

Dunkin' Donuts operator wins 'unprecedented' tax-based contract termination lawsuit

By: Richard Martin

BOSTON--In a case said to be unprecedented in the annals of franchising litigation, a federal court jury here returned not-guilty verdicts on some four dozen counts of criminal tax fraud and tax evasion alleged by Dunkin' Donuts Inc. against a seven-unit franchisee.

Miami attorney Robert Zarco, whose firm represented Dunkin' Donuts franchisee Manoochi Fallah Moghaddam and his partners, said the case was the first jury trial on record in which a private company had attempted to act as a kind of surrogate federal prosecutor in a case of purported tax evasion.

Dunkin' Donuts, the Randolph, Mass.-based franchisor arm of Allied Domecq Quick Service Restaurants, made the allegations in an effort to oust Fallah and his co-defendants from the chain by showing a breach of his contract's obey-all-laws provision.

However, Fallah, whose doughnut shops are in Fort Lauderdale, Fla., never had been investigated, charged, prosecuted or convicted of tax violations or any other crime by federal or state authorities, his attorney asserted. Zarco said the court had observed that the lawsuit against Fallah had "appeared" to be a case of selective prosecution, and he was looking into whether that could give rise to new litigation by the franchisee against the company.

"It is clear that this decision will be much more costly to Dunkin' Donuts than if they had taken any of the several opportunities to settle that were offered to them before and during the trial," Zarco said. He estimated that the franchisor already had spent more than \$1 million in litigating the case against Fallah.

Dunkin' Donuts said it was considering an appeal of the verdict. In a prepared statement the company added, "This case will not affect the efforts of Dunkin' Donuts to continue to require high standards of integrity of our franchisees in running their shops."

Zarco first dis-

cussed Fallah's Sept. 19 court victory publicly during a Sept. 22 panel presentation on the "litigation explosion" at the Multi-Unit Foodservice Operators Conference in Atlanta. Dunkin' Donuts, which has sued more than 300 franchisees in recent years for alleged underpayment of royalties and other contract infractions, acted with "arrogance" by initiating the Fallah case, by refusing the defense's settlement offers and by failing to monitor the actions of outside counsel, Zarco charged.

The successful defense by Fallah who wept openly in court upon hearing the jury's lengthy declaration of not-guilty decisions now will embolden other franchisees to fight back more vigorously against franchisors' lawsuits, Zarco predicted.

Dunkin' Donuts did not comment on Zarco's assertions that it had been arrogant in the prosecution, that the case would be unnecessarily costly to the company or that the verdict would bolster franchisees' resolve in other contract disputes.

According to Zarco, Fallah formerly was a "poster boy" of the chain's franchise community and had been appointed to several regional and national franchise committees before he incurred the company's wrath for filing a lawsuit of his own in 1999. In that complaint Fallah and two other franchisees alleged that Dunkin' Donuts had interfered in several franchise elections in which the chain's



Pictured during the MUFSSO 2003 litigation session are, from left, panelists Robert Zarco, Darden counsel Sally Blackmun and Morrison Management general counsel John Fountain.



South Florida operators were to decide whether to contribute an additional 1 percent of gross sales for local advertising.

In its statement about the tax case verdict, Dunkin' Donuts said the allegations in Fallah's 1999 lawsuit were untrue, including a charge of bribery against one of its officers. The company said documents discovered while it was forming its defense in that case indicated the franchisee's failure to comply with tax laws, which, it contended, violated his contract.

After Fallah's case was filed against the franchisor, he was selected for contract termination, according to an internal e-mail Zarco said was introduced at trial that outlined the company's "long-term" strategy to oust the franchisee from the chain.

Zarco's firm said Fallah was notified three times for different reasons that his contract was being terminated, including allegations that he had interrupted franchise meetings, unlawfully transferred his franchise agreements to different corporations and intentionally underreported sales while failing to maintain records and committing tax fraud.

Dunkin' Donuts dropped the unlawful-transfer and underreporting charges two weeks before the start of the trial, Zarco said. The franchisor was said to have reconsidered because it previously had not objected to Fallah's acting on advice to form seven different corporations for each of his doughnut shops and because of a Pittsburgh federal jury's decision last year in favor of another Dunkin' franchisee defended by Zarco's firm. In that underpayment-of-royalties case, the jury was not convinced by the franchisor's videotape methods for assessing sales volumes and not only rejected Dunkin' Donuts' complaint but also found in the franchisee's cross-complaint that the com-

pany had violated its contract by not assisting him adequately in his operation.

Dunkin' Donuts, in pursuing its tax evasion argument in the Boston case, claimed that Fallah had engaged in a "massive tax fraud" by concealing more than \$1 million in sales dating back to 1995. It also charged that Fallah had used corporate funds to pay off credit cards, misclassified income as shareholder loans and diverted money unlawfully to a management company. All those actions allegedly lowered his taxable income and constituted tax evasion, which would violate a contract provision requiring that he maintain lawful relations with all government agencies implicitly including the Internal Revenue Service.

Fallah's defenders Zarco and partner Robert F. Salkowski demonstrated to the jury that the basis of Dunkin' Donuts' contentions was "outrageously flawed," according to a statement issued by Zarco Einhorn & Salkowski in Miami. The defense team said it showed that the plaintiff had presented no evidence to establish the loan allegations and had used "false and otherwise misleading" charts and summaries prepared by an outside paralegal to present the testimony of the franchisor's accounting expert.

Dunkin' Donuts, in its statement on the verdict, said: "It is not our purpose to supplant the IRS. But when, in the course of our business, we are confronted with clear evidence of significant tax fraud, we will not turn a blind eye to it."

However, the seven-person jury saw that evidence as less clear-cut and took less than two hours to return its verdict

in favor of Fallah and his co-defendants. Because multiple charges were made against each of the franchisees' seven corporations, there were some 48 counts in all requiring separate verdicts, and "a single 'yes' would have meant we lost, but the jury came back on all of the counts with 'no,' 'no,' 'no,'" Zarco said.

Dunkin' Donuts, in its statement, conceded that the verdict was rendered even after Judge Edward Harrington had stated that a violation of tax law would qualify as a breach of the franchise agreement.

The franchisor's statement also contended that a federal court in Miami in February had found that a different franchisee, in a lawsuit brought by the company "on similar facts," had violated the obey-all-laws contract provision by evading taxes and filing false tax returns. That franchisee's agreements for five shops were terminated, Dunkin' Donuts said.

However, Zarco, who also defended the franchisee in Miami, said the facts were "nowhere near" similar to those of the Fallah case and instead involved clear instances of personal costs being written off as business expenses. Nonetheless, the Miami court granted a stay of judgment pending appeal, and "the franchisee is still in the stores," Zarco said, predicting that the case might not be resolved for two years.

Moreover, the Miami court pointed out that the franchise contract at issue there had not specified tax infractions as grounds for termination, Zarco said. He contended that a judicial ruling still was lacking on whether it was proper for a private party to invoke federal tax laws in a civil dispute, regardless of Dunkin' Donuts' insertion of a tax compliance provision in its franchise contracts, starting in December 2001.