How ConocoPhillips Prevailed In a Multidistrict Franchise Modification Dispute

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On April 13, 2011, United States District Judge Ronald Whyte dismissed franchise law claims brought by fifty-eight operators of Union 76 stations against ConocoPhillips.[1] The lawsuit, In re: *ConocoPhillips Service Station Rent Contract Litigation*, alleged that ConocoPhillips breached the California Franchise Investment Law by raising rents unilaterally in breach of the Union 76 station leases, and by failing to provide the franchise disclosure statements the law requires before franchise agreements may be modified. Remarkably, ConocoPhillips argued – and the court found – that the Franchise Investment Law's modification requirements did not apply, because the Union 76 station leases in question expressly allowed ConocoPhillips to raise rents unilaterally. In other words, the court found that the station leases were not modified, because the leases explicitly allowed ConocoPhillips to raise the dealers' rent payments mid-lease.

The case is important for two reasons. First, the case shows how artful language in a franchise lease was interpreted to give ConocoPhillips the power to raise rents on station operators in the middle of the lease's term. By extension, this language allowed ConocoPhillips to do by contract what it could not have done by franchise law. Second, even though ConocoPhillips prevailed in the dispute, the case teaches how energy franchisors can improve their own station lease agreements and franchise practices. With just a few small changes in the leases and rent modification notices, ConocoPhillips could not only have avoided some forceful legal arguments but, quite likely, could have prevented some of its fifty-eight lessees from filing suit in the first place.

The Union 76 Station Leases

Like most franchise disputes, the ConocoPhillips Service Station Rent Contract Litigation revolves around the language of the franchise agreement. A typical Union 76 station lease agreement was entered on the record;2 the agreement is styled as a "Union 76 Dealer Station Lease and Motor Fuel Supply Agreement," but it also includes non-lease terms relating to matters like credit card processing and telecommunications requirements, as well as environmental compliance documents and a separate "snack shop addendum."

The key section at issue in the litigation was the "Rental" section. The plaintiffs claimed that ConocoPhillips raised their rents, thereby effecting a "material modification" of the agreements. But as the court would ultimately remark in ruling against the lessees, "[t]he section on Rental in the Dealer Lease Agreement has subsections (a) through (g). . . . Plaintiff cannot fairly argue that they thought that [the lease] fixed rent for the term of the agreement when the surrounding subsections expressly

1 Order Granting Defendant's Motion to Dismiss Second Amended Complaint, *In re:* ConocoPhillips Co. Service Station Rent Contract Litigation, Doc. 98, 2011 WL 1399783 (C.D. Cal., Apr. 13, 2011).

2 Am. Consol. Master Compl., *In re:* ConocoPhillips Co. Service Station Rent Contract Litigation, Doc. 68, filed Mar. 11, 2010, Exh. A.

provide otherwise."[3] Thus, it is worth summarizing the salient points of the Rental section:

- Subsection (a) provides that the lessee shall pay rent as determined in accordance with a "Rent Policy . . . adopted by CONOCOPHILLIPS in good faith and in the ordinary course of business . . . which policy may be amended or modified by CONOCOPHILLIPS at any time or from time to time."
- Subsection (b) provides that the rent will be determined in accordance with the Rent Policy "[u]pon any renewal of this Agreement."
- Subsection (c) provides that the lessee shall pay the rent specified in the attached "Exhibit B." Exhibit B was unique for each lessee, but in the sample lease that was filed with the court, Exhibit B specifies that for the "rental period effective January 1, 2008" (the date on which the lease commenced[4]), the "monthly rent amount" for the Union 76 site would be $4,761.[5]
- Subsection (d) provides that ConocoPhillips must notify the lessee of all Rent increases "at least 90 days prior to the implementation of any such increases." Moreover, subsection (d) specifies that "that Rent may, at CONOCOPHILLIPS' discretion, be subject to an adjustment based on changes in the Consumer Price Index--All Urban Consumers . . . ."
- Subsection (g) provides that no provision of the lease "may be construed to prevent or limit CONOCOPHILLIPS' right to modify the terms or conditions of the Agreement, or offer additional or different terms to DEALER, upon a renewal of the Agreement . . . ." It also provides that rent may be modified at any time during the term of the lease if ConocoPhillips incurs "capital improvements" or "substantial rebuilding" to the site.[6]

To be sure, the Rental section of the Union 76 station leases is hardly a model of clarity. In one subsection, the leases provide a specific monthly rent amount that is "effective" as of the commencement of the lease. In two other subsections, the leases provide that the rent may be and, indeed, will be recalculated upon the renewal of the agreement. One subsection seems to limit ConocoPhillips's right to increase the rent in the middle of the lease only if it incurs significant capital expenses. But in another subsection, the leases provide that the rent may be determined by a policy that "may be amended or modified . . . at any time or from time to time." And in yet another subsection, the leases provide that ConocoPhillips may adjust the rent, at its sole discretion, in accordance with the Consumer Price Index.

In short, the leases are capable of several, mutually exclusive readings. May the rent be adjusted "at any time," or only upon ConocoPhillips incurring significant capital expenses, or only upon a renewal of the lease? And must rental adjustments be calculated in accordance with the Consumer Price Index, or must they bear some relation to ConocoPhillips' capital improvements, or may the rent really be adjusted in any manner that ConocoPhillips "in good faith and in the ordinary course of business" desired? These were some of the questions the Central District of California would be forced to confront.

3 Order, *supra* note 1, at 3-4.

4 *Id.* at § 2(a).

5 *Id.* at Exh. B.

6 Union 76 Dealer Station Lease and Motor Fuel Supply Agreement, *supra* note 2, at § 3.

The Rent Adjustment and Ensuing Legal Challenges

As the plaintiffs would eventually allege,[7] between September 2008 and March 2009, ConocoPhillips notified the Union 76 station operators that ConocoPhillips had amended its Rent Policy and was thereby raising the operators' rents. Included in the notice was a "revised Exhibit B" that purported to replace the Exhibit B in the lease, which would be effective July 1, 2009.

The Union 76 operators were not pleased. Fifty-eight of them filed a total of fifty-five separate lawsuits in courts across the state of California, alleging violations of the California Franchise Investment Law[8] and Unfair Competition Law[9] and seeking money damages, injunctive, and declaratory relief. ConocoPhillips removed the state court cases to federal court, and eventually the Judicial Panel for Multidistrict Litigation related or consolidated all fifty-five matters to the United States District Court for the Central District of California.[10]

Upon transfer to the Central District of California, the plaintiffs filed a consolidated master complaint that alleged, among other claims, that ConocoPhillips violated the California Franchise Investment Law by failing to provide the plaintiffs with a franchise disclosure statement prior to the plaintiffs' most recent renewals of their lease agreements.[11] The plaintiffs specifically cited California Corporations Code § 31011(c)(G), which requires franchisors to provide a statement that describes "any payments or fees other than franchise fees that the franchisee or subfranchisor is required to pay to the franchisor." In the plaintiffs' eyes, the law imposed a duty on ConocoPhillips to disclose all fees that the station operators would have to pay during the term of the lease, and ConocoPhillips breached that duty by failing to provide such disclosure prior to the lease renewals.

The problem with the plaintiffs' theory was that, in California, the duty to provide a franchise disclosure statement only applies at "the offer and sale" of a franchise;[12] the duty does not arise when a franchise is being renewed. The Union 76 operators had all operated their stations for long periods of time, and each of their current leases were renewals. Thus, the Central District of California readily dismissed the Franchise Investment Law claim against ConocoPhillips.[13] However, the court gave the plaintiffs leave to file an amended master complaint, which they did three weeks later.

The Amended Complaint and the Court's Order

In an amended master complaint, the plaintiffs changed their franchise claim from a theory that ConocoPhillips failed to provide the required disclosures at the onset of the leases into a theory that ConocoPhillips failed to follow the required procedures for making a "material

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7 The court noted that the plaintiffs changed their story between filing the first and second amended consolidated complaints. Whereas the second consolidated amended complaint alleges that the rent adjustment notices were sent between September 2008 and March 2009, the first consolidated amended complaint alleges that the notifications were given on or about March 24, 2009. Order, *supra* note 1, at 2 & n.2. The record included a copy of one such notification, which was dated precisely on March 24, 2009. See Def's. Notice of Mot. and Mot. To Dismiss Pls'. Sec. Am. Compl., *In re:* ConocoPhillips Co. Service Station Rent Contract Litigation, Doc. 82, filed July 6, 2010, Exh. A.

8 Cal. Corp. Code § 31000, *et seq*.

9 Cal. Bus. & Prof. Code § 17200, *et seq*.

10 See Joint Case Management Statement, *In re:* ConocoPhillips Co. Service Station Rent Contract Litigation, Doc. 65, filed Jan. 29, 2010, at 2. Thirty-four of the matters were consolidated for coordinated pretrial proceedings; and twenty-one were related to the Central District of California, but were not consolidated with the multidistrict litigation.

11 Am. Consol. Master Compl., *In re:* ConocoPhillips Co. Service Station Rent Contract Litigation, Doc. 68, filed Mar. 11, 2010, at ¶¶ 75-76.

12 Cal. Corp. Code § 31011(a).

13 Order, *In re:* ConocoPhillips Co. Service Station Rent Contract Litigation, Doc. 76, filed June 2, 2010.

modification" of an existing lease.[14] In support of this theory, the plaintiffs turned their focus to California Corporations Code § 31011(c)(2), which requires a franchisor to provide franchisees with written notice and ten business days to object before any material modification can be made to a franchise agreement.

Thus framed, the issue in dispute became whether ConocoPhillips's rent increase did, in fact, constitute a "material modification" to the leases. The court, turned to the language of the leases. According to the court, the "fatal flaw" for the plaintiffs was that they "agreed to such rental adjustments at the time they entered into their Dealer Station Leases."[15] The court focused its analysis on subsection (a) of the Rental section — noting that ConocoPhillips's Rent Policy would be adopted "in good faith and in the ordinary course of business" and "may be amended or modified" — but the court also lent weight to subsection (d)'s language about the timing and method for making rent adjustments. To the court, the Rental section explicitly authorized ConocoPhillips to make rent adjustments in the middle of the lease's terms.

In effect, the court determined that the Union 76 station leases built in a mechanism for making material modifications without triggering the requirements of the California Franchise Investment Law. In the court's words, "[a]n adjustment of rent made pursuant to the terms of a lease is not a material modification of that lease requiring disclosures under Section 31101(c)."[16]

That said, ConocoPhillips's right to adjust the station operators' rent was not "unfettered." To the contrary, the court remarked, ConocoPhillips was required to adjust rent "in the ordinary course of business" and "in good faith," which a court might evaluate by considering changes in the Consumer Price Index--All Urban Consumers referenced in subsection (d) of the Rental section.[17] However, the court made clear that any rent increase made outside the ordinary course of business or in bad faith still would not give rise to a California Franchise Investment Law claim; rather, the plaintiffs' remedy in such an event would merely be an action for breach of contract.[18]

Lessons To Learn from the Litigation

The ConocoPhillips Service Station Rent Contract Litigation is a case study in how franchisors should litigate franchise disputes. ConocoPhillips had a compelling argument that it followed all the procedures required by law for making a material modification to an existing franchise agreement: California requires franchisors to give written notice at least ten business days in advance of the modification, and evidence in the record reflected that ConocoPhillips had given the station operators written notice of the rent adjustment a full ninety days in advance.[19] Rather than focus on this argument, however, ConocoPhillips devoted most of its briefing to a clean and clever argument that the rent adjustment did not constitute a modification of the leases at all. ConocoPhillips focused on two artful clauses of the station leases to persuade the court that the lease itself authorized rent modifications. By this nifty maneuver, ConocoPhillips transformed a behemoth, multi-district franchise dispute into a simple question of contract, which the court was able to resolve in a six-page order.

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14 First Am. Consol. Master Compl., *In re:* ConocoPhillips Co. Service Station Rent Contract Litigation, Doc. 80, filed June 21, 2010, at ¶ 76.

15 Order, *In re:* ConocoPhillips Co. Service Station Rent Contract Litigation, Doc. 76, filed June 2, 2010, at 2-3 (quoting Union 76 Dealer Station Lease and Motor Fuel Supply Agreement, *supra* note 2, at § 3).

16 *Id.* at 3.

17 *Id.* at 3 & nn.3-4.

18 *Id.* at 3.

19 *See* Def's. Mot. to Dismiss Pls.' Sec. Am. Compl. Exh. A, Doc. 82-1, filed July 6, 2010, at 12.

At the same time, however, readers should not lose sight of the challenges ConocoPhillips faced in trying to argue that the station leases authorized rent adjustments. While subsections (a) and (d) seemed to favor ConocoPhillips, subsections (b), (c), and (g) and Exhibit B to the stations leases all arguably cut the other way. Subsection (b) provided that the rent will be determined "[u]pon any renewal of this Agreement;" subsection (c) and Exhibit B together provided a precise rent figure that would be effective upon commencement of the renewed lease, without any language suggesting that this figure could be modified mid-lease; and subsection (g) seemed to limit ConocoPhillips's right to modify the rent to circumstances where it made "capital improvements" or "substantial rebuilding" to the site.[20] Moreover, the plaintiffs offered an plausible, alternative interpretation to the language in subsection (a) that purported to give ConocoPhillips the power to modify the Rent Policy. Under the plaintiffs' reading, "a 'Rent Policy' can have many aspects to it, that do not necessarily include the amount of rent to be paid (i.e. how, when, and where rent should be paid)."[21]

In light of the internal inconsistencies and alternative interpretations potentially applicable to the station leases, it is perhaps surprising that the court did not resort to the rule of contractual interpretation that "ambiguities in standard form contracts are to be construed against the drafter."[22] In short, ConocoPhillips could easily have lost this litigation. Going forward, it should go without saying that parties planning to draft station leases that build in room for mid-lease rent adjustments should carefully review their current leases to eliminate any potential ambiguities and to state explicitly in all pertinent provisions and addenda that rent is subject to change at the franchisor's reasonable discretion.

Finally, parties that intend to draft and exercise contracts that allow mid-lease rent adjustments would be well advised to keep three lessons from the ConocoPhillips Service Station Rent Contract Litigation in mind. First, courts will not enforce contracts that give one party unfettered discretion to take advantage of the other party; therefore, it is critical for the contract to put reasonable constraints on the franchisor's discretion to adjust rent. The Union 76 station leases explicitly required that rent adjustments be made "in good faith" and "in the ordinary course of business." More advisable still would be to base all rent adjustments upon objective indices like the Consumer Price Index--All Urban Consumers referenced in the Union 76 station leases or, better yet, the Moodys/REAL Commercial Property Price Index.[23]

Second, it is important that all rent adjustments be communicated to lessees clearly and conscientiously. Of course, parties must comply with all statutory and contractual requirements relating to notice of modifications. But it also important for the franchisor to have a modification notice quote in full the relevant lease provisions that authorize adjustments. It is also important to word the notice carefully; one must be mindful not to describe the rent adjustment as a modification to the lease, but rather, one should describe it as an implementation of the lease. In ConocoPhillips's case, for example, the rent adjustment notice specified that "ConocoPhillips has amended its Rent Policy;"[24] by contrast, had the notice instead said that ConocoPhillips

20 Union 76 Dealer Station Lease and Motor Fuel Supply Agreement, *supra* note 2, at § 3.

21 Opp. To Mot. to Dismiss Pls.' Sec. Am. Compl., Doc. 87, filed July 23, 2010, at 5.

22 *Victoria v. Superior Court of Los Angeles County*, 40 Cal.3d 734, 740, 710 P.2d 833 (1985).

23 Better still would be to use indices that are specific to relevant geographies and property types. The MIT Center for Real Estate, for instance, calculates a "West Region – Retail Properties Index" that would have served the Union 76 station leases quite nicely. *See generally* MIT Center for Real Estate, Moodys/REAL Commercial Property Price Index (CPPI): National and Regional Level Indices, *available at* http://web.mit.edu/cre/research/credl/rca.html.

24 *See* Def's. Mot. to Dismiss Pls.' Sec. Am. Compl. Ex. A, Doc. 82-1, filed July 6, 2010, at 12

had "amended the Union 76 station lease," then ConocoPhillips might very well have lost this case.

Finally, as in all matters of business and life, parties will be well advised to act at all times honorably and with respect and sympathy for the other side. ConocoPhillips's rent adjustment notices were addressed "Dear Dealer:" and were written in sheer legalese: "Reference is made to that certain Service Station leased by and between. . . ." The notices also concluded impersonally: "Please contact your Account Representative for more specific information regarding your site."[25] This was a bad notice; it should have been no surprise that fifty-eight of the dealers responded to it with a lawsuit. A better rent adjustment notice would have been personally addressed to a human being at each station and would have opened with a sincere statement that the franchisor deeply regrets that business realities are forcing the franchisor to invoke the rent adjustment sections of the lease. And a better notice would close with the name and telephone number of a person the dealer can speak to with any questions about the notice.

Conclusion

The ConocoPhillips Service Station Rent Contract Litigation teaches valuable lessons in how to draft, exercise, and litigate disputes about station leases. While ConocoPhillips ultimately prevailed in the franchise modification claims brought against it, ConocoPhillips could have spared itself much aggravation, risk, and legal expense by drafting a clearer station lease at the onset and by notifying the station operators of the rent adjustment in a classier and less severe manner.

Meanwhile, ConocoPhillips is not out of the woods quite yet. On April 20, 2011, a single station operator filed a new franchise law claim against ConocoPhillips for substantially impairing the goodwill value of its franchise and forcing the operator to "walk away" from its station by virtue of raising the station's rent.[26] While this author will express no opinion on the merits of this amended claim, ConocoPhillips can expect this litigation to carry on for years into the future, with appeals likely to follow.

25 *Id.*

26 Sec. Am. Consol. Master Compl., *In re:* ConocoPhillips Co. Service Station Rent Contract Litigation, Doc. 100, filed Apr. 20, 2011, at ¶ 105.