions of the damages limitation were severable and therefore did not render the entire provision unenforceable. *Id.*

law and would have rendered such limitation provision against California public policy.

State relationship laws may even expressly contain a provision that provides that the parties cannot contractually waive any applicability of the state relationship law, including the damages provision.[313]

6. OTHER STATE LAWS

As noted by the Sanchez court, Consumer Fraud Act cases (even if not encompassed by a "Little FTC" Act and other similar state statutes, can render a limitation of damages provision unenforceable and/or void, if such damages limitation conflicts with another applicable state law.

In general, the question of whether a practitioner should agree to a limitation of damages claim requires an analysis of the State law which governs the agreement as well as the State law where the franchisee intends to operate. Regardless of the governing law agreed upon in the franchise agreement, there are state statutes that provide that its law will apply if certain triggers are met. For example, regardless of the governing law, if a franchisee is going to operate in New Jersey and its franchised business meets certain requirements, applies regarding to (1) maintaining a place of business in New Jersey; (2) having gross sales between the franchisor and franchisee for the previous twelve months which exceeds $35,000; and (3) more than 20% of the franchisee's gross sales are derived from the franchise, then the New Jersey Franchise Practices Act would apply to certain types of claims and any limitation of damages claims would not be enforced for such causes of action.[314]

E. DAMAGES CONCLUSION

When drafting a limitation of damages provision, practitioners can follow some general guidelines to increase the likelihood that such provision will be enforceable.

First, the waiver language should always be conspicuous. Including capitalized letters, or bold print to help the provision stick out are examples that courts have referenced. Courts have also referenced capitalized letters in the paragraph heading as sufficient to satisfy the requirement for the language to be conspicuous. If a court feels that the waiver language was buried and "hidden" in the franchise agreement, it may be more reluctant to enforce such provision.

Second, if the clause is not mutual, there is a chance that a court could deem the provision unconscionable and not enforce it. However, if a provision is being made mutual, then the Franchisor may want to reduce the scope of the waiver, as it will also be bound by such limitations.

Third, there may be instances where the enforcement of the provision would be against a state's public policy. The agreement should contain a severability provision. An example would be:

> *IF ANY TERM OF THIS AGREEMENT IS FOUND OR DETERMINED TO BE UNCONSCIONABLE OR UNENFORCEABLE FOR ANY REASON,*

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[313] *See, e.g., New Jersey Franchise Practices Act* N.J.S.A. 56:10-1 et seq., *See also, California Franchise Relations Act,* Cal. Corp. Code §§ 20000-20010

[314] See N.J.S.A § 56:10-4.

THE FOREGOING PROVISIONS OF WAIVER BY AGREEMENT OF PUNITIVE, EXEMPLARY, INCIDENTAL, INDIRECT, SPECIAL, CONSEQUENTIAL OR OTHER SIMILAR DAMAGES (INCLUDING, WITHOUT LIMITATION, LOSS OF PROFITS) SHALL CONTINUE IN FULL FORCE AND EFFECT.

Fourth, the clause should specify if the waiver of lost profits applies to both direct and consequential damages. An example this would be:

FRANCHISEE HEREBY WAIVES TO THE FULLEST EXTENT PERMITTED BY LAW, ANY RIGHT TO OR CLAIM FOR ANY PUNITIVE, EXEMPLARY, INCIDENTAL, INDIRECT, SPECIAL OR CONSEQUENTIAL DAMAGES (INCLUDING, WITHOUT LIMITATION, LOST PROFITS) AGAINST FRANCHISOR ARISING OUT OF ANY CAUSE WHATSOEVER (WHETHER SUCH CAUSE BE BASED IN CONTRACT, NEGLIGENCE, STRICT LIABILITY, OTHER TORT OR OTHERWISE) AND AGREES THAT IN THE EVENT OF A DISPUTE, THAT FRANCHISEE'S RECOVERY IS LIMITED TO DIRECT DAMAGES (EXCLUDING DIRECT LOST PROFITS).

Joyce Mazero

As Co-Chair of the Global Franchise and Supply Network practice, Joyce Mazero represents national and global product and service-based companies leading them through major initiatives including structuring franchise and distribution networks, purchasing cooperatives and buying groups; negotiating strategic alliances, joint ventures, domestic and international licensing, franchising, manufacturing, retail and logistics deals; buying and selling franchise chains, food service providers and manufacturing plants, and litigating franchise, intellectual property and distribution disputes around the world.

Managing supply chain risk and leveraging supply chains to maximize competitive advantage and, increase cash flow opportunities; managing risk in domestic and international franchise systems to enhance market expansion opportunities and foster sustainable value relationships among franchisors, franchisees and suppliers are critical focal points of Joyce's practice.

Chambers USA, the world's leading guide to the legal profession, has ranked Joyce "Top Ranked" in Band 1 for Franchising Nationwide for the past 16 consecutive years, since 2008. She is also highly ranked by Chambers Global. In interviews with clients during research for these rankings, Joyce was noted for her:

- "very strong sense of what it takes to drive a business"
- "well-rounded viewpoint on transactions"
- "extraordinary [experience] on supply chains and how they relate to franchising"
- "extraordinarily talented"
- "a very good strategist"

She is the recipient of several leadership awards from the International Franchise Association, the Women's Foodservice Forum and the Dallas Business Journal including the IFA's Bonnie Levine and Crystal Compass awards. A frequent national speaker and writer, Joyce co-authored *Franchise Management for Dummies,* a Dummies series publication, was co-editor of the ABA Forum on *Franchising's* Monograph on Financial Performance Representations, and is a Contributing Writer for *American City Business Journals* and Forbes.com. She also serves on the Advisory Board for the National Restaurant Association's Supply Chain Expert Exchange and is a certified mediator.

W. Michael Garner

W. Michael Garner is a partner in Garner, Ginsburg & Johnsen, P.A. and limits his practice to assisting franchisees, dealers and distributors in their relationships and disputes with franchisors and suppliers. He is the author of *Franchise & Distribution Law and Practice,* a three-volume treatise published by Thomson-Reuters/West, and is editor of the *Franchise Desk Book*. Michael is the 2016 recipient of the ABA's Lew Rudnick Award for lifetime achievement in franchise law, as well as of the 2017 Lifetime Achievement Award of the American Association of Franchisees and Dealers. He has also been designated a Super Lawyer, Legal Eagle and member of America's Best Lawyers. Michael has served on the Governing Committee of the ABA Forum on Franchising and as editor of the *Franchise Law Journal.* He has won over $250 million for franchisees and dealers; his work has been cited by the Supreme Court of the United States; and his cases have established important precedents for franchisees.

Adam J. Siegelheim

Adam J. Siegelheim is a Shareholder and member of Stark & Stark's Business & Corporate and Franchise Groups. Mr. Siegelheim's franchise practice includes the representation of franchisors and master franchisees in various matters, including the preparation of disclosure documents and franchise agreements, state registrations, compliance with applicable federal and state regulations, and international expansion. Mr. Siegelheim is a member of the International Franchise Association, the American Bar Association Forum on Franchising and is the Past Chair of the New Jersey Bar Association Franchise Law Committee. In 2012, Mr. Siegelheim was presented with the designation of Certified Franchise Executive by The Board of Governors of the Institute of Certified Franchise Executives.