

# When Good Faith Is Not Enough: Franchise Litigation and the Business Judgment Rule

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**T**he business judgment rule is a foundational legal principle in corporate law, designed to protect company directors and officers from liability in shareholder derivative suits stemming from adverse business decisions. This rule presumes that directors act not out of self-interest but “on an informed basis, in good faith, and in the honest belief that their actions are in the corporation’s best interest.” *Brehm v. Eisner*, 746 A.2d 244, 264 n.66 (Del. 2000) (citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

The business judgment rule dates back centuries, with its roots in English law. In 1742,

an English court in *Charitable Corp. v. Sutton*, 2 Atk. 400, 26 Eng. Rep. 642 (1742) reasoned that it would be unfair to judge directors with hindsight, emphasizing that directors should not be held liable for unforeseen adverse outcomes. American courts later embraced this principle in *Percy v. Millaudon*, 8 Mart. (n.s.) 68 (1829), where the Louisiana Supreme Court ruled that directors should not be liable for mistakes in judgment “if the error was one into which a prudent man might have fallen.” *Percy*, 8 Mart. (n.s.) at 77.

Over time, the business judgment rule has evolved through judicial refinement. From

common law, to being codified in twenty-nine states, directors have the freedom to take informed, good faith risks without the fear of personal liability. This evolution highlights the rule's crucial role in fostering prudent yet bold decision-making in corporate governance, reflecting America's core values of innovation, industry, and commerce.

However, the rule is not easily applied in the franchise context. While a franchisor's officers and directors owe a fiduciary duty to the franchisor, they have no such obligation to franchisees. See *Hickory Hills Foodmart, Inc. v. Equilon Enters., LLC*, 22-cv5393, 2023 WL 4273664, at \*6 (N.D. Ill. June 29, 2023) (citing *Sears Home Appliances Showrooms, LLC v. Appliance All., LLC*, 15-cv-4414, 2017 WL 839483, at \*8-9 (N.D. Ill. Mar. 3, 2017)) (noting "[T]he general rule that a franchisor does not owe a franchisee a fiduciary duty" because "control by the franchisor is an expected aspect of the commercial relationship"). As a result, the franchisor's directors and officers may be exposed to non-derivative suits from franchisees, most notably breaches of good faith and fair dealing for the misuse of the franchisor's discretionary authority under the franchise agreement.

To limit this potential liability, some franchisors adopt the reasonable business judgment standard in their franchise agreements. Despite this, some states have enacted "Little FTC Acts," modeled after the Federal Trade Commission Act, which prohibit "unfair methods of competition and unfair or deceptive acts or practices." See, e.g., 815 ILL. COMP. STAT. ANN. § 505/2. These statutes often require "good cause," as defined by the statute, when a franchisor terminates a franchisee. Little FTC Acts are intentionally broad to invite judicial scrutiny, with courts guided by Federal Trade Commission interpretations, when evaluating breaches of good faith and fair dealing, franchisee terminations, and potential fraud, misrepresentations, or omissions. See, e.g., ARIZ. REV. STAT. ANN. § 44-1522(C); CONN. GEN. STAT. ANN. § 42-110b(b); IDAHO CODE ANN. § 48-604(1).

## The Business Judgment Rule in Corporate Law

As a matter of law, the business judgment rule distinguishes between the merits of a director's business decisions and the basis for those decisions. *Fed. Deposit Ins. Corp. v. Loudermilk*, 761 S.E.2d

332, 335 (Ga. 2014). Simply put, a court will not substitute its own business judgment for that of the defendant director; instead, it will determine whether the decision falls outside the presumption of the rule, i.e., whether it was made in the director's self-interest, in bad faith, without adequate information, or was not in the best interests of the company. Accordingly, the court presumes the officers "to have acted in good faith and exercised ordinary care." *Id.* The court in *Loudermilk* explains this rationale succinctly as "the reality that the making of profits involves the taking of some risks, and the recognition that business people generally are more competent than judges to exercise business judgment." *Loudermilk*, 761 S.E.2d at 335 (citing *Janssen v. Best & Flanagan*, 662 N.W.2d 876, 882 (Minn. 2003)).

In practice, the business judgment rule functions as a burden-shifting affirmative defense, meaning the party challenging a decision must demonstrate why it does not apply rather than the defendants having to argue why it should.

If a plaintiff fails to rebut any of the rule's presumptions, "the court merely looks to see whether the business decision made was rational in the sense of being one logical approach to advancing the corporation's objectives." *Firefighters' Pension Sys. of Kansas City v. Found. Bldg. Materials, Inc.*, 318 A.3d 1105, 1139 (Del. Ch. 2024). Only when a decision lacks any rationally conceivable basis will a court infer bad faith and a breach of duty. *Id.* A decision is irrational when made in bad faith or wasteful (where no ordinary, businessperson of sound judgment could conclude that the corporation has received adequate consideration). In *re McDonald's Corp. Stockholder Derivative Litig.*, 291 A.3d 652, 693 (2023). In this limited context, courts may review the merit of an apparently well-motivated business decision. In *re J.P. Stevens & Co. Sholders Litig.*, 542 A.2d 770, 780-81 (Del. Ch. 1988).

## Franchise Law and the Business Judgment Rule

The business judgment rule is generally inapplicable to the franchisor-franchisee relationship. Corporate directors and officers owe a fiduciary duty to the corporation, and when shareholders allege the directors and officers breached this duty, they do so on behalf of the corporation. In contrast, the franchisor-franchisee relationship is rooted in contracts, such that the only duties a franchisor generally owes are the ones in its franchise agreement and as implied by

law. *Brock v. Baskin Robbins, USA, Co.*, No. 99-cv-274, 2003 WL 21309428, at \*7 (E.D. Tex. Jan. 17, 2003); see also, e.g., *Original Great Am. Chocolate Chip Cookie Co., Inc. v. River Valley Cookies, Ltd.*, 970 F.2d 273, 280 (7th Cir. 1992) (“[P]arties to a contract are not each other’s fiduciaries”); but see *In re Monahan Ford Corp. of Flushing*, 340 B.R. 1, 41 (Bankr. E.D.N.Y. 2006) (“However, a fiduciary relationship may arise in a franchisor/franchisee relationship if a confidential relationship was created or if the franchisee was obligated to accept the requirements allegedly imposed by the franchisor because of the franchisor’s position of dominance”) (citing *Lake Erie Distribs, Inc. v. Martlet Importing Co., Inc.*, 634 N.Y.S.2d 599, 601 (N.Y. App. Div. 4th Dept. 1995) (stating a distributorship agreement may create a confidential relationship out of which a duty of fiduciary care arises)).

Accordingly, disputes between the franchisee and franchisor are not derivative, i.e., the franchisee is not bringing the suit on behalf of the franchise. Rather, the franchisee is often suing the franchisor (and potentially some officers) for breaches of the franchise agreement and potential fraud, misrepresentation, violations of statutory law, and, for protected franchisees, potentially disparate treatment and retaliation claims under Section 1981 of the Civil Rights Act of 1870. Some states, such as California and Minnesota, have enacted legislation imposing statutory liability on a franchisor’s officers and directors for violations of state franchise law. See CAL. CORP. CODE § 31302; MICH. COMP. LAWS ANN. §§445.1531–32. Thus, when the franchisee names an officer of the franchisor as a defendant, that officer cannot invoke the business judgment rule.

There are, however, duties imposed by law, the most relevant being the duty of good faith and fair dealing, under which the party given broad discretion in the performance of the contract must exercise that discretion “reasonably and with proper motive, and may not do so arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties.” *Dayan v. McDonald’s Corp.*, 466 N.E.2d 958, 972 (Ill. Ct. App. 1984). Courts in many states, including Illinois, have ruled that this duty is implied in every contract unless expressly disavowed. *Id.* This distinction is significant because the duty of good faith and fair dealing does not require a showing of self-interest, negligence, or lack of adequate information—only that a party exercised its discretion arbitrarily, capriciously, or inconsistent

with the parties’ reasonable expectations. Accordingly, the good faith standard is lower than the business judgment rule.

Although a majority of states imply a duty of good faith and fair dealing in franchise agreements and other contracts, some states further prohibit any contractual waiver of this duty, viewing such waivers contrary to public policy. See, e.g., CAL. BUS. & PROF. CODE ANN. § 20010; 815 ILL. COMP. STAT. ANN. 705/41; WASH. REV. CODE ANN. § 19.100.180. In these jurisdictions, franchisors cannot escape liability for arbitrary or bad-faith conduct, even if their agreements attempt to limit their obligations.

For states that impose this duty but allow parties to contractually waive it, some franchisors choose to adopt reasonable business judgment language as the governing standard for their decision-making authority. Franchisors often include these standards in their franchise agreements to expressly prohibit arbitrators or judges from substituting their own judgment for that of the franchisor. For example:

The parties recognize, and any mediator, arbitrator or judge is affirmatively advised, that certain provisions of this Agreement describe the right of the Franchisor to take (or refrain from taking) certain actions in its discretion and other actions in the exercise of its reasonable business judgment. Where this Agreement expressly requires that the Franchisor make a decision based upon its reasonable business judgment, the Franchisor is required to evaluate the overall best interests of all Branches and the Franchisor’s own business interests. If the Franchisor makes a decision based upon its reasonable business judgment, a mediator, arbitrator, or judge will not substitute his or her judgment for the judgment exercised by the Franchisor. The fact that a mediator, arbitrator or judge might reach a different decision than the one made by the Franchisor is not a basis for finding that the Franchisor made its decision without the exercise of reasonable business judgment. The Franchisor’s duty to exercise reasonable business judgment in making certain decisions does not restrict or limit the Franchisor’s right under this Agreement to make other decisions based entirely on the Franchisor’s discretion as permitted by this Agreement. The Franchisor’s discretion means that it may consider any set of facts or circumstances that it deems relevant in rendering a decision.

By imposing the business judgment standard, the franchisor effectively shifts the burden to

the franchisee, requiring the franchisee to show that a decision was unfair and made with self-interest, irrationality, negligence, or bad faith. This creates a higher bar for franchisees seeking to challenge decisions regarding territory allocations and restructurings, encroachment, pricing structures, supplier restrictions, or franchise terminations.

### **The Business Judgment Rule and Good Cause for Termination**

Can a franchisor permissibly terminate a franchisee based on a franchisor director's or officer's alleged reasonable business judgment? Regardless of the applicable standard, attorneys representing franchisees should first determine if the franchisor made its decision in good faith. Even if the franchisee has waived the good faith requirement in favor of a reasonable business judgment standard, the key issue is whether the reasonable business judgment must rest on grounds independent of the franchisee's actions.

For example, under the Connecticut Franchise Act (the "CFA"), as in many states with franchise relationship laws, franchisors may only terminate a franchisee for "good cause." The CFA's non-exclusive language elaborates on what can be considered "good cause," stating that it includes, but is not limited to, the franchisee's refusal to substantially comply with the material obligations of the franchise agreement. CONN. GEN. STAT. ANN. § 42-133f (emphasis added). Connecticut courts have interpreted this language to allow for reasons beyond a franchisee's breach of the franchise agreement, including a franchisor's "legitimate business decision." See *Petereit v. S.B. Thomas, Inc.*, 63 F.3d 1169, 1172 (2d Cir. 1995).

While most cases where Connecticut courts found "good cause" were based on direct breaches of explicit terms of the franchise agreement, *Petereit* stands as an exception. In that case, the Second Circuit upheld the termination under the CFA after the franchisor decided to improve service frequency, which

involved rationalizing distributors' routes, thereby leading to the plaintiff's termination despite no breach of the franchise agreement. *Id.* at 1185. Similarly, in *Edmands v. CUNO*, No. CV010447171S, 2001 WL 835041 (Conn. Super. Ct. June 22, 2001) the court found good cause for a termination when the franchisor restructured its business to market products directly to consumers, eliminating the need for franchisees. *Edmands*, 2001 WL 835041, at \*7. In both instances, the terminations were an unintended consequence of significant changes to the franchisor's business model or operations.

An officer's animus toward a franchisee is insufficient "good cause" for termination, whether in good faith or as a "legitimate business decision." In *Hartford Elec. Supply Co. v. Allen-Bradley Co., Inc.*, 736 A.2d 824 (Conn. 1999), the court ruled that poor management, weak market share and sales, lack of commitment to product promotion, and a deteriorating, combative relationship with the plaintiff did not constitute good cause for termination under the CFA. See *Hartford Elec.*, 736 A.2d at 839-40.

There is a notable similarity between the business judgment rule and a "legitimate business decision" as permissible defenses in litigation. At a minimum, both require the officer or director to act rationally and in good faith.

### **Takeaway For the Business Judgment Rule in Franchising**

In the ever-evolving landscape of franchise law, attorneys on both sides seek stronger protection for their clients. Adopting a business judgment standard is appealing for franchisor counsel, as it increases the burden on franchisees by presuming good faith in decision-making. However, this presumption is not absolute and can invite greater judicial scrutiny. There is no one-size-fits-all solution, and regardless of whether a franchisor adopts this standard, the best method of reducing the risk of liability is to act in good faith. ■