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EVIDENTIARY & TRIAL ISSUES IN FRANCHISE CASES

The Implied Covenant of Good faith & Fair Dealing

Common Law Fraud

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I. INTRODUCTION

This chapter considers strategic evidentiary issues that are likely to arise in connection with two common law claims in franchise litigation: fraud in the inducement of the franchise relationship and breach of the franchise agreement (including claims based upon the implied covenant of good faith and fair dealing). We first consider the evidentiary back story behind a well-known franchise case and the strategic lessons it teaches. From there, we will review some basic rules of evidence and, with that backdrop, some important substantive issues in both fraud and contract cases, which we hope will stimulate your creativity and help you craft winning arguments in your next cases.

II. CASE STUDY: A TREE GROWS IN PARIS

We begin with two burning questions:

Do leaves on trees bloom in spring/summer, and fall in autumn?

Or is it the other way around?

If these seem like odd questions, please think again. In a well-known case, *Dayan v. McDonald's Corporation*, the legal issue was whether McDonald's had good cause to terminate the franchise of a seventeen store operator in Paris, France, on the grounds that the franchisee had breached the agreement's requirements for adherence to system standards for quality, service, and cleanliness (QSC).[1] McDonald's had inspected Dayan's restaurants in mid-summer, found that they did not pass, and gave a 60-day notice of default, with the opportunity for the franchisee to cure by complying with QSC standards going forward. McDonald's re-inspected in September, after the 60 days had passed, and upon finding no improvement, announced the termination of the franchise.

The franchisee sought an injunction against termination in an Illinois state court. The key fact issues were "whether the restaurants were clean, whether the food service was prompt

[1] 125 Ill. App. 3d 972; 466 N.E.2d 958; 1984 Ill. App. LEXIS 2076; 81 Ill. Dec. 156 (1st Dist. 1984).

and courteous, and whether the food was prepared properly and with specified products."[2] These fact questions were sharply disputed. Preparing for an injunction hearing that would last more than 60 trial days, both sides had to select their evidence and plan for its admission. McDonald's was seeking to prove that it was rightfully protecting its brand.[3] Dayan, on the other hand, argued that McDonald's was trumping up the alleged QSC violations as a pretext for reclaiming the lucrative Paris market for itself.

In inspecting and later re-inspecting Dayan's restaurants, McDonald's took many photographs, enabling it to present a very compelling case of extensive, uncured QSC violations that warranted franchise termination. For his part, Dayan testified that he, too, had taken many photographs, and that they would show that his restaurants met QSC standards, in direct contradiction to McDonald's evidence. But, alas, Dayan testified that all of his exculpatory photographs had been lost or destroyed in a fire at his office in Paris.

Everyone in the courtroom knew that Dayan's "my evidence was lost in a fire" argument was lame. But no one could have anticipated what would happen after McDonald's rested its defense. In rebuttal, the franchisee's attorney made the startling announcement that Mr. Dayan had suddenly located a number of photographs allegedly taken in late August or early September, about two weeks before the McDonald's re-inspection photographs were taken. These photographs had not been lost in the fire after all, and, according to the franchisee, they showed that Dayan was in compliance with QSC standards before his opportunity to cure had expired. The franchisee called its marketing director to the witness stand to authenticate these pictures.

"Something was wrong."[4] Had McDonald's field personnel fabricated evidence in their September re-inspection? That certainly was the inference urged by the franchisee. Trial counsel for McDonald's had very little time, but they noticed something interesting. Plainly visible in both the plaintiff and defense photographs was a tree, standing in front of one of the Dayan restaurants on a Parisian boulevard. But there was a discrepancy. In McDonald's pictures, taken in September, this tree still had its leaves, there for all to see. In the franchisee's pictures, supposedly taken two weeks earlier, the same tree was barren of its leaves.

How could this be? Did the leaves on a tree in front of the McDonald's in Paris somehow blossom over the Labor Day weekend? Did this tree defy the laws of nature? Had everyone been in wrong in thinking that Paris, France, was north of the equator? Or, perhaps, had a desperate franchisee seeking to avoid the termination of a business that was worth millions actually stooped to using photographs that in truth had been taken later that autumn or winter, after the franchise had been terminated? The answer was obvious. The Court denied the franchisee's request for an injunction against termination. McDonald's won the case and recovered all of its attorneys' fees due to the franchisee's bad faith in the litigation.

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[2] James R. Figliulo, "Going Out On A Limb", included in *Your Witness: Lessons on Cross-Examination and Life From Great Chicago Trial Lawyers*, edited by Steven F. Molo and James R. Figliulo (Law Bulletin Publishing Company) (2008), at 112 (hereinafter "Figliulo"). By way of disclosure, Mr. Figliulo is a former partner of one of the authors, Carmen Caruso.

[3] Technically, McDonald's was simply defending against the requested injunction and did not have a burden of proof, but nonetheless, McDonald's would present voluminous evidence in support of its position that the QSC standards had been violated.

[4] *Id.*, at 113.

What are the strategic lessons from this true life tale? Here are a quick handful:

- *Obtain and present the most persuasive evidence.* What we call "evidence" consists of words, documents, or images, which are either snippets of real life events or re-creations of those events, strategically presented to persuade the finder of fact to believe that something did, or did not, actually occur outside the courtroom walls. In "quality assurance" cases such as *Dayan*, photographs usually are going to be more persuasive than written inspection reports or testimony of those who witnessed store conditions.[5] Words can be contradicted or interpreted. One person's "mess" is another person's "order." Pictures therefore really are worth a thousand words. Seeing is believing. In other cases, however, photographs may not be available and words will matter. In every case, the advocate's task is to identify the most persuasive evidence, and to build the rest of the case around it.

- *Take nothing at face value.* Stop, look, and listen when examining evidence. Never assume that something is true. This process begins in the proverbial first phone call when a client describes the potential case. From that moment forward, and continuing until the close of evidence at trial, you must constantly challenge assumptions about whether a particular piece of evidence is believable or actually proves the point for which it is being offered. These assumptions may come from your client or your opponent, and they can exist in your own mind as well. Most obviously, from *Dayan v. McDonald's*, there were separate moments when both the plaintiff and the defense lawyers held those staged photographs in their hands for the first time. But only one set of these lawyers took the time to stop and think.

- *Be ready to adapt.* The evidence that might seem decisive at the start of a trial may not be decisive by the end of the trial. Things happen during trials that change the equation: courts rule on the admissibility of evidence; witnesses get impeached or disqualified; new witnesses or other evidence may suddenly appear. Trial counsel always must be ready to adapt to changed circumstances.

- *Credibility is key.* In virtually any case involving disputed questions of fact, the best evidence is that which bolsters your client's credibility, or which destroys the credibility of your opponent. The effect of such evidence goes far beyond the narrow point for which the evidence was introduced.

- *Turn the tables.* The best evidence often comes from the opposing party. As in *Dayan v. McDonald's*, there is no path to victory more swift or sure than to take the opponent's evidence and use it to destroy the opponent's credibility. This actually happens more than one might suspect.

- *Evaluate raising the stakes.* Sometimes, an opponent's evidence is so powerful, such as McDonald's extensive photographic evidence in *Dayan*, that the other side feels compelled to mount a *direct challenge* with its own contradictory evidence. When this is done, the stakes are necessarily raised. Suspense is heightened, for now it is clear that one side or the other is probably lying, and the case is likely to turn on credibility. To state the obvious, however, to intentionally raise the stakes in this manner, without exhausting all the factors that

[5] Inspection reports can present unique problems for franchisors, and a goldmine for the franchisee's attorney on cross-examination. In a variation of the well-known Stockholm syndrome, more than one franchise inspector has, over the years, come to identify more with the inspectee than the party that signs his paycheck.

will decide the resulting credibility contest, constitutes an extreme form of recklessness. Knowing when to raise the stakes -- and knowing when not to -- are key strategic decisions in almost any trial.[6]

- *Reductio ad absurdum.*[7] Often, there is nothing more effective than to assume the truth of evidence presented by the other side, and then demonstrate that the opponent's evidence must inevitably lead to an absurd or ridiculous outcome, thus proving that the other side's claim must be wrong. In *Dayan*, once it was clear that the franchisee was asking the court to suspend the laws of nature, Mr. Dayan was doomed.[8]

- *Less may be more*. In *Dayan*, the McDonald's trial team did not attempt a grandiose Perry Mason moment to expose the fraudulent photography with a witness on the stand. Sitting at counsel's table, noticing that the franchisee's evidence would contradict established laws of nature, they made what seemed like a routine request to *voir dire* the witness that Dayan had called to authenticate his photographs, to make sure that the witness was committed to her testimony as to the alleged date on which the pictures allegedly were taken. That was more than enough to permit McDonald's to argue in closing, based on the laws of nature, that the pictures were necessarily false. Moreover, by saving the *coup de grace* for closing argument, the defense pre-empted an evidentiary rebuttal, and thereby imposed a staggering blow, at the time it would count the most, and when it was way too late for the plaintiff to try and recover. Restraint in cross-examination paid huge dividends later. Less was more.[9]

III. A REVIEW OF EVIDENTIARY RULES

Effective trial strategy plainly requires knowledge of the evidentiary rules. Common law fraud and breach of contract claims in franchise disputes are subject to the same rules of evidence as other civil matters, and there is no substitute for knowing the rules, cold, before the start of any trial. In this section, we will review some of the basic rules, with reference to franchising disputes that involve fraud or contract claims.

A. Relevance and Materiality

Relevance is generally defined as the tendency of the evidence in question to establish a material proposition, i.e., to make something more likely to be true than not. Materiality is whether the evidence relates to an issue in the case. (FRE 401, 402). The advocate's task is to

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[6] There are other situations that call for an "indirect challenge" to an opponent's evidence, which is essentially an end run around the opponent's point, and sometimes there is room to mount both a direct and indirect challenge at the same time. There are other situations when the best choice is to ignore the opposing evidence and to hope that the finder of fact will ignore it too.

[7] Latin for "reduction to the absurd." *See* http://en.wikipedia.org/wiki/Reductio_ad_absurdum (last visited June 16, 2008).

[8] The same point was made to great effect in the film *My Cousin Vinny*, when actor Joe Pesci, playing a lawyer, asked on cross-examination whether the grits being cooked on the witness' stove were subject to the same laws of nature that applied on every other stove. Judging by the film's popularity, the cross-examination was effective. Moreover, in that movie, it helped the cross-examination immensely that in the venue where the fictional trial occurred, the jury was quite familiar with the cooking of grits. In other words, the effective cross-examiner chose a real life example that his audience was able to effortlessly relate to.

[9] *Figliulo*, at 113-19.

be clear in identifying, as early as possible, what the issues in the case are likely to be, and to evaluate all potential evidence in that light.[10] The district court in *Chicago Premium Yogurt, Inc. v. Yogurt Ventures,USA, Inc.*,[11] addressed the application of these basic rules in a franchising dispute (in which a franchisor refused to approve a proposed franchise transfer) as follows:

> A trial court judge had broad discretion to determine the relevance of proffered evidence. Rulings on admissibility of evidence ordinarily should be deferred until trial, so that questions of foundation, relevancy, and potential prejudice may be resolved in proper context. Evidence should not be excluded unless it is clearly inadmissible on all possible grounds. A ruling on a motion in limine is subject to change as events at trial unfold. (Internal citations omitted).

B. Undue Prejudice

Is any relevance outweighed by undue prejudice?[12] Under the Federal Rules of Evidence, the balancing test of relevance (Rule 401) versus undue prejudice (Rule 403) is heavily tilted, even in jury trials, in favor of the admissibility of logically relevant evidence with probative value, such that the alleged prejudice or confusion must substantially outweigh the probative value before exclusion is deemed to be required.[13] To the extent that evidence may be confusing or prejudicial, a limiting instruction from the judge usually will be sufficient to obviate any objection and allow the evidence to be admitted.

Although dated, two good examples of Rule 403's operation in franchise cases are presented in *Popeye's Inc. v. Shapiro*,[14] and *Kutner Buick, Inc. v. American Motors Corporation*.[15] In *Popeye's*, an ex-franchisee facing a possible injunction for violation of the post-termination non-compete clauses and alleged dissemination of trade secret recipes to the competing business alleged counterclaims for fraudulent inducement of the franchise relationship. The allegations were based on the franchisor's alleged omission of important

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[10] A related question is whether the evidence is conditionally relevant. "Conditional relevance" refers to evidence that only becomes relevant based on the introduction of other evidence, and as such, it pertains more to the sequence in which evidence is introduced, more than to any rule of substance. Under the Federal Rules of Evidence, and presumably in most states, a trial judge has wide latitude in admitting conditionally relevant evidence, subject to the later introduction of the other evidence. An example in franchising might be photographs or other business records from an inspection of a franchised location. Standing alone, those records might not be relevant, but if other evidence is introduced that puts the condition of the location into issue, as in *Dayan v. McDonald's*, then the photographs or other business records might become relevant. Thus, they can be conditionally relevant at the outset. *However, for the proponent of conditionally relevant evidence, there is always the danger that in the heat of a trial, one might forget to connect up the relevance of previously admitted evidence, and in that case, an alert opponent can ask the court to strike the previously admitted evidence based on the failure of the condition.* Likewise, if the evidence needed to establish the relevance of prior evidence is not admissible, the previous evidence may be stricken.

[11] 1992 U.S. Dist. LEXIS 36 (N.D. Ill. Jan. 2, 1992).

[12] FRE 403 provides that relevant evidence may be excluded if its probative value is substantially outweighed by the danger of unfair prejudice, confusion of the issues or misleading the jury, or by considerations of undue delay, waste of time, or needless presentation of cumulative evidence.

[13] Also, the court may elect to issue an instruction to the jury to guard against an alleged prejudicial effect. For bench trials or commercial arbitration hearings, an objection of undue prejudice is even less likely to succeed.

[14] 1987 U.S. Dist. LEXIS 13636 (N.D. Ill. Sept. 1, 1987).

[15] 868 F.2d 614 (3rd Cir. 1989).

information concerning the scope of the post-termination non-compete clause from the franchise offering circular, which contained a lease assignment requirement, of which the franchisee claimed to have been unaware. As part of its litigation strategy, the franchisee obtained from the Office of the Attorney General of Illinois a "Certificate of Noncompliance" pursuant to the Illinois Franchise Disclosure Act, which stated that Popeyes' 1983 Offering Circular "did not contain a provision regarding assignment of the franchisee's lease upon termination of the franchise."[16]

The franchisee sought to introduce the Attorney General's findings into evidence against Popeye's, which objected on the grounds of relevance and undue prejudice. The district court addressed the issue as follows:

> An Illinois statute has no bearing on whether the Certificate will constitute *prima facie* evidence or even be admissible in this court….Nevertheless, defendants contend that the Certificate is admissible under *Federal Rule of Evidence 803(8)(B)*, an exception to the hearsay rule made for public records of "matters observed pursuant to duty imposed by law as to which matters there was a duty to report. . . ." Popeyes argues that the Certificate constitutes a "factual finding resulting from an investigation made pursuant to authority granted by law . . ." which is governed by *Rule 803(8)(C)*. Popeyes advances a number of arguments why the Certificate does not qualify for admission into evidence. It is not necessary to decide whether the Certificate is admissible under either *Rule 803(8)(B)* or *(C)*, because the court finds that the Certificate is unduly prejudicial cumulative evidence and therefore it should be excluded under *Federal Rule of Evidence 403*.[17] …
>
> The Certificate that defendants seek to introduce into evidence states:
>
> > [The] Attorney General of the State of Illinois, and Administrator of the Franchise Disclosure Act ("Act"), Ill. Rev. Stat., chap. 121 1/2, par. 701 et seq., pursuant to authority of Section 24 of the Act, hereby certifies that the records of the Administrator reflect that the Popeyes Famous Fried Chicken, Inc. Offering Circular which was on file for 1983 does not contain a provision regarding assignment of the franchisee's lease upon termination of the franchise.
>
> The material defendants seek to introduce by way of the Certificate is already in evidence before the court in the form of Popeyes' 1983 Offering Circular. The court does not need the Attorney General to tell the court what the Circular does not contain. The only other information to be gained from the Certificate is a legal conclusion that a *prima facie* showing has been made that Popeyes has not complied with the Act. That issue is for the district court to decide. … [because] ultimate conclusions are admissible under 803(8)(C), but if the conclusion merely tells a jury how to decide the case, it may be excluded… Since the Certificate adds nothing to the evidence, defendants can have only one purpose in offering it and that is to use the aura of the Illinois Attorney General to urge the court to

[16] *Popeye's*, at *4.

[17] Internal citation omitted.

> reach a legal conclusion already fully (more than fully) briefed by the parties. This is undue prejudice under *Rule 403*, which in addition to the time, which would be spent by Popeyes exposing the weakness of the Certificate *(see* Popeyes' response to the motion), compels the conclusion that the Certificate should be excluded under *Rule 403* from consideration on the cross motions for partial summary judgment.[18]

Thus, the district court in *Popeye's* found the State Attorney General's findings to be unduly prejudicial because they risked adding an air of official credibility to facts which were otherwise easy to establish, creating the risk that a jury would rule against the franchisor in the belief that that such a verdict would comport with the wishes of the State Attorney General. The *undue* prejudice is fairly easy to see.

Kutner presents a different side of this story. In that case, an automobile dealer complained of territorial encroachment as the basis for claims for fraud and breach of contract. At trial, the district court granted the manufacturer a directed verdict on the fraud claim, but allowed the contract claim to go to the jury, which became deadlocked, prompting the district court to declare a mistrial, and then to dismiss the breach of contract claim, instead of ordering a new trial. On appeal, the franchisee complained, *inter alia*, that the trial court had erred in excluding from evidence an internal AMC memorandum which read in part:

> *State Franchise Law*
>
> The Pennsylvania State Legislature is presently considering a revised Motor Vehicle Franchise Law. The proposed law would allow similar line auto dealers the right to protest and block the establishment of a new dealer within an eight-mile radius. The Zone has been advised that this law could be approved as early as mid-September 1983. It is therefore extremely important that this franchise proposal be approved at the earliest date because it would be expected that Kutner Buick/AJR, who is approximately five miles from Potamkin, would utilize the new law to block Potamkin's Franchise.[19]

The franchisee argued that this memo was evidence that the manufacturer had acted with improper motives, while AMC argued it was unduly prejudicial. The court of appeals reversed the district court and ordered a new trial on the breach of contract claim. The court of appeals ruled that the cited memo was relevant, and therefore should not have been excluded on relevance grounds, but the appellate court also held that it would not foreclose the district court, on remand, from excluding this memo on the grounds of undue prejudice. This holding prompts an obvious question: What was *undue* about the prejudicial effect of this memorandum? As we all learned in law school, *every piece of evidence is intended to be "prejudicial" to your opponent,* and if it is not, there is no point in presenting it. Separating valid from "undue" prejudice is a discretionary balancing act for which the rules of evidence give wide discretion to the trial courts.

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[18] *Popeye's* at *10-12 (internal citations omitted). As indicated in the quoted passage, Popeye's was decided at the summary judgment stage, but the federal rule of evidence applied in full force under Rule 56 as the opinion made clear.

[19] 868 F.2d at 619.

C. Limited Relevance

"Limited relevance" comes into play where evidence is relevant for one purpose, but may be prejudicial if considered for other parts of the case. In franchising, one readily can imagine this principle arising. Financial records, for example, might be relevant for some purposes, but prejudicial if used for other purposes. A franchisor might argue that its net worth is irrelevant to the question of damages unless there is a valid claim for punitive damages in the case, and that to allow a jury to consider its net worth would be very prejudicial. However, if there is an issue in the case as to whether the franchisor misrepresented its net worth, then the franchisee might succeed in obtaining the admissibility of that evidence, and the franchisor might be left only with a limiting instruction (amounting to asking the jury to "un-ring the bell"). Additionally, in cases involving more than one franchisee, evidence might be admissible for, or against, one franchisee, but not the other(s).[20]

D. "Other Bad Acts" and "Habit"

Because franchising cases typically involve allegations of conduct by the franchisor that may have been repeated as against different franchisees, either the franchisor or the franchisee in any given case may wish to introduce such evidence, depending on the particular facts of the case. Two rules of evidence are potentially implicated, Rules 404(b) and 406 of the Federal Rules of Evidence.

Federal Rule of Evidence 404(b) ("Other crimes, wrongs or acts") provides that "[e]vidence of other crimes, wrongs, or acts is not admissible to prove the character of a person in order to show action in conformity therewith. It may, however, be admissible for other purposes, such as proof of *motive, opportunity, intent, preparation, plan, knowledge, … or absence of mistake* or *accident …*"

Federal Rule of Evidence 406 ("Habits and routine practices") provides that evidence of the habit or the routine practice of an organization, whether corroborated or not and regardless of the presence of eyewitnesses, is relevant to prove that the conduct of the . . . organization on a particular occasion was in conformity with the routine practice.

Note the similarities and differences between these two rules. They both address the situation where one party allegedly acted the same way on different occasions, but Rule 404(b) applies only where one party is trying to prove that the opposing party had acted badly on another occasion, whereas Rule 406 is facially neutral. A party might try to invoke Rule 406 to prove that it acted in the case at bar in the same commendable way it has acted on other occasions, or a party might try to prove that an opponent acted badly on other occasions, in which case Rule 406 overlaps Rule 404(b).

However, even when Rules 404(b) and 406 overlap (because one party is trying to prove the other party acted badly on multiple occasions), there are stark differences. Rule 404(b) provides that evidence of these other occasions is generally not admissible to prove that the person acted the same way in the case at bar (but allows for the introduction of such evidence for the enumerated other purposes). Rule 406 qualifies Rule 404(b) by allowing evidence of

[20] As a general proposition, a party who objects to the introduction of evidence for all purposes in a case must make an appropriate objection and ask for a limiting instruction at the time that the evidence is offered.

how the person acted on other occasions but only when the evidence is said to reach the level of a "habit" or "routine practice" and is not merely an isolated "other" act.[21]

In franchising cases, it typically will be the franchisee seeking to prove that the franchisor acted badly on multiple occasions in its dealings with various franchisees or franchise sales prospects. In that situation, should a franchisee seek to invoke Rule 404(b), Rule 406, or both of them? To answer that question, consider the two cases in which a franchisee sought to introduce evidence that the franchisor had made oral misrepresentations to several other franchisees and to the plaintiff/franchisee as well.

The court in *Jannotta v. Subway Sandwich Shops, Inc.*,[22] held that prior acts of fraud were admissible where the plaintiff (a landlord) alleged that a franchisor (Subway) misrepresented material facts concerning the lease for one particular store location.[23] Applying F.R.E. 404(b), the court approved the testimony of five former landlords that Subway had made similar misrepresentations in their separate lease transactions with Subway.[24]

By contrast, in another case from the same district, *West Coast Video Enters. v. De Leon*,[25] the court rejected an attempt by franchisees to prove that they were the victims of a verbal misrepresentation by introducing testimony from eight other franchisees that they, too, were the victims of the same misrepresentation. According to the plaintiff/franchisee, these misrepresentations were a part of "West Coast Video's routine business practice" and hence relevant to the issue of whether West Coast Video made the same representations to the Ponce de Leons. The court rejected the evidence from the eight other franchisees, holding:

> Although the testimony regarding West Coast Video's representations to others on different occasions arguably falls within the scope of Rule 406, admission of this evidence would be highly prejudicial. The Ponce de Leons seek to convince the jury that West Coast Video made false statements to the Ponce de Leons by asserting that West Coast Video habitually committed other wrongs or acts against persons unrelated to the Ponce de Leons. Rule 404(b) precludes the use of such evidence. In addition to the danger of unfair prejudice, the testimony of the eight franchisees is likely to confuse the jury, because each of the eight witnesses will have to testify to the facts and circumstances surrounding their decision to purchase their particular franchise. The result would be eight individual mini-trials, all regarding factual circumstances totally unrelated to the Ponce de Leons' communications with West Coast Video. In sum, any possible probative value under Rule 406 is far outweighed by the danger of unfair prejudice, confusion of the issues, delay of trial and waste of time.

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[21] The cases do not provide a clear-cut answer to how much evidence is needed to establish the existence of a habit or routine practice – and there is no requirement that the habit be corroborated by other evidence or by an eyewitness. Conceivably, a person can testify that they have held a position for a period of time and that "I always do this" – thus laying a sufficient foundation for the introduction of habit evidence.

[22] 125 F.3d 503 (7th Cir. 1997).

[23] *Id.* at 506.

[24] *Id.* at 517. The *Jannotta* court allowed additional evidence that twelve different landlords held unpaid judgments against Subway. This evidence was probative of Subway's intent. *Id*.

[25] 1991 U.S. Dist. LEXIS 4209 at *4 (N.D. Ill. April 4, 1991).

Why the different results in *Ponce de Leon* and *Janotta*? There is not a clear answer, other than that these rules are discretionarily applied. However, from the two courts' respective opinions, it is not clear that the plaintiff/franchisee in *Ponce de Leon* had articulated a convincing "other purpose" under Rule 404(b) for the proposed testimony of the eight other franchisees. The *Ponce de* Leon opinion suggests that the only purpose of this evidence was to "prove" that the alleged verbal misrepresentation had been made to these plaintiffs. That meant that the evidence was inadmissible under Rule 404(b) and it left the "habit" argument under Rule 406 vulnerable to the charge of undue prejudice under Rule 403.

What is the lesson from these conflicting decisions? Plainly, the ability to articulate an "other purpose" such as *intent* makes for a stronger argument under Rule 404(b) than simply trying to prove that the other party acted in conformity with its conduct on other occasions. The Rule 404(b) argument is clearly preferred. Moreover, once an important "other purpose" such as an intent to commit fraud, or acting with bad faith in the performance of contract duties, is articulated, it ought to be much harder for an opponent to block such evidence with a cry of "undue prejudice." Again, applying the rules of evidence calls for a balancing of interests. Put another way, *there may be no stronger evidence* of an opponent's state of mind than the evidence of other bad acts under Rule 404(b), whereas merely trying to prove conformity to behavior on other occasions may be much weaker, and hence more vulnerable to being outweighed in the balance.

There is an interesting Texas appellate decision that further illustrates this point. From *Texas Cookie Co. v. Hendricks & Peralta*,[26] it is fair to argue that where a defendant repeats a misrepresentation to multiple franchisee candidates, even as contradictory facts come to light, fraudulent intent is properly inferred. In *Texas Cookie*, the appellate court held that it had been harmless error (in a jury case) to allow a franchisee (who alleged that he was fraudulently induced into the franchise purchase by the franchisor's false predictions of likely business success) to present the testimony of another franchisee, who had purchased its franchise shortly before the plaintiff's purchase, and who testified that he, too, had been defrauded by the same bogus financial representations. The Texas Appellate Court held that this testimony was not probative on the franchisor's fraudulent intent. However, this holding was based on the fact that the defendant had made the misrepresentations to both franchisees at about the same time, creating the possibility that the franchisor could simply have been mistaken twice – and hence the court was not willing to infer fraudulent intent.[27] Critically, the appellate court in *Texas Cookie* expressly held that:

> Had [the earlier purchasing franchisee] testified to a past occurrence of unreasonably optimistic predictions followed by disappointing results, this may have been admissible to show that appellants were aware, at the time they represented the franchise potential to [the later purchasing plaintiff], that such predictions were likely to be wrong.

[26] 747 S.W.2d 873, 880-881 (Texas Ct. App. 1988).

[27] *Id*. However, the trial court had given the jury a limiting instruction, and hence the admission of the other franchisee's testimony was harmless.

E. The Habit/Hearsay Problem

There is another issue lurking in habit cases. Frequently a party resorts to habit evidence precisely because it lacks direct evidence of the conduct in question on a particular occasion. For example, a franchisor might be unable to locate the employee who mailed the default notice to the franchisee before declaring a termination. Where the witness wishes to testify that *someone else* in the organization is the one who "always" does something, there could be a hearsay problem. And, even when habit evidence is allowed, the ruling on admissibility does not establish the weight of the evidence. One can imagine the closing argument if, in a franchise termination case, the franchisor was reduced to relying primarily or exclusively on habit evidence as the sole grounds for taking away someone's franchise.

F. Subsequent Remedial Measures

What if, in response to a franchisee's complaint, a franchisor changes its business practices – or vice versa, in response to an actual or threatened notice of default, a franchisee changes its business practices? In either case, is the subsequent remedial measure admissible against the party that changed its ways in response to a complaint? Under Federal Rule of Evidence 407, the change in practices is generally not admissible to prove "culpable conduct" in relation to the event in question.

However, there is a strong argument that this rule does not apply in contract cases on the grounds that an alleged breach of contract is not the type of "culpable conduct" that the rule was intended to address.[28] The rule should apply in fraud cases to bar evidence of subsequent remedial measures (*i.e.,* procedures put into place to make sure that no further fraud was committed); however, courts may be reluctant to interpret changes in an organization's internal controls as an admission of past deficiency, and to exclude such changes as irrelevant in the first instance.[29]

Even when the subsequent remedial measures rule would apply, there are exceptions that risk swallowing the general rule, as evidence that the remedial act was performed can be admitted for other purposes, such as proving control or feasibility, if these matters are controverted, or for impeachment. There is also the possibility of arguing that a subsequent change in franchise agreement language constitutes evidence of what the parties meant in previous versions of the franchise agreement (a topic that is addressed below). These situations present classic examples of when a limiting instruction would be appropriate – coupled with classic illustrations of why limiting instructions are usually considered ineffective.

G. Offers to Compromise

Franchising disputes are rife with offers to compromise, particularly where the dispute arises in the course of an ongoing franchise or dealer relationship, and where the parties, by definition, remain in contact with each other on as much as a daily basis. In those circumstances, it is almost inevitable that the parties will try to "work things out." In fact, the business parties are very likely to try to work the dispute out without the lawyers. Under Federal

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[28] *See Mowbray v. Waste Management Holdings, Inc*,. 45 F. Supp.2d 132 (D. Mass. 1999) ("Breach of contract . . . requires no showing of any sort of fault, thus apparently negating the operation of Rule 407").

[29] *See Higginbotham v. Baxter Int'l, Inc.*, 495 F.3d 753, 760 (7th Cir. 2007).

Rule of Evidence 408, if the parties to such a discussion expressly include an offer to compromise a disputed claim, then arguably the fact that such an offer was made is not admissible as an admission of liability by the party who made the offer to compromise.[30] Evidence of conduct or statements made in the course of a "settlement conversation" is likewise inadmissible.

However, there are also some important limitations on this rule. The rule does not require the exclusion of evidence that is otherwise admissible, merely because it is presented in the course of negotiations to compromise. Thus, if in the course of a settlement discussion, one party alludes to a fact that can be proven independently, the fact remains admissible.

Rule 408 also does not require exclusion of evidence as to the parties' negotiations, when that evidence is offered for another purpose such as proving bias, prejudice, negating a contention of undue delay, or proving an effort to deliberately mislead or obstruct an ongoing investigation. For example, if there is a settlement conversation in the course of an investigation of whether a franchisee has underreported its royalties, a franchisee's misstatements as to its revenue would arguably be admissible not as evidence of actual revenues, but as evidence of an attempt to mislead the franchisor.

Finally, Rule 408 does not apply when the settlement discussions "involved a different claim than the one at issue in the current trial … even if one of the parties to the suit was also a party to the compromise."[31]

H. Admissions of a Party Opponent and Statements Against Interest

A primer on the law of hearsay is beyond the scope of this paper. However, there is one particular hearsay problem that often arises in franchising cases when one party seeks to introduce evidence of out-of-court statements attributed to lower level employees of either the franchisor or franchisee. Under Federal Rule of Evidence 801(d)(2), admissions by a party opponent are not hearsay where:

> The statement is offered against a party and is (A) the party's own statement, in either an individual or representative capacity, or (B) a statement of which the party has manifested an adoption or belief in its truth; or (C) a statement by a person authorized by the party to make a statement concerning the subject; or (D) a statement by a party's agent or servant concerning a matter within the scope of the agency or employment, made during the existence of the relationship; or (E) a statement made by a co-conspirator of a party during the course and in furtherance of the conspiracy.

The rule further provides that:

> The contents of the statement shall be considered but are not alone sufficient to establish the declarant's authority under subdivision (C), the agency or

[30] Lawyers, of course, seek to avoid ambiguity by putting their clients' offers in writing under a heading which recites that this is a confidential settlement communication. Lawyers also advise their clients not to have such discussions unless the ground rules of confidentiality are agreed upon in advance and preferably confirmed in writing.

[31] *Armstrong v. HRB Royalty, Inc.*, 392 F. Supp. 2d 1302, 1305 (S.D. Ala. 2005) (citations omitted).

> employment relationship and scope thereof under subdivision (D), or the existence of the conspiracy and the participation therein of trhe declarant and the party against whom the statement is offered under subdivision (E).

Plainly, sub-paragraphs (B), (C), and (D) potentially raise issues in franchising cases as to the relationship between the speaker, perhaps a store manager (franchisee side) or a field representative (franchisor side) and the organization party to whom the statement is attributed.[32]

An admission also must be relevant. An interesting twist on the relevance of alleged admissions was presented in *Chicago Premium Yogurt*, *supra*, where a franchisee sought to introduce evidence of a franchisor's statements in a version of its Offering Circular that was not issued until after the plaintiff/franchisee had acquired its franchise.[33] There was no dispute that a franchisor's statements in its Offering Circular were admissions, but the issue was whether the post-sale disclosures to other prospective franchisees were relevant. The franchisor in *Chicago Premium Yogurt* had "refused to consent to [a proposed franchise transfer] on the grounds that [the proposed transferee] would not meet a purported Yogurt Venture policy requiring that new franchisees be active on-site managers of their franchises." After the plaintiff/franchisee had acquired its franchise, the franchisor had stated in subsequent disclosures that the active on-site management was merely recommended, and not required. The district court ruled that this post-sale disclosure *was relevant* to the interpretation of the franchisor's policy, overruling the franchisor's relevance objection.

I. Opinions by Lay Witnesses

Federal Rule of Evidence 701 permits lay witnesses to give an opinion (or to present an inference) that is (a) "rationally based on the perception of the witness; (b) helpful to a clear understanding of the witness's testimony or the determination of a fact in issue; and (c) not based on scientific, technical, or other specialized knowledge within the scope of Rule 702."

Arguably either a franchisor or a franchisee might wish to testify as to his or her opinions on any number of issues, such as:

- The truth or falsity of statements made by the franchisor in its disclosure document, or by the franchisee in its application to buy the franchise.

- Compliance or non-compliance by the franchisee with the company's operating manual.

- The adequacy or inadequacy of training (or field visits, etc.,) provided by the franchisor.

- Whether the franchisor has met good faith standards in adapting the franchise "system" to changing market conditions.

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[32] Sub-paragraph (E) raises interesting conspiracy issues that go beyond the scope of the common law fraud and contract claims being discussed herein.

[33] 1992 U.S. Dist. LEXIS 36.

- The severity or materiality of any alleged default(s) by the franchisee or of any alleged breaches by the franchisor.

- Damages sustained by either side to the dispute, where the losses are fairly easy to compute and do not depend on numerous assumptions as to market conditions etc.

For each of these topics, there will be a range of potential complexity as to the particular issue, such that in some cases, lay opinion testimony will be admissible, while in other cases, it won't. A good rule of thumb is to inquire whether the lay witness typically forms such opinions in the course of his or her job, and to establish that the particular opinion being offered in this case is well within the witness's actual day to day experiences and that others or the company typically rely on the person's opinions in the decision-making process.

It is also important to consider whether the lay witness is purporting to give his or her particular opinion for the first time in the case, or whether he or she actually expressed the opinion, during the underlying controversy, and if so, the circumstances in which the opinion was expressed. Where the opinion was expressed out of court, the opponent of the opinion might object on hearsay grounds, but the proponent may succeed in having the statement admitted as a "verbal act," *i.e.* as an utterance that is direct evidence (as of the thing or event that is the subject of the statement) and, therefore, is not hearsay on the part of the witness.[34] This ground for admissibility is particularly strong where the verbal act served as the basis for a decision that was made, where that decision is part of the dispute. The verbal act is relevant as an explanation for the decision, and once the statement is admitted, it is very unlikely that the speaker would be precluded from giving all the reasons for the opinion, either on direct or on cross-examination.

In addition, depending on the importance of the particular issue, it can be worthwhile to supplement a lay opinion with the opinion of a qualified expert, who can corroborate the lay witness, and who is not subject to the charge of bias to which the lay witness will be subject.

J. Direct Versus Circumstantial Evidence

A final point on the basic rules of evidence as applied in franchising cases. There is a natural tendency to consider direct evidence (*e.g.,* eyewitness testimony that the cat ate the blueberry pie) to be superior to circumstantial evidence (coming home to find the pie tin empty and plenty of blueberries on the cat's whiskers). However, this is not always true.

Direct evidence, when presented from the testimony of a single witness, is subject to impeachment for bias, prior inconsistent statements, etc., and circumstantial evidence, when woven together from a number of independently proven facts, can be quite compelling and less susceptible to impeachment. Ideally, one will not have to choose between uncorroborated direct evidence and a circumstantial case. The point here is to eliminate bias.

IV. BUILDING A CASE FOR FRAUD

It happens every day. Somewhere, there is a franchisee or dealer who fervently and honestly believes that he or she was duped into buying what has turned out to be an

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[34] *See* Merriam-Webster's Dictionary of Law, © 1996 Merriam-Webster, Inc.

unsuccessful franchise. And there are other franchisees and dealers who were not the least bit duped, but who wish to present themselves as victims of fraud in order to gain undue advantage for themselves. The phone rings, and you ask to hear the story. It does not matter if your prospective client is the accuser or the accused. Either way, you have started the process of evaluating potential evidence and thereby determining whether your client's claim or defense will be believable and persuasive.

Dispute their similarities, each fraud case is fact dependent and therefore different. To evaluate any case, you must have in mind the elements of the claim and its ready defenses, and the related evidentiary questions that are most likely to arise in your particular case. We therefore will now present some basic legal principles to consider in view of the evidentiary principles discussed above. As you consider each substantive point, it will be helpful to ask yourself:

1. What types of evidence come to mind, for either plaintiffs or defendants, to prove or disprove the point in question?

2. How does the particular point relate to other elements of the case, *i.e.*, will the whole case come together, or fall apart?

3. How can this point be made in ways that will resonate with the real life experiences of the finder of fact, which may vary depending on whether a case is being tried before a judge, jury, arbitrator, or a panel of arbitrators?

A. Elements of Fraud

Common law fraud is proven by a (1) false statement of material fact, (2) known or believed to be false by the party making the representation (or made by in reckless disregard for the truth);[35] (3) with an intent to induce the other party to act; (4) action by the other party in justifiable reliance on the truth of the statement, and (5) resulting damage to the other party.[36] In considering what types of evidence to prove a fraud claim, keep in mind that there is "no inflexible rule" and "[no] technical standard" for determining fraud.[37] The plaintiff is usually given wide latitude "in proof, especially in the cross-examination of parties charged with fraud."[38] This is true because "[o]utright admissions of impermissible … motivation are infrequent and plaintiffs often must rely upon other evidence."[39]

1. False Statements Of Material Fact, Opinions and Omissions

The first question, whether there was a false statement of material fact, presents the first opportunity to think creatively in evaluating the potential evidence in the case. From the first

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[35] *Hartmann v. Capital Bank & Trust Co.*, 296 Ill. App. 3d 593, 602, 694 N.E.2d 1108 (1st Dist. 1998); *Gerill Corp. v. Hargrove Builders, Inc.,* 128 Ill. 2d 179, 193, 538 N.E.2d 530 (1989).

[36] *I.L.P.*, Fraud, § 21, p. 150. Arguably, only the first two elements of common law fraud need be proven by "clear and convincing evidence" (*i.e.* "highly probably true") (IPI 800.02A and IPI 800.03).

[37] *I.L.P.,* Fraud, § 3, pp. 111-113. Plaintiffs must prove the "substance" or the "material parts" of their fraud claims, but need not prove the complaint "word for word." *Id.*, § 36, p. 191.

[38] *I.L.P.,* Fraud, § 2, p. 190

[39] *Hunt v. Cromartie*, 526 U.S. 541, 553 (1999).

phone call and continuing through trial, the lawyer seeking to prove fraud will be trying to broaden the scope of the alleged misrepresentation while the defense attorney will wish to narrow it. As a matter of common law (at least in Illinois), "*anything calculated to deceive*" may be actionable as fraud, including the:

> "creation of a false impression by words or acts or by any trick or device, or … the concealment or suppression of truth, or of both suggestion of falsehood and suppression of truth together or … a …. combination of circumstances … whether it be by direct falsehood or by innuendo, by speech or by silence, or by word of mouth or by look and gesture … "[40]

Likewise, it is typically held that whether a statement is a "false statement of material fact" depends on "the sense in which it is reasonably understood" given "all the facts and circumstances of a particular case"[41] For a plaintiff, these are wonderful "black letter" holdings that open up nearly an endless range of potential fraud claims:

- Fraud in the offering of a business opportunity exists when the offeror falsely represents past business income;[42] or projects future financial performance without subjective good faith (*i.e.* if the maker did not genuinely believe them) or without having an objectively reasonable basis in fact to make them.[43]

- False affirmative statements of value are actionable when "made in pursuance of a scheme … to induce plaintiff to trade with [defendant]" or when made with knowledge that it would be relied upon or when made by a party having special knowledge.[44]

- Whether a statement is a "false statement of material fact" depends on "the sense in which it is reasonably understood" given "all the facts and circumstances of a particular case"[45]

- Opinions may be fraudulent if they "were expressed as [being based on] affirmative facts [that were false and] material to the transactions;"[46] or if they are incorrectly represented as based upon defendants' superior knowledge as to its business history.[47]

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[40] *I.L.P.,* Fraud, § 2, p. 110.

[41] *Schrager v. North Community Bank*, 328 Ill. App. 3d 696, 704, 767 N.E. 2d 376 (1st Dist. 2002); *Heider v. Leewards Creative Crafts, Inc.* 245 Ill. App. 3d 258, 266 (2nd Dist. 1993).

[42] *Mother Earth, Ltd. v. Strawberry Camel, Ltd.*, 72 Ill. App. 3d 37, 48-49, 390 N.E.2d 393 (1st Dist. 1979).

[43] *Grassi v. Information Resources*, 63 F.3d 596, 599 (7th Cir. 1995) (applying Rule 10b-5 of the federal securities laws); *Norville v. Alton Bigtop Restaurant, Inc.,* 22 Ill. App. 3d 273, 282, 317 N.E.2d 384 (5th Dist. 1974). ("Unfounded predictions of future performance are impermissible under both Illinois and Federal antifraud provisions"); *Lucas v. Downtown Greenville Ltd. Partnership*, 284 Ill. App. 3d 37, 51, 671 N.E.2d 389 (2nd Dist. 1996) (Rule 10b-5 (17 C.F.R. § 240.10b-5) is based on common law fraud); *see also Douglass v. Tonigan,* 830 F. Supp. 457 (N.D. Ill. 1993); *Sequel Capital, LLC v. Rothman*, 2003 U.S. Dist. LEXIS 20967 (N.D. Ill. 2003).

[44] *Duhl v. Nash Realty Inc.*, 102 Ill. App. 3d 483, 489-90, 429 N.E.2d 1267 (1st Dist. 1981).

[45] *Schrager v. North Community Bank*, 328 Ill. App. 3d 696, 704, 767 N.E. 2d 376 (1st Dist. 2002).

[46] Schrager, 328 Ill.App.3d at 704; Heider v. Leewards Creative Crafts, Inc. 245 Ill. App. 3d 258, 266 (2d Dist. 1993).

[47] *I.L.P.*, Fraud, § 23, p. 156.

- Cautionary instructions that accompany financial projections do not excuse fraud where the defendant misrepresents existing facts giving rise to the projections.[48]

- Fraud may be proven by a combination of falsehoods that collectively (or individually) create the false belief that the business opportunity has a much greater likelihood of success than actually exists at the time it is presented. For example, in Salkeld v. V.R. Bus. Brokers,[49] where both common law fraud (and Illinois Consumer Fraud Act) liability were established, where the defendant (a franchisor) misled the plaintiff into buying the franchise by painting an inaccurate, deceptive picture that the defendant would support the franchise with trademarks, advertising, marketing, training, and promotional support; and by misrepresenting the likely financial success of the franchise.

- There is a "duty of a person to speak, so that a party with whom he is dealing may be placed on an equal footing with him, and where the failure to state a fact is equivalent to a fraudulent concealment and amounts to fraud equally with affirmative falsehood."[50]

- Concealing material facts shows intent to deceive (and creates a duty to speak).[51]

- A statement that is "technically true as far as it goes may nevertheless be fraudulent, where it is misleading because it does not state matters which materially qualify the statement as made…. [A] half-truth is sometimes more misleading than an outright lie."[52]

- A "seller must disclose facts which "materially affect the value or desirability of the [opportunity] are known or accessible only to him, and that he knows are not known or accessible to a diligent buyer." [53]

- As has been argued in this Forum many times, the failure to completely and accurately disclose material facts in the manner prescribed by the Federal Trade Commission Franchise Rule should be accepted as proof of common law fraud.[54]

2. The Defendants' State of Mind

When it comes to the defendants' state of mind in a fraud case, the plaintiff will face the fundamental question of just "how evil" the defendants should be portrayed, once again requiring an evaluation of the available evidence and (most probably) the exercise of some discretion in deciding what to present. Consider these holdings:

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[48] *Lucas Downtown Greenville Ltd. Partnership*, 284 Ill. App. 3d 37, 49, 671 N.E.2d 389 (2d Dist. 1996); *Griffin v. McNiff*, 744 F. Supp. 1237, 1254 (S.D. N.Y. 1990).

[49] 192 Ill. App. 3d 663, 548 N.E.2d 1151 (2nd Dist. 1989).

[50] *I.L.P.*, Fraud, § 6, p. 125.

[51] *Kinsey v. Scott*, 124 Ill. App. 3d 329, 336-39, 463 N.E.2d 1359 (2d Dist. 1984).

[52] *St. Joseph Hosp. v. Corbetta*, 21 Ill. App. 3d 925, 953, 316 N.E.2d 51 (1974); *W.W. Vincent and Co. v. First Colony Life Ins. Co.*, 351 Ill. App. 3d 752, 814 N.E.2d 960, 969 (1st Dist. 2004); *Restatement (Second) Torts*, § 529; *I.L.P.,* Fraud, §§ 5, 26.

[53] *Wash. Court Condo. Assoc. v. Washington-Golf Corp.*, 267 Ill. App. 3d 790, 815, 643 N.E.2d 199 (1st Dist. 1994).

[54] *See Rodopoulous v. Piki Enterprises*, 570 So.2d 661 (Alabama 1990).

- *Fraud may be proven "regardless of motive."*[55] Obviously, being able to prove some bad motive is better than not. Franchisors typically argue that they have no motivation to *intentionally* cause a store to fail, but that does not mean that they did not *intentionally* want a franchisee to sign up, pay an initial fee, pay royalties, and to buy supplies from the franchisor or an affiliate. Motive for fraud is usually easy to find in franchise/dealer cases.

- *Fraud may be proven regardless of "intent"* since "a party is considered to intend the necessary consequences of his own acts or conduct" and a party "cannot escape liability … by showing that he did not intend injury"… [and] "it is not necessary to prove intent to cause pecuniary loss."[56]

- "[I]f what a defendant says is false within his own knowledge, and [causes] damage … the law will infer an improper motive" … "Inferences of knowledge of untruthfulness are particularly apt … when the matter in question is peculiarly within the range of facts known to the maker [and] circumstantial evidence may justify such inferences that stand unless rebutted."[57] In *Little Caesar Enters., Inc. v. OPPCP, LLC*[58] a franchisor's false statements that nearby outlets would not compete were actionable where the franchisor had "specialized knowledge and authority."[59]

- Evidence of alleged "general business integrity" does not refute proof of fraud.[60]

3. Justifiable Reliance

Plaintiffs alleging common law fraud face often feel embarrassed by the fact that they let someone else get the best of them and may shy away from fully presenting such evidence in their testimony. But the substantive law confirms the appropriateness of this evidence. In presenting a franchisee as a fraud victim, these concerns play out over the issue of reliance. Consider these holdings, for example:

- Justifiable reliance exists where "the person to whom the representations are made lacks equal facilities for learning the truth"; and absent "circumstances putting a reasonable person on inquiry, a person is justified in relying on a [material] misrepresentation without making further inquiry" and "the mere presence of opportunities to investigate will not of itself preclude the right of reliance."[61]

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[55] *I.L.P.,* Fraud § 3, p. 116, & n.48, citing *Beuchin v. Ogden Chrysler Plymouth, Inc.*, 159 Ill. App. 3d 237, 511 N.E.2d 1330 (2d Dist. 1987).

[56] *I.L.P.*, Fraud, § 3, pp. 115-16 & n.44.

[57] *Id.*, § 51, p. 204.

[58] 219 F.3d 547, 551 (6th Cir. 2000).

[59] *See also Duhl*, *supra,* 102 Ill. App. 3d at 491.

[60] *I.L.P*, Fraud, § 53, p. 213.

[61] *I.L.P.,* Fraud, § 7, p. 133, § 8, pp. 136-37.

- "There is no defense of contributory or comparative negligence to fraud … [T]he fraudfeasor generally cannot escape [liability] by saying that the fraud might have been discovered had the parties [who were] deceived exercised reasonable diligence."[62]

- "[W]here the person making a false statement has inhibited the plaintiff's inquiries by either creating a false sense of security or blocking investigation, the [alleged] failure to inquire is not fatal" to the plaintiffs.[63]

- "The law does not require more [diligence] than that which is reasonable under the circumstances."[64]

- "Where statements of matters of material fact concern matters which may be assumed to be within the knowledge of the party making them, the party to whom they are made may rely on them and need not make inquiries for himself in the absence of suspicious circumstances."[65]

- "Where a party has been guilty of an intentional and deliberate fraud, by which and to his knowledge the other party has been misled, the guilty party cannot escape the consequences of his conduct by saying that the fraud might have been discovered had the other party used reasonable care."[66]

- Merger or integration clauses (arguably) do not preclude a finding of fraudulent inducement.[67]

4. Proximate Causation

Closely related to reliance is the question of whether the defendants' conduct is sufficiently deemed to have caused the plaintiffs' injury. Persuasive evidence of causation is critical. "A fraudulent misrepresentation is a legal cause of a pecuniary loss resulting from an action or inaction in reliance upon it if, but only if, the loss might reasonably be expected to result from the reliance."[68] A proximate cause need not be the sole cause of the loss.[69] For example, proximate causation was established when investors were financially damaged

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[62] *Id.*, § 33, p. 177.

[63] *Id.*, p. 138.

[64] *Id.,* § 7, p. 133.

[65] *I.L.P.,* Fraud, § 8, p. 137.

[66] *Id.*, pp. 137-38.

[67] *W.W. Vincent & Co., supra,* 351 Ill. App. 3d at 761; *Vigortone Ag Prods. v. AG Prods.*, 316 F.3d 641, 644 (7th Cir. 2002); *see also Miller v. Whelan*, 158 Ill. 544, 555 (1895) (merger clauses cannot be used to accomplish fraud or injustice).

[68] *Restatement (Second) Torts* § 548A.

[69] General Motors Acceptance Corp. v. Central Nat'l Bank of Mattoon, 773 F.2d 771, 781 (7th Cir. 1985), citing Mother Earth, supra, 72 Ill. App. 3d at 50.

because they were induced to invest in a business by false and misleading information on the health and stability of the business.[70]

5. Punitive Damages for Fraud[71]

In considering liability issues (especially the nature of the fraud and the defendants' state of mind), the plaintiff often also must consider whether there is enough evidence to support an award of punitive damages, which are proper at common law where the "fraud is gross" or if there are other circumstances showing "malice" and "willfulness" or where "the false representations are wantonly and designedly made."[72] The court can "properly consider the character of the defendants' act, the harm the defendant caused or intended to cause and the wealth of the defendant."[7374] Accordingly, in building a fraud case, this type of evidence will be important.

B. Persuasion in a Fraud Case

Now comes the fun part. You understand the rules of evidence and the common law of fraud, and you know the facts of your case. You have searched for the best cases in your jurisdiction, which you have used to prepare your jury instructions, and as you plan your evidence, you will refer to the applicable jury instructions to be sure that you have some evidence to cover every point that you have to prove, or disprove. It is time to put it all together and assemble a persuasive fraud case for the plaintiff or the defendant. The following are the types of overlapping questions you should be asking.

1. What is the Motive

It is virtually standard in a franchise fraud case for the defense to argue that it had no motive to increase the likelihood that any of its franchisees would fail. Indeed, to the contrary, most franchisors will argue that they had every reason for the franchisee to succeed. No plaintiff in a franchise fraud case can ignore that argument, and therefore, the plaintiff needs to find a convincing motive to overcome that argument. Possible motives for franchise fraud may include:

- To increase sales of franchises (*i.e.* a short term motive).
- To take over the location and thereby take for itself the franchisee's profits.

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[70] *Tone v. Halsey*, 286 Ill. App. 169, 3 N.E.2d 142 (1st Dist. 1936); *Goodwin v. Wilbur*, 104 Ill. App. 45 (1st Dist. 1902); *see also Salkeld*, *supra*, 192 Ill. App. 3d 663.

[71] While a full discussion of damages is beyond the scope of this paper, in general, compensatory damages for fraud may include "out of pocket" losses including liabilities incurred on loans, leases, opening expenses, and in continued operations; and "benefit of bargain" damages to place plaintiffs in the same position they would have occupied, had the false representations been true; and it is appropriate to use the defendants' projections of future profits as a basis for calculating the lost profits (benefits of the bargain) claim.

[72] *I.L.P.,* Fraud, § 63, p. 228-230.

[73] *Restatement (Second) Torts*, § 908(2).

[74] The question of "loss causation" also deserves close consideration by the defendant in any fraud case. *See*, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (U.S. 2008).

- To benefit an individual (*e.g.,* an employee or officer of the franchisor, or perhaps another franchisee) by having that person take over the failed location.

- To create a revenue stream where the royalties are fixed, and thus not dependent on whether the franchisee succeeds (the same argument can be made to a slightly lesser degree where the agreement provides a percentage royalty formula, but where the franchisor is mainly focused on increasing top line sales without regard to whether the franchisee can earn a reasonable margin).

- To create a revenue stream by creating a captive market for goods or services being sold by the franchisor or by one of its affiliates (or by a third-party that provides rebates to the franchisor).

- To have the franchisee develop a site that can be flipped to another operator (or converted into a company store) down the line.

- And, perhaps, to trap the franchisee into the possibility of paying a liquidated damage claim down the line.

Virtually every fraudulent inducement case in franchising will fall into one of these motive patterns, some of which will be more implausible or harder to prove, and others which are more likely to ring true. It is imperative to know which one fits your case, or whether you are going to try to prove some combination of them. Once those decisions are made (*i.e*, once the theme of the case is decided), you must be vigilant in presenting evidence that is consistent with your theme. For example, evidence that a franchisor's internal accountants may have erred in presenting financial data to a franchisee may be important evidence for a franchisee when the franchisor is charged with fraud based on a "reckless disregard of the truth" theory; but may be exculpatory for the franchisor if the charge is one of intentional fraud.

2. <u>What was the Defendants' State of Mind?</u>

Consistent with your assessment of motive, you must decide whether the evidence will support a charge of intentional fraud or whether there was "merely" a reckless disregard for the truth (depending of course on the law in your jurisdiction). You might be inclined to assume that recklessness is easier to prove, and therefore, you might be tempted to argue recklessness instead of intentional fraud. But be warned. If you settle on presenting a recklessness case, you may lose your opportunity to ask for punitive damages (at common law, although the opportunity may still exist under a statutory claim).

In preparing your case, you therefore should ask yourself these questions:

- *Does the alleged state of mind match the alleged motive?* You must make certain that they do. Is it feasible that a defendant would "recklessly" induce a prospect into buying a franchise in order to accomplish a longer term goal such as flipping the property?

- *Who perpetrated the fraud* --the president of the company, or a lower level employee? What motive or incentives did the perpetrator have? Was a lower level fraud ratified higher up? How could the higher-ups not have known? Were they just lazy? Or where they complicit?

- *What is the severity of the alleged misrepresentation?* Is it an extreme, blatant lie? Or, is it materially misleading in the context in which presented? Both types of misrepresentation may be actionable, but this distinction will have tremendous ramifications for the entire case.

- *How bad are the numbers?* If the misrepresentation was based on numerical misstatements, whether in terms of sales dollars, net profit dollars, costs, store closings, it is important to determine the magnitude of the error. Obviously smaller errors as a percentage of the total numbers will be much easier for the defense to explain. Both sides need to analyze the applicable numbers very closely. Statistical analysis, for example, should be considered as a means of proving or disproving the proposition that numerical errors were intentional, and not mere errors in computation.

- *When was the misrepresentation allegedly made – in the sales process, or afterwards?*[75] This question can be very important because the integration and no reliance clauses that franchisors rely upon to defeat fraudulent inducement claims may be irrelevant if the fraud begins after the agreement is signed, *e.g*. by allegedly deceiving the franchisee into borrowing too much money from its bank in order to build a bigger store that it could never hope to operate profitably.[76]

- *How was the misrepresentation communicated?* To one person or many? In writing or verbally? All at once, or in stages? Again, these distinctions will carry forward and affect virtually all subsequent evidentiary decisions.

- *Was there a cover-up?* What happened after the fraud victim first became suspicious? Did the defendant compound its offense with more lies?

Each one of these questions presents a blend of substantive and evidentiary issues, but what comes first, the "evidence" or the "substance"? The answer is that the available evidence must determine the substance of the case that you present.

V. BUILDING A CASE FOR BREACH OF CONTRACT

Contract cases turn on determining the parties' respective rights and duties, whether there was sufficient performance or breach, and damages.[77] At core, the ultimate question in a contract case is "what did the parties *intend*?"[78] In preparing the claim or defense of a franchise contract case, you must consider all available evidence of the parties' written and spoken words, their conduct, and other extrinsic evidence that may bear on that ultimate issue.

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[75] Keep in mind that those contractual defenses are probably not available if the alleged fraud occurs after the franchise agreement is already signed.

[76] Which of the usual motives would you look for in such a case?

[77] *See Monus v. Colorado Baseball 1993*, 1996 U.S. App. LEXIS 32995 (10th Cir. Colo. Dec. 17, 1996) (under Colorado law, a plaintiff seeking recovery for breach of contract must show: (1) the existence of a contract; (2) performance by the plaintiff or some justification for nonperformance; (3) failure to perform the contract by the defendant; and (4) resulting damages to the plaintiff.)

[78] *See Home Ins. Co. v. Chicago & NW Transp. Co.*, 56 F.3d 763, 767 (7th Cir. 1995).

A. The Contractual Duties

1. Express Contractual Duties

The question of whether the parties' signed written franchise agreement should be the sole and exclusive source of their respective rights and duties has been debated many times in this Forum. As a general proposition, it is no doubt fair to say that franchisors typically have as their strategic trial goal the exclusion of all other evidence beyond the written agreement, while franchisees tend to have the opposite goal.[79]

In any event, even a franchisee seeking to go beyond the written agreement usually must concede that the written franchise agreement provides the parties' expressly-defined duties, and a signed franchise agreement is usually admitted into evidence without serious objection. Once the agreement is in evidence, trial counsel may question a friendly witness on some key points in the agreement that relate to the specific issues in the case, but there is no need to have your witness read every relevant clause into evidence from the witness stand. All important clauses can be cited in closing argument once the agreement as a whole has been admitted. Likewise, opposing witnesses can be cross-examined effectively where other parts of their testimony are contradicted by express contract terms.

Nonetheless, parties often skirt these rules, and one way or another, testimony as to what a franchise agreement means, or what its terms allegedly require, often seep into a trial. For example, in *Rodgers v. Ohio Valley CFM, Inc.*,[80] the court held that opinion testimony from an expert designated by the franchisee, on the subject of the franchisor's accounting practices with respect to its advertising fund, was properly admissible even though the expert was referencing the applicable franchise agreement terms that delineated the required accounting procedures. The court held further that "even if the testimony in fact went to the interpretation of the contract and was not properly admissible, the admission into evidence of such was not inconsistent with substantial justice and fails to rise to the level of reversible error." *Id.* **28-29.

2. Parol Evidence and Contract Ambiguity

The party seeking to introduce evidence of subjective intent is likely to face an objection based on the parol evidence rule, backed up by the integration clause in the parties' franchise agreement which recites that the agreement is complete. However, "a document is not integrated merely because it says so." *Marcoux v. Shell Oil Prods. Co. LLC*, 524 F.3d 33, 43 (1st Cir. 2008) ("[U]nder Massachusetts law, the determination of whether a contract is completely or partially integrated, or whether a second contract is collateral to an integrated agreement, is a question of fact to be decided in the first instance by the trial judge.") (citations omitted). There may be room for extrinsic evidence, depending on the case and issues.

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[79] *See* Carmen D. Caruso & J. Michael Dady, "*What Lies Beneath: The Franchisee Perspective On Franchise Claims Beyond The Written Agreement*" (ABA Forum on Franchising (2003) (hereinafter "Dady/Caruso"), in which the authors sought to delineate all of the ways in which franchisees might succeed, substantively, to present claims that go beyond their written agreements.

[80] 774 F.2d 1163, 1985 U.S. App. LEXIS 23559 (6th Cir. 1985).

Ambiguity is one recognized exception to the parol evidence rule.[81] Often, a lawyer will ask one of the parties to a franchise agreement: "*What did this term mean*" – *e.g.*, a clause that provides that the franchisee has the exclusive right to "open an office" in a defined territory. Almost inevitably, such a question will draw a relevance objection on the grounds that courts may construe written agreements as a matter of law, such that the subjective understanding of the drafter or of a signatory is not relevant to the contract's legal meaning. When this objection is made, the party seeking to introduce subjective understandings usually must resort to arguing that the agreement is ambiguous, *i.e.,* that it is reasonably susceptible to more than one interpretation.

In most jurisdictions, the determination of whether a written agreement is *intrinsically* ambiguous (*i.e,* that the ambiguity exists within the agreement's four corners, taking into account the rule of construction that contracts must be construed as a "whole") is a question of law for the court to decide. However, many (if not most) jurisdictions have abandoned a strict "four corners" test for ambiguity, and allow the consideration of *extrinsic* evidence on this issue.[82] As the Iowa Supreme Court has held, in words that will delight attorneys for franchisees who are trying to get beyond the written contract terms:

> Generally, contracts are interpreted based on the language within the four corners of the document. However, when the language is ambiguous, the [trial] court must engage in a process of interpretation to search for the meanings attached by each party at the time the contract was made. To reveal this intent, extrinsic evidence is admissible when it sheds light on *the situation of the parties*, *antecedent negotiations*, the *attendant circumstances*, and *the objects they were striving to attain*.[83]

At trial, a court may find it necessary to hold argument on this question out of the presence of the jury (if the issue was not decided *in limine*).[84] In arguing that an agreement is or is not ambiguous, the trial lawyers are essentially proffering what their witnesses would testify that the disputed terms mean (if the witnesses would be allowed to testify on that issue). The court, as gatekeeper, must then decide whether the disagreement between both sides is a reasonable one, and if so, the determination of what an ambiguous term actually means becomes a question of fact.

Once the door is open to the introduction of subjective intent, the door is usually open wide. Each side then should be entitled to introduce not only testimony of claimed subjective intent, but also evidence of conduct that is arguably consistent with the claimed intent. Evidence relating to other franchisees might become relevant under Rule 404(b), *supra*, in order to prove that the claimed intent was consistent across the system.

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[81] *Interim Health Care of Northern Illinois, Inc. v. Interim Health Care, Inc.*,1999 WL 571005 (N.D. Ill. 1999), *aff'd in part, rev'd in part on other grounds*, 225 F.3d 876 (7th Cir. 2000).

[82] *See, e.g., Baxter Healthcare Corp. v. O.R. Concepts, Inc.*, 69 F.3d 785, 789 (7th Cir. 1995); *see also Alliance to End Repression v. City of Chicago*, 742 F.2d 1007 (7th Cir. 1984) (while contract language is ordinarily the best evidence of parties' intent, court may disregard even [intrinsically] unambiguous language when it is convinced that the parties mean something different).

[83] *Clinton Physical Therapy Servs., P.C. v. John Deere Health Care, Inc.*, 714 N.W.2d 603 (Iowa 2006).

[84] *Dady/Caruso*, p. 8 (providing examples of ambiguous franchise agreement terms).

However, not every piece of evidence is going to be relevant. As the Iowa Supreme Court explained in *Clinton Physical Therapy*, *supra*, the inquiry is what were the parties thinking at the time they signed the written contract? Where a party seeks to introduce evidence of post-signing conduct, the bar is often raised. In *Clinton Therapy*, a party sought to introduce evidence of changes made by the franchisor in its standard franchise agreement in an effort to prove the meaning of the same clause in an earlier version of the agreement.

> One issue the jury had to decide in resolving the contract claim in this case was whether paragraph 3(c) of the 1996 contract applied to services provided at a new location. CPT sought to introduce the 2001 contract because it contended paragraph 12 of that contract, which specifically addressed the situation of opening a new office, showed that John Deere did not intend paragraph 3(c) of the old contract to cover the situation of addition of a new office. Rather, CPT claimed paragraph 3(c) only applied to the situation of addition of particular services at existing locations.[85]

The trial court rejected this evidence and the appellate court affirmed. It simply was impossible to tell whether the change in contract language coming five years after the specific agreement was signed was a *change* or a *clarification*. What was missing from the franchisee's case in this instance? Arguably, if the franchisee had been able to present course of performance evidence (discussed below) or other corroborating evidence, it is possible that the post-signing change in language might have been admissible.

3. Verbal Agreements

Enforceable verbal franchise agreements are generally considered non-existent because of the Federal Trade Commission Franchise Rule's written disclosure and other requirements.[86] However, once a franchise agreement is signed, it is possible for a franchisor

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[85] 714 N.W.2d at 615.

[86] However, as an exception that proves the rule, consider *Suburban Leisure Ctr., Inc. v. Amf Bowling Prods.*, 468 F.3d 523 (8th Cir. 2008), wherein "the parties entered into an oral franchise agreement, whereby they agreed that Suburban would have the right use the AMF trade name, trademark, or service mark in order to sell AMF's line of pool tables and related accessories from Suburban's stores located in the St. Louis, Missouri region. Subsequently, the parties executed a written E-Commerce Dealer Agreement ("e-commerce agreement"), in which Suburban agreed to provide delivery and installation of AMF's products sold by AMF via its website to customers in Suburban's specified areas." *Id*. at 525. The written E-Commerce Dealer Agreement contained an arbitration clause, and also contained a standard merger clause. Thereafter, when a dispute arose:

> AMF sent a termination letter stating that Suburban would be "required to cease promoting" AMF's line of pool tables and accessories within sixty days. The letter made no mention of the e-commerce agreement. Suburban filed suit in Missouri state court alleging that it was entitled to damages from the cancellation of the oral franchise agreement without the requisite notice pursuant to Missouri Revised Statute section 407.405 as well as recoupment for improvements it had made to its stores in reliance on the oral franchise agreement. *See* Mo. Ann. Stat. § 407.405 (West 2001). *Id*.

The E-commerce agreement did not address the franchisee's ability to promote or sell the franchisor's products, which was the subject of the oral agreement; thus, the facts did not implicate the parol evidence rule because the oral agreement did not seek to contradict or supplement the subsequent agreement. The Eight Circuit held that the e-commerce agreement, which did not cover the contractual relationship addressed by the oral agreement, did not extinguish the oral agreement because it constituted an independent agreement under Virginia's collateral contract doctrine; thus, arbitration language in the e-commerce agreement was not attributed to the oral agreement.

and franchisee to enter into other oral agreements, for example, as to the expansion of territory, the approval of a supplier, the waiver of a claimed default, or as to transfer or renewal.

No doubt, any such verbal agreements probably could be characterized as reflecting poor business practices, but they do exist, particularly as busy clients make deals without observing the legal formalities. Proving the existence of a verbal agreement usually requires testimony of the conversations in which the agreement is reached. Often, the evidence may include confirming letters or emails, which may provide proof that an agreement was reached, without purporting actually to *be* the agreement or to set forth all of the terms. The parties, of course, also will be looking for other evidence of conduct that is consistent with their views of whether or not an agreement exists and, if so, what its terms are.

a. The Statute of Frauds

When verbal agreements are alleged in franchising, the statute of frauds must be considered. In *Western Chance No. 2 v. KFC Corp.*,[87] a franchisee alleged that it entered into an oral agreement with KFC to build and operate several "six KFC outlets within a specified time and to continue to open outlets as the population of Tucson grew"; that "this oral agreement accorded with the 'area-wide' franchises KFC was offering at the time"; and that it was promised exclusivity in the territory for 20 years by KFC. KFC, for its part, denied that the existence of the alleged oral agreement – and argued further that even there had been an oral agreement, it was unenforceable due to the statute of frauds. Applying Arizona state law, the district court granted summary judgment to the franchisor on statute of frauds grounds, and the Ninth Circuit reversed, in part, because there was a question of fact as to whether the agreement to open six stores was capable of being performed within one year.[88] The Ninth Circuit adhered to the general rule that the "mere possibility" of performance within one year is sufficient to take a case out of the statute, with the "one year" requirement to be construed narrowly, and rejecting a minority view that would require a more stringent "reasonable possibility" test.[89]

In terms of evidentiary considerations, the issue of what may be "possible" for a franchisee or area developer to achieve in a year's time (so as to take an agreement outside the statute of frauds):

- Calls for inherent speculation, thus creating an exception to the usual rule that speculation is not admissible.

- Surely invites evidence as to experience by other developers in the same system; and arguably in other systems as well.

- Likewise invites an examination of whether the franchisor has, on other occasions, sought to impede the efforts of a developer, in order to block the developer from

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[87] 957 F.2d 1538 (9th Cir. Ariz. 1992).

[88] Under Arizona law, which governed the KFC case, "contracts which are not to be performed within one year from the making of the contract must be in writing. *Ariz. Rev. Stat. § 44-101*. The one-year provision of the statute of frauds is narrowly construed. The mere possibility that performance can be completed within one year - even if not contemplated by the parties - is usually sufficient to remove the agreement from the statute of frauds. The fact that performance is completed in more than a year is immaterial." *Id.* at 1541.

[89] *Id.* at 1541.

achieving a stated performance goal. (In this way, the question of what may be possible becomes a way for the franchisee to try and give the franchisor a black eye).

- Invites, by the same token, the franchisor to introduce evidence of the franchisee's past business failures or other shortcomings.

- Invites expert testimony.

In *Western Chance*, *supra*, a trial was necessary to determine whether the alleged agreement for the franchisee to try to build six stores was outside the statute of frauds, and, separately, there were other questions of fact requiring trial as to an important additional term that the franchisee wanted to prove – that it had an agreement for an "exclusive" territory to last 20 years. This alleged contract term had to be analyzed separately, as it raised discrete fact questions as to whether it could possibly be performed within one year. In other words, the Ninth Circuit viewed the key terms of the alleged overall agreement as being severable, with the possibility that some parts of the overall verbal agreement would be subject to the Statute of Frauds, while other key terms might not be.

On the exclusivity question, the franchisee alternatively attempted to satisfy the Statute by offering two letters written by a KFC franchising director as alleged evidence of the parties' oral agreement.[90] However, the district court held, and the Ninth Circuit affirmed, that the letters offered by the franchisee were insufficient because they did not address the "central term" of whether the franchisee was given an exclusive territory. The letters therefore were inadmissible as a matter of law on that issue.[91]

b. No Modification Clauses

Also relevant to the question of whether a franchisor and franchisee entered into an enforceable verbal agreement, after the franchise was already established, is whether the alleged oral agreement would constitute a modification of the written franchise agreement. Written franchise agreements typically provide in a so-called "no modification clause," that the written agreement cannot be modified except by a writing signed by both sides. Those clauses, however, can be waived, and waiver may be found where there is persuasive evidence that the parties intended to modify their agreement, and hence, intended to waive the "no modification" clause.[92] As a general proposition, however, the evidence that an opposing party agreed to an oral modification despite the existence of a "no oral modification clause" ought to be pretty clear and unequivocal. Without obtaining an admission, this is a difficult proof.

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[90] The court explained that in order to "satisfy the statute of frauds, a memorandum must state with reasonable certainty the identity of the parties, the subject matter of the agreement, and the essential terms. John D. Calamari & Joseph M. Perillo, *Contracts* § 19-29 (3d Ed. 1987). It also must be signed by the party to be charged. *Id.*, at § 19-31. The parties need not intend the writing to be the full and final expression of their agreement; an informal letter setting forth the required information can suffice." 957 F.2d at 1541.

[91] The court also rejected, without discussion, alleged evidence of "part performance" on the exclusivity term. *Id.* at 1452.

[92] *See* U.C.C. § 2-209 (providing that an agreement may be modified orally and that no separate consideration is required provided that it is made in good faith); *Kelly-Stehney & Assocs., Inc. v. MacDonald's Indus. Prods., Inc.*, 658 N.W. 2d 494 (Mich. Ct. App. 2003); *Allapattah Svs., Inc. v. Exxon Corp.*, 188 F.R.D. 667 (S.D. Fla. 1999); *Atlantic Sport Boat Sales, Inc. v. Cigarette Racing Team*, 695 F. Supp. 58, Bus. Franchise Guide (CCH) ¶ 9,202 (D. Mass. 1988); but see *LaGuardia Assoc. v. Holiday Hospitality Franchising, Inc.*, 92 F. Supp. 2d 119 (E.D.N.Y 2000).

4. Course of Dealing and Course of Performance

Franchise agreement terms may be affected by evidence of course of dealing as well as course of performance. These terms are frequently confused. Course of dealing refers to a party's dealings over a number of transactions over a period of time, and such evidence may supply evidence as to the meaning of ambiguous terms or ambiguous conduct. A franchisor's course of dealing may include its transactions with other franchisees that have the same or similar franchise agreements. Introducing evidence of how a franchisor has dealt with other franchisees invites hearsay problems.[93]

Course of performance, on the other hand, refers to the manner in which the parties had previously performed their duties under an existing contract, and such evidence can also supply evidence as to what the parties meant when they used a particular contract term, and also may supply evidence that the parties intended to modify their contract.[94]

5. Industry Standards, Custom and Practice

Going beyond the parties' own conduct, the meaning of contract terms also may be proven by evidence of industry standards, customs, and practices. It is helpful, of course, to show that the party being charged with having tacitly accepted an industry-wide meaning had knowledge of the industry standard.

6. Good Faith and Fair Dealing

There are other sources of implied legal duties, but in franchising, the implied covenant of good faith and fair dealing remains paramount. For purposes of our evidentiary considerations, the definition of this covenant in the *Restatement (Second) of Contracts* will suffice. Section 205 of the Restatement provides that "[e]very contract imposes upon each

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[93] *See, e.g.*, *Lockhart v. Home-Grown Indus. of Ga., Inc.*, 2007 U.S. Dist. LEXIS 67256 (W.D. N.C. 2007). Although this is not a course of dealing case, the opinion discusses the obvious hearsay problem when one side or the other seeks to introduce evidence as to "other franchisees I have spoken to." The court allowed that hearsay in the context of a motion for preliminary injunction (to enforce a non-compete) while noting it would otherwise be inadmissible.

[94] *See, e.g., Ralph's Dist. Co. v. AMF, Inc.*, 667 F.2d 670 (8th Cir. 1981) (holding that the course of dealing between the parties created a genuine issue of material fact as to whether the parties intended an exclusivity term in their agreement, even though no express exclusivity term existed); *Dunafon v. Taco Bell Corp.*, Bus. Franchise Guide (CCH) ¶ 10,919 (D.C. Mo. 1996) (finding that an oral agreement could have existed given the course of dealings of the parties over a 20-year period); *B.P.G. Autoland Jeep-Eagle, Inc. v. Chrysler Credit Corp.*, 785 F. Supp. 222, Bus. Franchise Guide (CCH) ¶ 9,920 (D. Mass. 1991) (finding that abrupt change in a course of dealing of consistent leniency with respect to financing constitutes a breach of the covenant of good faith and fair dealing); *Globe Distribs., Inc. v. Adolph Coors Co.*, 129 B.R. 304, Bus. Franchise Guide (CCH) ¶ 9,821 (Bankr. D.N.H. 1991) (awarding over $10 million to a wrongfully terminated distributor where, among other things, Coors accepted late payments and then terminated the distributor for failure to pay; the court concluded that Coors used this reason as a pretext when truly Coors desired to force the distributor to sell to Coors and to prevent sale to another distributor); *Jack Rowe Assoc., Inc. v. Fischer Corp.*, 833 F.2d 177 (9th Cir. 1987) (reversing summary judgment and holding that a written contract providing for termination on notice does not preclude evidence of oral assurances that termination would only be for poor performance uncorrected after notice); *Nanakuli Paving and Rock Co. v. Shell Oil Co., Inc.*, 664 F.2d 772 (9th Cir. 1981); *Carter Baron Drilling v. Badger Oil Corp.*, 581 F. Supp. 592 (D. Colo. 1984) (holding that a complete negation of the term "operator shall pay contractor" is the term "operator shall not pay contractor"); *Handlebar Cycle, Inc. v. Polaris Indus., Inc.*, No. 56 181 6014098 (A.A.A. 1999) (holding that the course of dealing between the parties operated to modify their contract to require a notice of deficiency and an opportunity to cure prior to nonrenewal).

party a duty of good faith and fair dealing in its performance and its enforcement." The *Restatement* further recognizes:

> The phrase "good faith" is used in a variety of contexts, and its meaning varies somewhat with the context. Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving "bad faith" because they violate community standards of decency, fairness or reasonableness. The appropriate remedy for a breach of the duty of good faith also varies with the circumstances.[95]

The *Restatement* articulates several examples of bad faith that would constitute a breach, including "evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance."[96]

For those who like open-ended inquiries with wide-ranging evidence, the implied covenant is the gift that keeps on giving. Consider the many different things that the implied covenant arguably might require, exclude or prohibit in any given case and, from there, consider all of the types of evidence (fact and opinion) that might be relevant to proving each one:

- Requiring "*faithfulness*" to an "*agreed*" "*common purpose*" and "*consistency*" with the "*justified*" "*expectations*" of the other party."

- Excluding a variety of types of conduct characterized as involving "*bad faith*" because they violate "*community standards*" of "*decency*," "*fairness*" or "*reasonableness*."

- Prohibiting conduct including "*evasion*" of the "*spirit*" of the "*bargain*," "*lack*" of "*diligence*" and "*slacking off*," "*willful*" rendering of "*imperfect performance*," "*abuse*" of a "*power*" to "*specify" "terms*," and "*interference*" with or "*failure*" to "*cooperate*" in the "*other party's performance*."

In the author's view, cases involving the implied covenant may turn on any one of the above definitional terms*, i.e.* the introduction of evidence related to any one of those terms may prove decisive in any given case. The range of evidence that could be introduced to prove or disprove any one of them is endless – although the range of evidence that might be admissible will also depend on whether the duty of good faith is measured objectively, or subjectively, in the particular jurisdiction.[97]

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[95] Restatement (Second) of Contracts § 205 & cmt. (a).

[96] *Id.*, cmt. (d).

[97] Statutes in existence at the time a contract is signed are another source of implied legal duties under a contract. *See, e.g., Selke v. New England Ins. Co.*, 995 F.2d 688, 689 (7th Cir. 1993). As franchising cuts across so many different industries, this often-overlooked legal principle may be worth examining in any particular dispute.

B. Performance or Breach

The question of whether a party breached its franchise agreement of course depends on the extent of its duty. That is, the higher the bar is raised, the more likely that someone is going to fall short. Consider these examples:

- A pizza franchisor is charged with failing to keep pace with the competition when it attempts to introduce a pan pizza, but the franchisees complain that it is too difficult to make.

- A quick service food franchisor is charged with bad faith when it purports to require its franchisees to modernize or remodel their way to an entirely new, more upscale restaurant concept, in which the franchisees will ultimately have higher operating costs, and arguably in which they will not be likely to obtain a sufficient return on investment to justify the investment costs.

- A franchisor that agreed not to open a competing outlet in a franchisee's territory instead offers its goods through other retailers within the territory or sells them over the Internet.

- A franchisor discloses that it will require its franchisees to purchase products from the franchisor or its affiliate and discloses that it will earn revenue on these purchases, but nonetheless the franchisees complain that the prices are too high or commercially unreasonable.

- A territory developer agrees to open a specified number of units over a specified period of time, but only reaches 90% of the stated goal.

- A franchisor promises to supply a designated number of new business leads to its franchisee over a specified period of time, but only reaches 90% of the stated goal.

- A franchisee commits three defaults in a twelve month period, but each alleged default in itself would have been minor.

- A franchisee who agrees to operate its franchise in "compliance with all applicable laws" is found to have improperly hired an undocumented alien; or is found to have taken improper deductions on its income tax return.

In each of these examples, the question of whether the party breached its contract is much more complicated than whether "the light was green." To prove or disprove breach, you will have to introduce proof of what the agreement required in terms of duty, whether that duty was substantially performed, and whether any shortfall in performance was material. As explained by the Tenth Circuit in *Colorado Baseball*, *supra*:[98]

- The performance element means "substantial" performance, which occurs when, although the conditions of the contract have been deviated from in trifling particulars not materially detracting from the benefit the other party would derive from a literal performance, the defendant has received substantially the benefit he expected, and is, therefore, bound to pay.

[98] 1996 U.S. App. LEXIS 32995

Whether there has been substantial performance is a question of fact for the jury except where the facts are undisputed and only one inference can be drawn reasonably.

- The proper inquiry to determine substantial performance is how much of the benefit the injured party expected from the exchange has been received

Not surprisingly, there is a very wide variety of case-specific evidence that may be introduced on the question of whether performance was adequate.

C. Damages

Putting aside specific contract terms that may limit certain types of damages, franchise contract cases present interesting evidentiary issues when a party claims liquidated damages, lost profits, or other consequential damages. While a full discussion of damages evidence is beyond the scope of this paper, the following are a few points to remember.

With respect to liquidated damages, there is usually an issue of whether the liquidated amount would be a penalty. To overcome this argument, the franchisor should be prepared to present evidence of actual damages in the instant case, and arguably in other similar cases, such that the liquidated damage clause hopefully will be seen as a reasonable approximation. For the franchisee, the goal is the opposite. The franchisee must persuade the court in the first instance, if possible, that the discrepancy between the liquidated damages and the actual damages is just too striking to be ignored.

With respect to all types of consequential damages, the rule of *Hadley v. Baxendale* was that contract damages must have been foreseeable at the time the contract was signed.[99] You must develop evidence to satisfy this rule. And, with respect to lost profit claims, you must have evidence that ties the loss to the breach. Lost profits claims therefore usually require expert testimony as to the scope of the market opportunity that was lost as the "but for" result of the claimed breach.

VI. CONCLUSION

As we hope this chapter has taught, to effectively persuade, a solid working knowledge of the rules of evidence and mastery of the substantive fraud and contract law are necessary, but are not enough. To paraphrase Justice Cardozo's discussion of the nuances of the federal tax code:

> "One struggles in vain for any verbal formula that will supply a ready touchstone. The standard[s] set up … are not a rule of law; it is rather a way of life. *Life in all its fullness must supply the answer to the riddle."*[100]

This famous maxim holds up well for trial lawyers making strategic evidentiary decisions. In *Dayan v. McDonald's Corp.*, after 60 days of trial and a multitude of conflicting testimony, the simple laws of nature determined the fate of seventeen franchised restaurants on the tree-lined boulevards of Paris. In every case, lawyers must know the evidentiary rules, know the

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[99] 9 Exch. 341, 156 Eng. Rep. 145 (1854).

[100] *Welsh v. Helvering,* 290 U.S. 111, 115 (1933).

substantive rules, know the facts and, ultimately, strive to align their clients' cause with our common understandings of "life in all its fullness."