General Counsel Corner

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Judicial Inconsistency Resolved

Last autumn, we wrote an article titled "Judicial Inconsistency" concerning two cases with uncanny similarities, which were decided in a totally inconsistent manner within the same federal district court, the Central District of California, within one month of each other.

In *Chevron U.S.A., Inc. v. El-Khoury*, 2000 WL 33711537 (C.D. Cal. 2000), and *Chevron U.S.A., Inc. v. Mebtahi*, 148 F.Supp. 2d 1019 (C.D. Cal. 2000), the dealers had refused Chevron's repeated offers to buy each of them out for $400,000 or more.

Following their refusals, Chevron availed itself of the audit provision contained within the dealers' franchise agreements to send in the same firm of accountants to examine the dealers' books.

In both instances, the accountants concluded that, although the dealer had fully reported his sales to Chevron under Chevron's percentage rent program, he had underreported those sales on his state sales tax returns.

Chevron promptly fired off termination notices, and filed declaratory judgment actions in federal court to establish that the terminations were in compliance with the Petroleum Marketing Practices Act. Both cases were resolved on summary judgment, in opinions released during the same month that reached directly opposite results.

In the *El-Khoury* case, Judge Collins granted summary judgment to Chevron, finding that it was entitled to terminate the dealer's franchise pursuant to §§2802(b)(2)(A) and 2802(c)(11) of the PMPA because dealer had violated the requirement in his franchise agreement that he comply with state law, and because his failure to comply was "relevant to the operation of the marketing premises."

Further, Judge Collins refused to consider evidence outside of the four corners of the franchise agreement, which tended to show that Chevron had no legitimate interest in auditing the dealer's state tax returns, holding that California's parol evidence rule barred the court from considering such extrinsic evidence.

Finally, Judge Collins rejected as irrelevant the dealer's contention that Chevron's purported reason for termination was pretextual, and that its true intent was simply to take over the dealer's business following his refusal to accept Chevron's buyout offer.

In the *Mebtahi* case, Judge Cooper rejected the very arguments urged by Chevron that Judge Collins had accepted. First, she admitted into evidence extrinsic materials similar to those rejected in the *El-Khoury* case, finding that they were pertinent to the issue of whether the dealer's state sales tax reporting was truly material to the franchise relationship.

Further, Judge Cooper found that the dealer's underreporting to the state did not necessarily mean that he was "untrustworthy", and that his noncompliance could not be presumed to constitute a material breach of the franchise relationship.

Finally, although making no definitive ruling on the dealer's claim of pretextual termination, Judge Cooper acknowledged that the record contained at least some evidence casting doubt on Chevron's motives.

Last month, this "judicial inconsistency" was resolved by the Ninth Circuit in a soon-to-be published opinion, *Chevron, U.S.A., Inc. v. El-Khoury*, 2002 WL 530994 (9th Cir. 2002). In reversing Judge Collins decision against the dealer, the appellate court did not directly refer to Judge Cooper's *Mebtahi* decision. Nevertheless, the appellate court largely adopted her reasoning.

The Ninth Circuit first emphasized that a mere technical or unimportant failure to comply with the franchise agreement would not justify termination either under §2802(b)(2)(A) or §2802(c)(11).

Further, the appellate court held that the district court had erred in refusing to consider the dealer's extrinsic evidence concerning the extent of Chevron's audit rights, holding that, while the earlier drafts of the audit provision could not be used to contradict the final version, they could be used to show that Chevron did not place much importance on its right to audit state sales tax records.

Finally, the appeals court by footnote held that it need not consider the dealer's pretextual termination argument because the lower court's decision had to be reversed for the other stated reasons.

The Ninth Circuit's opinion is a strong endorsement of dealers' rights under the PMPA. Nevertheless, it is too bad that the appeals court did not address — and reject — the trial court's refusal to consider the dealer's pretextual termination claim.

Basically, Judge Collins had found that the dealer had "no legal basis" for asserting a pretextual termination defense because an earlier Ninth Circuit decision upon which the dealer relied, *Reyes v. Atlantic Richfield Co.*, 12 F.3d 1464 (9th Cir. 1993), contained specific allegations that the dealer's race or nationality was the real reason for termination. No pretextual termination argument could be raised, according to Judge Collins, therefore, unless the non-stated reason for termination was based on the dealer's "race or on any other impermissible basis." Because no such allegation had been raised, Judge Collins determined that no basis existed for a pretextual termination defense.

We believe that the Judge Collins read the *Reyes* opinion too narrowly. Although *Reyes* did involve issues of race and nationality, the Ninth Circuit's analysis of the PMPA does not appear to be so limited.

The Ninth Circuit stressed the overall character and structure of the PMPA. It emphasized that, to justify termination, the "franchisor must not only show that there was a legitimate reason for the termination or renewal," but "must also demonstrate that this reason was in fact a ground for the termination or non-renewal decision."

True, the supplier can satisfy the second-half of its burden of proof by introducing self-serving evidence that the non-renewal was based on the breach. But, the Ninth Circuit emphasized, “the franchisee is free to rebut this element of the franchisor’s case by producing evidence that the termination was in fact based on an illegitimate reason.”

One would think that it would be “illegitimate” for an oil company to attempt to rely upon minor contractual violations, which were really of little or no concern to it, in order to terminate a protected franchise operation if its real intent was to convert the station to company operation.

Significantly, *El-Khoury* and *Mebtahi* are not the only recent decisions arising from the Central District of California in which Chevron’s utilized its audit rights to terminate franchise dealers. In *Chevron U.S.A., Inc. v. Gulessarian*, Bus. Fran. Guide ¶11,975 (C.D. Cal. 2000), and *Nahabet v. Chevron U.S.A., Inc.*, 2001 WL 1800904 (C.D. Cal. 2001), Chevron also used that same contract provision to accomplish that same result. Evidence of that pattern should be relevant to evaluate Chevron’s intent and the bona fides of its conduct.

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