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THE DOCTRINE OF IMPLIED HONESTY IN CONTRACT: IS NEITHER A SLIPPERY SLOPE NOR A "NEW VISTA" OF CONTRACT NULLIFICATION THAT SHOULD CONCERN BUSINESSES OR FRANCHISORS

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In the fourteen years since the New York Law Journal published *Franchising:* LJL Transportation*, Contract Nullification by Franchisor*,[1] the sky has not fallen nor has the concept of honesty in contract slipped down any slope that threatens contract law generally or franchise systems, specifically. Time has proven the critic, the criticism, and any consternation for the franchise termination opinion in *LJL Transportation, Inc. v. Pilot Air Freight Corp.*[2] and the implied honesty in contract doctrine to be wrong.

One franchise contracts treatise embraces and cites the *LJL* case for the proposition that "[h]iding revenue from the franchisor in order to avoid paying royalties, which conduct is in breach of the franchise agreement, does not entitle a franchisee to an absolute right to cure its breach prior to termination of the agreement."[3] In other words, franchisors are permitted to immediately terminate—and are not otherwise required to adhere to cure periods in franchise agreements—when the franchisee commits acts of dishonesty that go to the heart of the business relationship, like paying royalties. Conceptually, there is no reason that this implied honesty in contract concept cannot be applied to permit immediate termination of non-franchise contracts containing cure periods where the breaches arise from severe acts of dishonesty by the breaching party.

In *LJL*, an intermediate Pennsylvania appellate court held that "there are circumstances where the nature of the breach permits the aggrieved party to immediately terminate the contract despite a 'cure' provision" and affirmed a franchisor's immediate termination of a franchise agreement for breach of an implied honesty obligation, even though the franchisor failed to abide by the franchise agreement's cure provision. Thus, *LJL* and the decisions it cited[4]

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[1] Rupert M. Barkoff, *Franchising:* LJL Transportation*, Contract Nullification by Franchisor*, 236 N.Y. L.J. 3 (Nov. 27, 2006), https://www.law.com/newyorklawjournal/almID/900005468018/franchising/.

[2] 905 A.2d 991 (Pa. Super. Ct. 2006), *order aff'd*, 962 A.2d 639 (Pa. 2009).

[3] 62 Am. Jur. Bus., 2d Private Franchise Contracts § 214.

[4] *E.g.*, Southland Corp. v. Froelich, 41 F. Supp. 2d 227 (E.D.N.Y. 1999).

imposed an implied *honesty* obligation in contract performance that superseded any "cure" right. Analyzing the *LJL* decision's impact, this author suggested that the implied honesty obligation would be beneficial to franchisors,[5] while a critic suggested that it represented a "new vista" of contract nullification that would be neither beneficial to contract law, generally, nor franchise systems, specifically.[6]

The criticism of the implied honesty doctrine was that it threatened contractual certainty. Both 1) time, and 2) the lack of slippery slope evidence, have exposed the fallacy of this criticism. In truth, dishonesty in contract performance poses a greater threat to franchising and contract law than does any potential for "inconsistency" in the application of the implied honesty obligations on contracting parties. The rarity with which severe dishonesty breaches justify immediate termination is evidenced by the fact that, after the first seven years following the *LJL* decision, the U.S. Court of Appeals for the Third Circuit recognized it as "the only case in which the Pennsylvania Supreme Court found a breach to be severe enough to justify immediate termination of a contract with a right-to-cure provision involv[ing] fraudulent conduct by one of the contracting parties."[7] Contrastingly, one decisional dissent concluded that the majority "seemingly" endorsed an expansion of the doctrine to encompass a company's "obstinate behavior" to frustrate the purpose of a shareholder agreement *even though the issue was not addressed in detail* in the majority's memorandum.[8]

The Pennsylvania Supreme Court affirmed the intermediate appellate *LJL* decision in 2009, holding without "difficulty" that "when there is a breach of contract going directly to the essence of the contract, which is so exceedingly grave as to irreparably damage the trust between the contracting parties, the non-breaching party may terminate the contract without notice, absent explicit contractual provisions to the contrary."[9] To reach this decision, the *LJL* court cited case law from multiple jurisdictions, including New York federal cases like *Southland Corp. v. Froelich*.[10] Subsequent courts have applied *LJL*'s

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[5] John J. Jacko, III, *Honesty Is Fundamentally the Best Policy*, LJN'S FRANCHISING BUS. & L. ALERT, Vol. 13, No. 2 (Nov. 2006).

[6] *See* Barkoff, *supra* note 2.

[7] Milton Reg'l Sewer Auth. v. Travelers Cas. & Sur. Co. of Am., 648 F. App'x 215, 217 (3d Cir. 2016) (alteration in original).

[8] TeleTracking Techs., Inc. v. Gori, No. 940 WDA 2014, 2015 WL 7093512, at *6 (Pa. Super. Ct. May 28, 2015) (Bender, P.J.E., dissenting).

[9] LJL Transp. Inc. v. Pilot Air Freight Corp., 962 A.2d 639, 652 (Pa. 2009).

[10] 41 F. Supp. 2d 227 (E.D.N.Y. 1999); *see also* Southland Corp. v. Mir, 748 F. Supp. 969 (E.D.N.Y. 1990); D.C. Films, Inc. v. Best Film & Video Corp., 46 B.R. 861 (Bankr. E.D.N.Y. 1985).

reasoning in contract contexts outside of franchising.[11] Time and the conceptual underpinnings of the implied honesty doctrine provide additional support to assuage any "new vista" concerns about that doctrine's effect on modern contract law or franchising.

At issue in *LJL* was the propriety of the franchisor's immediate termination of a franchise agreement in response to a franchisee's demonstrated and admitted dishonesty, where the franchisor did not provide notice and an opportunity to cure under a 90-day cure provision. There was no express right to immediate termination for dishonest conduct in the franchise agreement. The grounds for termination were that the franchisee (1) improperly shipped products through third parties affiliated with the franchisee, and (2) failed to disclose the shipments and make royalty payments on them. The trial court awarded summary judgment to the franchisor because the franchisee was hiding its transactions and cheating the franchisor.[12]

On appeal, the franchisee unsuccessfully argued that the termination was improper because 1) it deprived the franchisee of the *absolute right* to a ninety-day cure period, and 2) the absolute right to cure meant that the franchisee should have been given the opportunity to pay the royalties on the shipments that were improperly diverted. Rejecting these arguments, the intermediate appeal court, and later the Pennsylvania Supreme Court, adopted the reasoning of cases from New York[13] and other jurisdictions relating to incurable breaches arising from egregious conduct.[14]

The critic's concerns of the threat to contract law and franchising, which *LJL* represented, were always overstated. *LJL* is nothing more than an incremental extension of the U.S. Supreme Court's 138-year-old decision in *Lyon v. Pollard.*[15] The franchisor in *LJL* cited *Lyon*, as did a few of the cases on which the *LJL* courts relied.

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11 *E.g.*, Falls v. State Farm Ins. Mut. Auto. Ins. Co., 774 F. Supp. 2d 705 (M.D. Pa. 2011) (demonstrating that a former employee's dishonest conduct constituted a material breach of employment contract that relieved former employer of obligation to perform)*; see also* Stacey v. Redford, 226 S.W.3d 913, 918–19 (Mo. Ct. App. 2007) (favorably citing LJL in support of the "general principle of Missouri law" that "does not require written notice to be given when doing so would be a vain and useless act" and as being "in accord with appellate decisions from other jurisdictions more specifically holding that the failure to give written notice, pursuant to a notice-and-cure provision in a contract, does not prevent immediate termination of the agreement if the breach is incurable.").

12 LJL Transp., 962 A.2d at 639-50.

13 *See supra* note 12.

14 LJL Transp., 962 A.2d at 650-51.

15 87 U.S. 403 (1874).

In *Lyon*, a hotel owner terminated the hotel manager's employment because she was deemed unfit to perform due to her use of opiates and unsound mental condition. Recognizing that the owner's exercise of the contractual right of termination after a cure period was not "the only remedy" available, the *Lyon* court—without citation to precedent—held that if the manager "rendered herself, or otherwise became, incapable of performing [her] duties, that of itself authorized [the employer] to rescind or terminate the contract."[16] The owner was "not bound to continue as the superintendent of a large hotel a person who was a lunatic, or who was so stupid under the influence of narcotics that her presence was a danger and an injury, and who could render no reasonable service" because the "contract on her part implied some capability of performing the duties she had assumed, of rendering some service" such that if she could not render the required services, then the employer was not bound to continue employment for the required thirty day termination notice period.[17]

The *Lyon* decision figures prominently in the oft-cited decision in *Olin Corp. v. Central Industries, Inc.*[18] There, the U.S. Court of Appeals for the Fifth Circuit addressed the issue of whether the existence of a contractual termination provision provided the exclusive means of contract termination in a review of the conflicting contract concepts characterized as the *Corbin* and *Williston* treatise views. In the *Corbin* view, such a contractual provision constitutes the *exclusive* means of terminating the contract and requires compliance with termination notice provisions.[19] In the *Williston* view, such provisions are *not determinative*, but rather are a *cumulative* remedy that does not bar the ordinary remedy of termination for a material breach that goes to the root of the matter or essence of the contract, unless the provision by its terms is "exclusive."[20] In other words, other common law remedies remain available under the *Williston* view absent an express statement of the provision's exclusivity. The Fifth Circuit adopted the *Williston* view and the franchisor in *LJL* made this its argument on appeal.

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[16] *Id*. at 404 (alteration in original).

[17] *Id*.

[18] 576 F.2d 642 (5th Cir. 1978).

[19] 6 ARTHUR CORBIN, CORBIN ON CONTRACTS §1266, 64 (1962), *reprinted in* 13 SARAH HOWARD JENKINS, CORBIN ON CONTRACTS-DISCHARGE §68.9 (Joseph M. Perillo, ed., 2003) (the *Olin* decision's "pronouncement of the right of a party to put an end to an agreement because of the other's material breach is correct and in accord with this treatise")*; see also* LJL Transp. Inc., 962 A.2d at 649 n.4.

[20] WILLISTON ON CONTRACTS § 842, 165 n.1 (3d ed. 1962). The Third Circuit recently applied the *Williston* view in Orion Drilling Co., LLC v. EQT Prod. Co., 826 F. App'x 204, 212-13 (3d Cir. 2020) *citing* LJL, 962 A.2d at 652.

Further, as the Ninth Circuit discussed in *L.K. Comstock & Co., Inc. v. United Engineers & Constructors Inc.*,[21] even under the more restricted *Corbin* view, notice to cure termination provisions assume curable breaches. Where there is a frustration of purpose, there is no cure right and there is sufficient reason to permit an immediate termination.

The "new vista" criticism of the *LJL* decision is nothing more than an appeal for the judicial application of the most dogmatic interpretation of the *Corbin* view—that notice to cure termination provisions are an absolute bar to termination by any other method or remedy! This is **not** a refutation of the *Williston* view, but rather is merely a statement of the critic's preferred view.

The jurisdictions are split as to which view should be applied and how. By analogy, as distinct from the *Corbin* view, the current *Williston* treatise discusses contract "rescission" and "termination" by de-emphasizing legalistic semantics and advocating the practical utility of permitting co-extensive remedies in affording relief. It attaches no significance to the use of words like "rescission," "termination," or "abrogation" which are unnecessarily confusing since "a contract may be terminated not only by mutual consent, but also by the act of one party, or by the court."[22] The practical ease with which the more expansive *Williston* rubric can be applied may explain why the majority of courts favor it over the more technical and legalistic *Corbin* rubric.[23]

Federal cases applying Pennsylvania fiduciary duty law,[24] like "[v]irtually all of the reported cases,"[25] have consistently determined that neither the franchisor/franchisee relationship, nor underlying franchise agreements, create any fiduciary relationship. Yet, a "new vista" critic—without citation to any legal authority and contrary to the majority of decisional case law—used the *LJL* decision to suggest that "there may be a fiduciary relationship, or something akin, in a franchise agreement."[26] That critic used the *LJL* decision to identify a

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21 880 F.2d 219 (9th Cir. 1989).

22 26 WILLISTON ON CONTRACTS §68.3 (4th ed. 2007) (emphasis added) (citations omitted) (formerly 12 WILLISTON ON CONTRACTS §1454A (3rd ed. 1962)).

23 *See, e.g.*, Manpower Inc. v. Mason, 377 F. Supp. 2d 672 (E.D. Wis. 2005) (applying the *Williston* view).

24 *See* Onconome, Inc. v. Univ. of Pittsburgh, No. 09cv1195, 2009 WL 5064481, at *16 (W.D. Pa. Dec. 17, 2009) ("Contractual relationships, even franchise agreements, do not ordinarily give rise to confidential or fiduciary relationships between the parties.") (citing Cottman Transmission Sys., LLC v. Kershner, 536 F. Supp. 2d 543, 556 (E.D. Pa. 2008) (citations omitted)); *see also* 2 Summary Pa. Juris. Torts § 16:41 (2d ed.) ("[A] fiduciary relationship is not established by a franchise relationship between the parties.") (citing AAMCO Transmissions, Inc. v. Harris, 759 F. Supp. 1141 (E.D. Pa. 1991)).

25 FUNDAMENTALS OF FRANCHISING 222 (Rupert M. Barkoff & Andrew C. Selden eds., 4th ed. 2015).

26 *See* Barkoff, *supra* note 2.

hypothetical threat to franchise systems that fails to recognize the longstanding judicial application of the *Williston* view to permit immediate contract termination for fundamental dishonesty in contract performance—notwithstanding any cure period provision. The critic's fallacious hypothetical forebodingly foresees the possibility of franchise system collapse due to a sudden exodus of franchisees who—armed with the *LJL* decision's reasoning—might elect *en masse* to immediately terminate their franchise agreements upon learning of franchisor dishonesty using the example of franchisees caused to pay higher supplier prices because of secret kickback payments being made by the suppliers to the franchisor.

First, the dishonest acts by the *LJL* franchisee deprived the franchisor of its franchise fees—an "essence" of the relationship—as contrasted with the hypothetical dishonest franchisor whose acts, even if unlawful, do not deprive the franchisees of any of the fruits of their franchise agreements—most especially not their fundamental license right to use the franchisor's trademark in marketing—the core of franchising! As the critic might agree, and as *that* critic's own franchise treatise confirms, the fruit of any franchise that a franchisee enjoys is the right to operate and utilize "a system of marketing and distributing goods and services in accordance with standards and practices established by the trademark owner, who furnishes a well-established trademark and brand image, expertise, training, stability, and marketing know-how."[27]

As despicable as the hypothetical kickback scheme is, it does not result to deprive the franchisees of the fruits of their franchise agreements because no rights to operate or utilize the trademark or the associated system of marketing established by the hypothetical franchisor are lost. The scheme is not a misuse of the trademark that would confuse the public as to the quality or provider of goods and services being sold thereunder nor does it risk an adverse impact upon the "consistency and quality of the goods and services bearing the trademark" which, after all, are the nexus of the franchisor-franchisee relationship.[28]

Unlike the *LJL* franchisee's dishonest acts—which likely did or would confuse the public as to the provider and quality of the services being provided—the hypothetical kickback scheme would not go to the heart of any contractual obligation of a franchisor on which a franchisee would depend, nor would it

[27] FUNDAMENTALS, *supra* note 25. *See also* Piercing Pagoda, Inc. v. Hoffner, 351 A.2d 207, 211 (1976) ("[T]he franchise has evolved into an elaborate agreement by which the franchisee undertakes to conduct a business or sell a product or service in accordance with methods or procedures prescribed by the franchisor . . . ."); 16 C.F.R. § 436.2 (2007) (defining "franchise").

[28] FUNDAMENTALS, *supra* note 25.

deprive any franchisee of its investment. Thus, hypothetical franchisees would have no immediate right to terminate under either *LJL* or the *Williston* view.

Second, the right to immediately terminate for dishonest acts that go to the heart of the franchise relationship is a benefit not only to franchisors, *but also to honest franchisees*. Franchise systems have an interest in protecting the goodwill of their trademarks. Franchisees can, and often time do, compete with their fellow franchisees. In this intra-system competition, honest franchisees should not be unfairly disadvantaged by the opportunistic acts of dishonest franchisees. Dishonest franchisee acts, by implication, run counter to selling goods and services in accordance with the franchisor's prescribed methods and is deserved of judicial intolerance. For courts to recognize this as a benefit to honest franchisees in no manner signals the erosion of judicial enforcement of contractual notice and cure provisions where franchisees fail to meet their contractual obligations due to neglect or ineptitude. In such circumstances, contractual notice and cure provisions will continue to be judicially enforced under the *Williston* view. Thus, traditional judicial enforcement merely runs parallel to the imposition of an implied honesty obligation with a permissible immediate termination right for non-curable breaches.

Third, the courts have historically demonstrated a "strong tendency . . . to uphold the sanctity of contracts"[29] and sparingly apply the *Williston* view. The resultant limited volume of case law is a testament to the absence of any practical contract uncertainty with which contract law or franchise systems must be concerned. Application of the *Williston* view is like the application of equitable principles: any uncertainty inherent in their application is no more threatening to franchise systems than when equity is applied by any court. For a critic to focus on the magnitude of the potential loss, *i.e.*, destruction of the franchise system, is wrong, since the analysis should instead be driven by recognition of the fact that economic efficiencies and "efficient breaches"[30] in search of a better deal are what permit contracting parties to willfully, but honestly, breach their contracts—provided they are willing to pay the other party's expectation damages. Thus, it is fair to argue that a greater societal threat to the continued viability of the contractual theory of efficient breach rests in 1) tolerating dishonesty in contract performance and 2) requiring parties to contract around it, than does exist in permitting immediate termination for dishonesty notwithstanding the existence of a notice to cure provision. Economic efficiency presumes that the parties are performing their contractual obligations honestly

29 FUNDAMENTALS, *supra* note 25.

30 JOHN E. MURRAY, MURRAY ON CONTRACTS 110 (5th ed. 2011).

while dishonesty in that performance, *e.g.*, theft and fraud, should constitute enough reason to immediately end a contractual relationship without regard to any notice to cure provision.

Lastly, the dishonest acts in *LJL* were not curable.[31] At least one court has refused to enforce a statutory notice-to-cure period designed to protect dishonest franchisees.[32] Applying the *Corbin* view to preserve a cure right for dishonest actors sends the wrong message to contracting parties and to the franchise community.

Although the debate on applying the conflicting *Corbin* and *Williston* views will continue, it is incorrect to argue that the *Williston* view is a "new vista" of contract uncertainty with which franchise systems ought to be concerned. Time and longstanding U.S. Supreme Court precedent and its progeny, all make it fair to conclude that honesty in contract performance remains of paramount importance to American jurisprudence, not a threat to it. Thus, contract law and franchising both will endure with vibrancy far into the foreseeable future.

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[31] *See also, e.g.*, 28 N.Y. PRAC., CONTRACT LAW §13:12 (1990) ("Strict compliance with a notice and cure provision is not required where it would be futile . . .. For example, a franchisor could terminate a franchise agreement without complying with a notice and cure provision where the franchisee engaged in dishonest and fraudulent behavior.") (citations omitted).

[32] *See* AAMCO Indus., Inc. v. DeWolf, 250 N.W.2d 835 (Minn. 1977) (refusing to enforce statutory 24-hour notice to cure provision to protect franchisee where any attempt to cure was futile and franchisor issued an immediate termination for franchisee's dishonest and illegal acts).