Transfers of Franchises:
Disputes Arising From Assignments

Fredric A. Cohen
CHENG COHEN LLC
Chicago, Illinois

and

Nicole Liguori Micklich
GARCIA & MILAS PC
New Haven, Connecticut

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TRANSFERS OF FRANCHISES: DISPUTES ARISING FROM ASSIGNMENTS

I. INTRODUCTION

Many franchisees will want to transfer ownership of the franchise at some point during the franchise term. Buying a franchise is sometimes viewed by franchisees as an investment in one’s future and in the future of one’s family. There is also an entrepreneurial aspect to franchising. Some franchise owners build a business with a view toward maximizing the return on their investment by selling to a third party. Others simply hope to pass down the franchised family business to the next generation.

From the franchisor’s perspective, proposed transfers can be a cause for concern. They perceive that they enjoy tremendous goodwill associated with their brands as the result of their development, implementation and consistent enforcement of high system standards. Franchisees who own and operate franchised businesses play an important role in the implementation of their franchisors’ system standards. For this reason, franchisors carefully select franchisees based on specific criteria.

These divergent interests frequently result in conflict. To protect their interests, franchisors commonly impose restrictions on the transfer or assignment of franchise rights. In response, some state legislatures have enacted laws limiting the circumstances in which a franchisor may prohibit the transfer of franchise rights. These laws most commonly require that the franchisor have “good cause” to refuse consent to a proposed transfer. What constitutes “good cause” is subject to debate, and unsurprisingly depends on one’s point of view and economic interests.

This paper seeks to provide an overview of considerations relevant to the transfer or assignment of franchises. These include the statutory and common law limitations on franchisors’ ability to prohibit or to reject proposed transfers; common drafting considerations, including contractual provisions imposing conditions precedent to transfer rights; franchisors’ rights of first refusal; transfers in bankruptcy; public offerings of franchise ownership interests; and claims often arising in connection with transfers or franchisors’ refusal to consent to proposed transfers. Certain of these considerations have been addressed previously in the Forum. This paper builds upon and updates these previous works.

II. PROHIBITIONS ON FRANCHISOR RESTRICTIONS ON TRANSFER

A. Franchise Relationship Laws

Various states have enacted “franchise relationship” statutes, which govern various aspects of the franchisor-franchisee relationship. Nine such states specifically address the issue of franchise transfers. Those statutes strengthen franchisees’ rights by prohibiting the franchisor from refusing to permit transfer of the franchise without good reason (articulated in various ways).

1. Arkansas

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1 See Brian Balconi & Kevin M. Shelley, Legal Issues Surrounding Transfers, Assignments and Resale Programs, ABA 32nd ANNUAL FORUM ON FRANCHISING (2009); Claudia K. Levitas & Allan P. Hillman, Hot Topics on Transfer and Assignment by Franchisees, ABA 28TH ANNUAL FORUM ON FRANCHISING (2005).
In Arkansas, the franchisor has 60 days after receipt of notice from the franchisee to either approve the transfer or advise the franchisee of the unacceptability of his/her proposed transferee, in writing, and any disapproval must set forth a material reason relating to the character, financial ability, or business experience of the proposed transferee. If the franchisor does not reply within the specified 60-day period, approval is deemed granted. Furthermore, the transferee must agree in writing to comply with all of the requirements of the franchise then in effect.²

2. **California**

California bars a franchisor from denying the surviving spouse, heirs, or estate of a deceased franchisee (or the majority shareholder of the franchisee) the opportunity to succeed the franchisee for a reasonable time after the death of the franchisee (or majority shareholder of the franchisee). The surviving person must satisfy the franchisor’s then current standards for new franchisees and maintain all standards and obligations of the franchise. This does not prohibit the franchisor from exercising its right of first refusal to purchase a franchise after receiving a bona fide offer to purchase the franchise by a proposed purchaser of the franchise.³

3. **Hawaii**

The Hawaii statute provides that a franchisor may not decline to permit a transfer of ownership of a franchise except for "good cause." “Good cause” is a defined term and includes, but is not limited to, the failure of a proposed transferee to meet any of the franchisor’s reasonable qualifications or standards then in effect for a franchisee, the fact that the proposed transferee (or any affiliated person of the proposed transferee) is a competitor of the franchisor, the fact that the proposed transferee will not agree in writing to comply with all lawful obligations imposed by the franchisor or refuses to sign the current form of franchise agreement, or the failure of the transferor or proposed transferee to pay any sums owing to the franchisor and to cure any default in the then-existing franchise agreement. This list is non-exhaustive; thus a franchisor may otherwise prove that its reasons for refusal of approval are based upon good cause. The franchisor must approve or disapprove, in writing, a transfer within 30 days after being given written notification of a proposed transfer. Failure of the franchisor to approve or disapprove a proposed transfer in writing within such period will be deemed approval of the transfer.⁴

It should be noted that Hawaii incorporates the concept of good faith into its statute, thus a franchisor must act in good faith when considering a request by a franchisee to transfer its franchise.⁵

4. **Indiana**

Indiana prohibits franchisors from denying the surviving spouse, heirs, or estate of a deceased franchisee the opportunity to participate in the ownership of the franchise for a

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⁵ Id. § 482E-6(1) (“The parties shall deal with each other in good faith.”).
reasonable time after the death of the franchisee, provided that the survivor maintains all standards and obligations of the franchise.⁶

5. **Iowa**

Iowa requires a franchisor not to restrict a transfer if the transferee satisfies the reasonable current qualifications of the franchisor for new franchisees. A “reasonable current qualification” for a new franchisee is a qualification based upon a legitimate business reason. Where the proposed transferee does not meet those reasonable qualifications, the franchisor may refuse to permit the transfer as long as the refusal is not “arbitrary or capricious.”⁷

In addition, the Iowa statute expressly permits a franchisor to condition its consent to transfer upon any of the following: (a) the proposed transferee’s completion of the franchisor’s training program; (b) the payment of a transfer fee to the franchisor for reimbursement of the franchisor’s reasonable and actual expenses attributable to the transfer; (c) a requirement that the franchisee pay or make provisions reasonably acceptable to the franchisor to pay any amount due the franchisor or any of its affiliates; or (d) the financial terms of the transfer complying at the time of the transfer with the franchisor’s then-current financial requirements for franchisees.⁸

A transfer by a franchisee will be deemed approved 60 days after the franchisee submits the request for consent to the transfer to the franchisor, unless the franchisor withholds consent, in which case it shall do so in writing and specify the reason(s) for withholding consent. The written notice must be delivered to the franchisee prior to the expiration of the 60-day period.⁹

A franchisor may exercise a right of first refusal contained in a franchise agreement after receipt of a proposal from the franchisee to transfer the franchise.¹⁰

Noteworthy, the Iowa statute provides that none of the following occurrences are considered transfers which require the franchisor’s consent under a franchise agreement, and therefore, shall not result in the imposition of any penalties or make applicable any right of first refusal by the franchisor:

a. The succession of ownership of a franchise upon the death or disability of a franchisee, or of an owner of a franchise, to the surviving spouse, heir, or a partner active in the management of the franchise unless the successor fails to meet within one year the then current reasonable qualifications of the franchisor for franchisees and the enforcement of the reasonable current qualifications is not arbitrary or capricious.

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⁸ Id. §§ 523H.5(3), 537A.10(5)(c).
⁹ Id. §§ 523H.5(7), 537A.10(5)(e).
¹⁰ Id. § 523H.5(2).
b. Incorporation of a proprietorship franchisee, provided that such incorporation does not prohibit a franchisor from requiring a personal guaranty by the franchisee of obligations related to the franchise.

c. A transfer within an existing ownership group of a franchise provided that more than fifty percent of the franchise is held by persons who meet the franchisor's reasonable current qualifications for franchisees. If less than fifty percent of the franchise would be owned by persons who meet the franchisor's reasonable current qualifications, the franchisor may refuse to authorize the transfer, provided that enforcement of the reasonable current qualifications is not arbitrary or capricious.

d. A transfer of less than a controlling interest in the franchise to the franchisee's spouse or child or children, provided that more than fifty percent of the entire franchise is held by those who meet the franchisor's reasonable current qualifications. If less than fifty percent of the franchise would be owned by persons who meet the franchisor's reasonable current qualifications, the franchisor may refuse to authorize the transfer, provided that enforcement of the reasonable current qualifications is not arbitrary or capricious.

e. A transfer of less than a controlling interest in the franchise of an employee stock ownership plan, or employee incentive plan, provided that more than fifty percent of the entire franchise is held by those who meet the franchisor's reasonable current qualifications for franchisees. If less than fifty percent would be owned by persons who meet the franchisor's reasonable current qualifications, the franchisor may refuse to authorize the transfer, provided that enforcement of the reasonable current qualifications is not arbitrary or capricious.

f. A grant or retention of a security interest in the franchised business or its assets, or an ownership interest in the franchisee, provided the security agreement establishes an obligation on the part of the secured party enforceable by the franchisor to give the franchisor notice of the secured party's intent to foreclose on the collateral simultaneously with notice to the franchisee, and a reasonable opportunity to redeem the interests of the secured party and recover the secured party's interest in the franchise or franchised business by paying the secured obligation.\footnote{Id. §§ 523H.5(12)(a)-(f), 537A.10(5).}

Additionally, like Hawaii, Iowa also incorporates the duty of good faith into its statute, defining “good faith” as “honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.”\footnote{Id. §§ 523H.10, 537A.10(11).} Accordingly, a franchisor must act in good faith when considering a franchisee’s request to transfer its franchise.
6. **Michigan**

The Michigan statute also requires good cause for transfer disapproval by a franchisor, which includes the failure of the transferee to meet the franchisor’s reasonable qualifications or standards, the fact that the transferee is a competitor of the franchisor, the transferee’s refusal to agree in writing to comply with all lawful obligations, and the failure of the franchisee or proposed transferee to pay any sums owing to the franchisor or to cure any default in the then-existing franchise agreement.\(^\text{13}\) This list is non-exhaustive, and the franchisor can otherwise prove good cause for transfer disapproval.

7. **Minnesota**

Minnesota simply states that a franchisor may not unreasonably withhold consent to transfer if the transferee meets the franchisor’s then-current qualifications and standards.\(^\text{14}\)

8. **Nebraska**

The Nebraska franchise relationship statute provides the franchisor 60 days after notice from the franchisee to either approve or advise the franchisee of the unacceptability of his/her transferee, in writing, articulating material reasons relating to the character, financial ability, or business experience of the proposed transferee. If the franchisor does not reply within the 60-day period, approval is deemed granted. Furthermore, the transferee must agree in writing to comply with all the requirements of the franchise then in effect.\(^\text{15}\)

9. **New Jersey**

The applicable New Jersey statute is the same as the Nebraska statute.\(^\text{16}\)

**B. Industry-Specific Statutes**

Analogous transfer restrictions have been statutorily enacted within specific industries. Practically every state has enacted legislation limiting the restrictions a franchisor may impose on the transfer of a franchise in the motor vehicle industry,\(^\text{17}\) and at least thirty (30) states

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\(^{16}\) N.J. Rev. Stat. § 56:10-6 (2013); see Maple Shade Motor Corp. v. Kia Motors Am. Inc., 260 Fed. Appx. 517, 518-19 (3d Cir. 2008) (affirming summary judgment in favor of franchisor, upholding the franchisor’s rejection of a proposed transfer under the New Jersey Franchise Practices Act because (1) the proposed transferee of a Kia car franchise lacked the exclusive showroom required under the terms of the franchise agreement, and (2) the franchisee had no franchise rights to transfer free and clear to a third party as, pursuant to a consent agreement between the franchisor and franchisee, the franchisor only agreed to maintain the status quo, thus franchisee had only an interest subject to a notice of termination).

\(^{17}\) All states have imposed statutory limitations on the restrictions a franchisor may impose on the transfer of a franchise in the motor vehicle industry, except for the following states: HI, ID, MS, NE, ND, SC, and TN. SC and TN have additionally limited transfer restrictions for a franchise in the motorcycle industry.
regulate franchise transfers in the beer, wine, or liquor industries. A non-exhaustive list of industries affected by statutes governing transfer includes the beverage (soft drinks, liquor, wine, beer, and malt beverages), equipment (office, agricultural, heavy or construction, and outdoor power equipment), motor vehicle, and recreational vehicle and products (motorcycles, powersport vehicles, all-terrain vehicles, vessels, watercraft and outboard motors, marine products, trailers, and mobile homes) industries.

Although the statutes vary from state to state and industry to industry, these statutes usually prohibit franchisors from unreasonably withholding consent to the transfer of a franchise in the specific industry regulated, some specify reasons why consent to a transfer may be withheld, and some even require that the franchisor communicate the material reasons for its refusal to consent to the transfer.

Moreover, several states regulate or restrict the use of a right of first refusal for motor vehicles, while at least one motor vehicle franchise statute outright prohibits the use of a right of first refusal.

Therefore, clients and counsel representing clients in the regulated industries should be aware of these industry specific regulations and the restrictions they impose on the sale, transfer, or assignment of a franchise.

C. Case Law Applying Statutory Transfer Restrictions

If a franchisee’s written notice of transfer is required by the franchise agreement, a court may not look any further as to whether the franchisor unreasonably withheld consent if no such written transfer request is provided by the franchisee. In H-D Michigan, LLC v. Sovie’s Cycle Shop, Inc., the franchisee-dealer asserted that the franchisor violated the New York Franchised Motor Vehicle Act when the franchisor unreasonably withheld its consent to transfer to the franchisee’s wife and children after the franchisee received notice of termination. The court found that the language of the contract required the franchisee to provide written notice of the proposed transfer, and since the franchisee never submitted a written request to transfer the

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18 States that have not regulated franchise transfers in the beer, wine, or liquor industries are as follows: AK, AZ, DE, GA, HI, ID, KS, KY, ME, MD, MA, MO, NM, OK, SD, and WI.

19 A franchisor may not unreasonably withhold consent to transfer in the following industries: beverage industry: AL, AR, CA, FL, IL, IA, LA, MN, MS, MT, NE, NV, NH, NJ, NY, NC, ND, RI, TX, UT, VA, WA, WV, and WY; equipment industry: CA, CO, CT, FL, GA, ID, ME, MA, MI, MO, MT, NH, NY, OK, OR, RI, TX, UT, VT, VA, and WA; motor vehicle industry: CA, CT, DE, FL, IN, KS, KY, LA, MD, MN, NM, NY, OK, OR, PA, RI, SD, TX, UT, WA, WV, and WY; and recreational vehicle and products industry: CA, ME, MI, MO, and TX.

20 The industries in which states have specified reasons why consent to transfer may be withheld are as follows: agricultural equipment industry: WA; and motor vehicle industry: MN and UT.

21 Franchisors must state material reasons for withholding consent in the following industries and states: agricultural equipment industry: CO, MT, and PA; and motor vehicle industry: KS.

22 IA prohibits the use of a right of first refusal for motor vehicles. In addition, the following states regulate or restrict the use of a right of first refusal for motor vehicles: AL, AZ, GA, KS, LA, MA, MN, MT, NV, NJ, NC, OR, SD, VA, and WI.


24 Id. at 278-79.
franchise (though he did orally request it), the franchisor “cannot be said to have unreasonably withheld consent where it never received a proper request to transfer the franchise.”

Additionally, the court reasoned the franchisor’s refusal of the oral transfer request was not unreasonable because it was made after the franchise was already the subject of a termination notice. Under these circumstances, the court concluded the franchisor did not unreasonably withhold its consent to transfer.

On the same note, in Shieh v. Kumon North America, Inc., the Northern District of California denied the franchisee’s action for injunctive and declaratory relief, which requested that the franchisor be ordered to allow the franchisee to transfer the franchise to his wife, or alternatively, give him a reasonable amount of time to find a third party buyer, after the franchisee pled no contest to the battery of a minor child thereby terminating his franchise agreements. Although the franchise agreements provided that the franchisee could transfer the franchise if the transferee met specified requirements and the franchisor consented to the transfer, the agreements also expressly provided for automatic termination of the franchises without notice or right to cure in the event the franchisee pleaded no contest to a crime against a child under the age of 18. In denying injunctive relief, the court also noted that “any injury flowing from Kumon’s alleged breach of its obligations to permit Shieh to transfer his franchises is compensable by monetary damages.”

However, the franchisee’s failure to provide any required notice of transfer does not absolve the franchisor from its remaining statutory transfer obligations, including its obligation to act commercially reasonable and in good faith toward the franchisee. In Southeastern Distributing Co. v. Miller Brewing Co., the plaintiff operated a wholesale beer distributing company for the defendant franchisor. The franchisee alleged the franchisor had violated the Arkansas Beer Wholesaler’s Act and the Arkansas Franchise Practices Act because it was unable to market its business freely and was forced to sell for substantially less than fair market value. The franchisee claimed the franchisor did not act in good faith, as required under the Arkansas Franchise Practices Act, when it prevented the franchisee from selling its business to any purchaser other than the franchisor’s preferred purchaser; while the franchisor argued its obligations were never triggered because the franchisee failed to provide the required notice of intent to transfer under the statute.

25 Id. at 279.
26 Id.
27 Id.
29 Id. at *5. The franchisee also argued the franchisor was required to give notice of the termination under California law, despite the automatic termination provision of the franchise agreement, but the court disagreed and held that whether under New Jersey (choice of law provision) or California (state of franchise location) law, the franchisor complied with state law, having given such notice. Id. at *7.
30 Id. at *8.
32 Id. at 66-67.
33 Id. at 70-71.
franchisee failed to provide the required notice, it found that this did not release the franchisor from dealing with the franchise in a commercially reasonable manner and in good faith, reversing the trial court’s grant of summary judgment in favor of the franchisor.\textsuperscript{34} Likewise, despite agreeing that the franchisor’s obligation to review or approve any of the franchisee’s potential buyers was never triggered because the franchisee did not submit a written notice of intent to transfer to those buyers, as required under the Arkansas Beer Wholesaler’s Act, the court still concluded that the franchisee had a potential claim against the franchisor for forcing the franchisee’s resignation.\textsuperscript{35}

But if the franchisor’s disputed conduct in connection with a transfer request is permitted under the express terms of a contract, it will likely be found neither to breach the contract nor breach an implied covenant of good faith and fair dealing.\textsuperscript{36} In \textit{De Walshe v. Togo’s Eateries, Inc.}, the franchisee contended that the franchisor breached the implied covenant of good faith and fair dealing when it required the buyers to take an English Language Proficiency Assessment (“ELPA”), and therefore, unreasonably withheld its consent to transfer the franchise when the proposed buyers failed the ELPA test.\textsuperscript{37} The franchisee argued that the franchisor’s proficiency test was arbitrary and unreasonable but the court disagreed and found the test requirement reasonable on four bases: (1) given that franchisees are required to complete training, understand and comply with corporate operation instructions, communicate with suppliers, and interact with customers, it was reasonable to require franchisees to be proficient in both written and spoken English; (2) the language of the franchise agreement stated that it was at the “absolute discretion” of the franchisor to require the assignee to enter into the franchisor’s then current standard form of the franchise agreement, which included the ELPA requirement; (3) the franchisee had already agreed that any proposed transferee of his franchise would need to meet the ELPA requirement when it agreed to follow the franchisor’s “system requirements relative to . . . operations and all other aspects of the conduct of the franchise business and to accept such requirements as an integral aspect of the rights licensed herein”; and (4) the franchisee and buyer had already expressly agreed to the ELPA requirement in the rider to the contract for sale.\textsuperscript{38} Because the express terms of the agreement provided the franchisor with “absolute discretion” to require the buyers to agree to the terms of its “then current” franchise agreement, which included the ELPA requirement, the court also found that the franchisor’s conduct did not violate the implied covenant of good faith.\textsuperscript{39} Therefore, the court granted summary judgment in favor of the franchisor on these claims.\textsuperscript{40}

\begin{itemize}
  \item[34] \textit{Id.} at 71, 76.
  \item[35] \textit{Id.} at 72-73.
  \item[36] \textit{De Walshe v. Togo’s Eateries, Inc.}, 567 F. Supp. 2d 1198, 1204 (C.D. Cal. 2008); \textit{but see} \textit{Ganley v. Mazda Motor of Am., Inc.}, 367 Fed. Appx. 616, 624-27 (6th Cir. 2010) (holding that the franchisor’s refusal to approve a transfer proposal, by deviating from its usual transfer evaluation criteria, was not unreasonable under either the Ohio Motor Vehicle Dealers Act or the parties’ agreement providing that consent to transfer “shall not be unreasonably withheld,” because the franchise agreement had already terminated for good cause given that the franchise was extremely unprofitable and the proposal did not involve significant changes for turning the franchise around).
  \item[37] \textit{De Walshe}, 567 F. Supp. 2d at 1200-01.
  \item[38] \textit{Id.} at 1202-03.
  \item[39] \textit{Id.} at 1204.
  \item[40] \textit{Id.} at 1205.
\end{itemize}
Similarly, a franchisor’s imposition of a customer satisfaction rating threshold is not a per se unreasonable restriction on a franchisee’s right to transfer. In Gray v. Toyota Motor Sales, U.S.A., after being denied two times in the sale of its franchise on grounds that the prospective buyers had unsatisfactory consumer satisfaction ratings, the franchisee commenced action against the franchisor, asserting that the franchisor unreasonably withheld its consent to transfer and forced the franchisee to sell the franchise to a third purchaser for less than what the other two purchasers were willing to pay. Disagreeing, the court found that the franchisor’s criterion of evaluating the prospective buyers’ customer satisfaction index was an acceptable reason to deny the transfer because “[c]ustomer goodwill is critical to any business;” hence, it was logical for the franchisor to be concerned about its dealers’ ability to satisfy their customers. For these reasons, the court held there was no breach of contract from the franchisor withholding its consent to the proposed sale and also dismissed the franchisee’s breach of covenant of good faith and fair dealing claim, reasoning that such a claim was redundant of the dismissed breach of contract claim.

D. Standing Related to Transfers of Franchises

In determining who has standing to sue under the various state franchise transfer laws, the starting point must always be the statute. In general, the express purpose of the various statutes is to regulate the relationship between the franchisor and its franchisee and protect actual franchisees. Therefore, unless a state statute provides otherwise (which is rare), and even if it has suffered an injury in fact, the proposed transferee of a franchise will not have standing to sue the franchisor who disapproves the transfer or otherwise fails to act in good faith in consenting to the transfer.

E. The Federal Petroleum Marketing Practices Act

In enacting the Petroleum Marketing Practices Act ("PMPA"), Congress sought to balance the marketing power between distributors of petroleum products and their franchisees

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41 See Long John Silver's Inc. v. Nickleson, No. 3:11-CV-93-H, 2013 U.S. Dist. LEXIS 18391, at *10-14 (W.D. Ky. Feb. 12, 2013) (holding that for common law fraud claims brought under Kentucky and Minnesota law and Minnesota Franchise Act claim, only the signatory franchisee had standing to sue; dismissing third parties, even an individual who executed a personal guarantee for the signatory franchisee, because they were neither parties or third party beneficiaries to the franchise agreement); Fresno Motors, LLC v. Mercedes-Benz USA, LLC, 852 F. Supp. 2d 1280, 1303-07 (E.D. Cal. 2012) (prospective transferees had no standing under the California Vehicle Code); Tacoma Auto Mall, Inc. v. Nissan N. Am., Inc., 279 P.3d 487, 491, 493 (Wash. Ct. App. 2012) ("[T]he purpose and design of the Washington manufacturers’ and dealers’ franchise agreements act 'is to protect selling dealers rather than prospective purchasers[.]") (holding that prospective purchaser was not “within the zone of interests the statute in question protects,” and did not have “standing under the act”); cf. Bowser Cadillac, LLC v. Gen. Motors Corp., No. 07-1149, 2008 U.S. Dist. LEXIS 54906, at *20 (W.D. Pa. July 18, 2008) (prospective purchaser who was also a dealer had standing to bring claim under the Pennsylvania Board of Vehicles Act); but see Wingate Inns Int'l, Inc. v. Cypress Centre Hotels, LLC, No. 11-6287 (ES), 2012 U.S. Dist. LEXIS 179345, at *15-21 (D.N.J. Dec. 19, 2012) (holding that guarantor of franchisee had standing to assert counterclaim against franchisor for breach of the franchise agreement under exception to general rule that a guarantor lacks standing to assert the principal's claims against its franchisor, namely that the franchisor sued both the principal franchisee and guarantor).
by giving franchisees certain protections from arbitrary or unfair termination or nonrenewal.\textsuperscript{46} The PMPA governs two aspects of a petroleum franchise relationship: the circumstances in which franchisors may terminate a franchise or decline to renew a franchise relationship.\textsuperscript{47} A franchisor may decline to terminate a franchise or decline to renew a franchise, and thereafter, decide to sell such franchise if such determination is made by the franchisor in good faith and in the normal course of business.\textsuperscript{48} If the premises are leased, a franchisor must either “make a bona fide offer to sell, transfer, or assign franchisor’s interest;” or, if applicable, “offer the franchisee a right of first refusal.”\textsuperscript{49} The right of first refusal must be extended to the franchisee within the 90 day period following notice of non-renewal of the franchise and the right of first refusal must be of at least 45-days duration of an offer.\textsuperscript{50} Under the PMPA, the franchisee has the burden of proving the termination of the franchise and the franchisor bears the burden of producing evidence that the termination or non-renewal was permitted under Section 2802(b).\textsuperscript{51}

Under the PMPA, if the franchisor imposes restrictions on the transfer of a franchise, such restrictions must clearly interfere with the franchisee’s ability to operate the franchise in order for the franchisee to maintain a claim of improper transfer.\textsuperscript{52} In Caputo v. BP West Coast Productions, the franchisor initially refused to renew the franchisee’s agreement, subsequently attempted to sell the franchise gas station to third party buyers, but then offered the franchisee a right of first refusal, which the franchisee exercised, purchasing the gas station facility.\textsuperscript{53} The franchisee claimed, in pertinent part, that the franchisor failed to make a bona fide offer to transfer its complete interest to potential buyers and failed to grant the franchisee a right of first refusal because the franchisor’s proffered grant deed to potential buyers did not convey all of the franchisor’s interest in the property, as it contained a variety of restrictions (including a reservation of mineral rights) on what could be built.\textsuperscript{54} In addition, the franchisee alleged that the buyers were not ready, willing, and able, and thus, the right of first refusal was improper, because the buyers had not secured a loan to purchase the facility before their bid was accepted by the franchisor and that given contamination on the site, their likelihood of securing a loan to purchase the facility was slim.\textsuperscript{55} Despite all these allegations, the court discounted the franchisee’s “ready, willing and able buyer” argument because the buyers had other sources of cash for the purchase; held that the franchisor complied with its PMPA obligations because the complete interest transfer requirement was between the franchisor and franchisee (not the franchisor and third party buyers); and found none of the franchisor-imposed restrictions,

\textsuperscript{46} 15 U.S.C. § 2801 et seq.
\textsuperscript{47} 15 U.S.C. § 2802(b).
\textsuperscript{48} Id. § 2802(b)(3)(D).
\textsuperscript{49} Id. § 2802(b)(3)(D)(iii).
\textsuperscript{50} Id. § 2802(b)(3)(D)(iii)(I)-(II).
\textsuperscript{52} Caputo, 2012 U.S. Dist. LEXIS 138702, at *19-21.
\textsuperscript{53} Id. at *1-5.
\textsuperscript{54} Id. at *17, *19-20.
\textsuperscript{55} Id. at *17-18.
including the reservation of mineral rights, interfered with the franchisee’s ability to operate the
facility. Additionally, condemnation of a franchise is considered a reasonable basis for a
franchisor to withhold its consent to transfer under the PMPA. In Singh v. BP Productions
North America, Inc., in the course of their dealings, the franchisee notified his franchisor of a
proposed buyer for the franchised gas station, granting the franchisor its contractual opportunity
to exercise its right of first refusal pursuant to the lease agreement between the franchisee and
franchisor. The franchisor declined to exercise its right of first refusal, but still refused to
consent to the proposed sale, terminating the franchise agreement about one year later, without
nonrenewal, due to condemnation of part of the leased premises. The court determined that
the termination was reasonable given the language in the statute providing for termination in the
event of condemnation, in whole or in part, of the marketing premises. Consequently, the court
held that the franchisor did not act in an unreasonable manner in withholding its consent to the
proposed sale of the franchise because the franchisor had legitimate business concerns about
the impact of condemnation, including consumer safety and necessary reconfiguration of the
gas station.

III. WHY DRAFTING IS IMPORTANT

Franchisors can control the conditions under which a franchisee can transfer or assign
the franchise agreement and the conditions under which the franchisor may, or must, approve
the transfer or assignment. When the franchise agreement contains a provision regarding the
conditions pursuant to which the franchisee can transfer, the franchisor must realize that in that
agreement, it is setting the standard for its own actions when evaluating a proposed transfer.
The franchisor, then, must be cognizant of its statutory obligations, any industry regulations that
apply to its business, and good faith or reasonableness obligations. Some franchise
agreements state that the franchisor’s consent to transfer “will not be unreasonably withheld.”
This limitation is required if the franchisor wishes to be on the Small Business Administration
Franchise Registry.

Initially, in the disclosure document and franchise agreement, the franchisor can, and
should, define transfer and assignment. For the purposes of this paper, transfer has its literal
meaning - any direct or indirect change of ownership – and is synonymous with assignment.
But for purposes of a franchise agreement, these terms may take on a more specific meaning.
For example, it may be in the franchisor’s interest to define transfer to mean a change in
ownership that is above a certain threshold, such as to change control of the franchised
business. A transfer provision might specify that it applies to any change in the ownership of
50% or more of the ownership interest in the franchise. It might further specify whether the

56 Id. at *20-21.
57 Id. at 21.
59 Id. at *4-6.
60 Id.
61 Id. at *11 (citing 15 U.S.C. § 2802(c)(5)).
62 Id. at *18-20.
provision applies to the addition of a partner or investor. Some franchisors specify that the transfer provision applies if there will be a change of 25% interest or greater.

Inevitably, disputes related to the proposed transfer of a franchise are dominated by the issue of whether the consent was “unreasonably withheld.” Franchisors should understand that if they intend to wield unlimited and sole discretion to disapprove a transfer for any reason whatsoever, the franchise agreement should state that exactly and should recite no specific conditions. Often though, franchisors impose conditions precedent to transfer or assignment to a third party. These conditions typically include a minimum time in the system before a franchisee can apply to transfer. For example, “After three years, you [franchisee] may transfer or assign…provided…” or, “You [franchisee] may not transfer this agreement for one (1) year.”

Most franchise agreements that contain a transfer provision state that the franchise business cannot be transferred without the prior written consent of the franchisor. Some go on to provide that provided the contractual conditions set out in the transfer provision are satisfied, the consent will not be unreasonably withheld.

It is sound practice for franchisors to exercise discretion with respect to proposed transfers consistent with the implied covenant of good faith and fair dealing. Doing so will likely save time and money later. Franchise litigators often debate whether the contractual grant of a right to disapprove a transfer permits the franchisor to disapprove without regard to the motive for exercising the right. If the franchisor clearly acts in good faith, the lawyers’ debate may be stymied.

The requirements for the transferee's qualifications and how they are investigated are also appropriate in the transfer provision. Drafting becomes important in this regard for many reasons. If the franchisor is too stringent, it may find its hands tied or encounter scenarios in which it is making exceptions more often than it would like. When the market presents a challenge for franchise sales, more lenient requirements for prospective transferees are preferable to a near-inability to transfer at all.

Franchisors are wise to use terms in this regard that are not exhaustive. The clearest approach is probably to simply state in the transfer provision, “This list is not exhaustive.” Another example is using the phrase “such as”, which could also be to the franchisor’s benefit if a dispute arises about its refusal to consent to a transfer. By conditioning approval upon the “transferee's qualifications, such as financial condition, education and experience, and good moral character…” the franchisor arguably affords itself broad discretion.

Absent such language, the franchisor may not have complete discretion with respect to a proposed transfer. A transferor franchisee whose application to transfer was denied will undoubtedly argue that if the articulated conditions are met, the franchisor must consent to the transfer. Culligan Soft Water Service of Inglewood, Inc. v. Culligan International Co. is directly on point. In Culligan, the parties’ agreement required the defendant franchisor to consent to the transfer of the franchise agreement if “in the reasonable determination of [the franchisor], [the proposed transferees] are financially qualified, without conflicting interest, and possess the essential personal qualifications and business competence, skill, integrity and character for successfully performing the functions of a SERVICE DEALER pursuant to this Agreement.”

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63 Culligan Soft Water Serv. of Inglewood, Inc. v. Culligan Int'l Co., 288 N.W.2d 213 (Minn. 1979).

64 Id. at 217.
The court noted that the agreement did allow the franchisor some discretion in deciding whether to consent to the transfer, but held that the remaining language of the provision listed specifications that defined reasonability, such that it was unreasonable for the franchisor to refuse to consent where the transferee met those specifications. The defendant franchisor drafted the agreement and the plaintiffs proved by a preponderance of the evidence that the proposed transferee met the specific criteria the defendant laid out in the contract. Thus, the court ruled that the trial court’s findings that the proposed assignees were qualified to assume the Agreement and that the defendant’s consent was unreasonably withheld were not clearly erroneous.

Likewise, where a Dairy Queen franchise agreement provided that “the interest of Licensee…may not be transferred…without…consent of Company (franchisor), which consent shall not be withheld unreasonably, but Company may insist that any proposed assignee be a person, in Company’s judgment, qualified to provide active supervision…. The court held that if the proposed transferees were able to “provide active supervision,” Dairy Queen “must accept them as assignees.”

In Larese v. Creamland Dairies, Inc., the Tenth Circuit Court of Appeals reversed a Colorado District Court holding that a franchisor did not have an absolute right to refuse its consent to the sale of franchisees’ interests to another prospective franchisee. The Court determined that although a provision which expressly grants to the franchisor an absolute right to refuse consent may be enforceable, that sort of absolute right does not exist in a provision that simply provides that the franchisee must obtain franchisor consent prior to transfer. "Rather," the Court said, "the franchisor must bargain for a provision expressly granting the right to withhold consent unreasonably, to insure that the franchisee is put on notice.

A. Common Conditions Precedent To Transfer

Commonly, franchisors impose conditions that further the purpose of protecting the system, the good will and the marks. These include that the proposed transferee: meets certain financial requirements and has a satisfactory credit rating; meets the franchisor’s educational requirements or has a certain level of experience in the relevant industry; has demonstrated management ability; is of good moral character; passes the franchisor’s standardized test(s); and, provides a written and/or oral proposal for the maintenance and development of the franchised business.

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65 Id. at 218.
66 Id.
67 Id.
69 Id. at 510; see also Larese v. Creamland Dairies, Inc., 767 F.2d 716 (10th Cir. 1985); Burger King Corp. v. Ashland Equities, Inc., 161 F.Supp.2d 1331 (S.D. Fla. 2001).
70 Larese, 767 F.2d at 718.
71 Id.
72 Id.
It is also typical for the franchisor to require that all accounts of the seller and the buyer, if he/she is an existing franchisee, are current. This would normally include all royalties and advertising fund payments, lease payments, loan payments, vendor accounts, and anything else related to the operation of the franchised business for which the franchisor may be on-the-hook. From a practical standpoint, this is important because once a franchisee is out of the system it is exponentially more difficult for the franchisor to collect amounts due. The broadly stated requirement that the transferor may not be in default is lawful.

Generally, a franchisor has a right to withhold consent to transfer if the transferor is in default or subject to termination. Franchisors are mindful though that it sometimes makes sense to permit a transfer by a problem-franchisee if the transferee is a qualified candidate likely to run a profitable franchised business in compliance with the franchisor’s system. Oftentimes in such a scenario a franchisor can collect sums due, such as unpaid royalties, from the purchase price paid.

In Dunkin Donuts, Inc. v. Sharif, Inc., the Dunkin’ Donuts franchisor withheld consent to a transfer between two defaulting franchisees. The district court held that the franchisor did not unreasonably withhold its consent to the transfer for at least four independent reasons. The Court of Appeals agreed that the transferor’s claim that the franchisor acted unreasonably in not approving the proposed sale should fail, noting that it needed to only accept one of the district court’s reasons to affirm. The franchisor was justified in withholding its consent because the proposed buyer was in default of a franchise agreement he already had with Dunkin’ Donuts. “Under the Franchise Agreement, Dunkin’ Donuts was not allowed to ‘unreasonably withhold its consent to any transfer’ as long as “[t]he transferee . . . shall have a good credit rating and business qualifications reasonably acceptable to Dunkin’ Donuts.” Dunkin’ Donuts provided evidence that the proposed purchaser had failed to report gross sales of one of his units and failed to pay fees owed to the franchisor. Crediting the evidence the court wrote, “Under these circumstances, we agree with the district court that no reasonable jury could conclude that Dunkin’ Donuts violated the Franchise Agreement by unreasonably withholding its consent to the June 25, 2003 proposed transfer agreement.”

It is also a common condition that the transferee be willing to reside in the specific state, country, or region where the franchise is located. While at first glance this may sound controversial, in most instances franchisors have a legitimate interest in assuring themselves

74 Id. at 813.
75 Id.
76 Id. at 814.
77 Id. at 813.
78 Id. at 814.
79 Id.
80 Id.
81 Id.
that franchisees are present in the business and that the transferee the franchisor is approving is the person who will run the business. It also may be reasonable for a franchisor to require that the proposed transferee pass an English language test.  

Franchisors can also protect their interest by refusing approval based on a franchisee’s refusal to agree to certain terms. The Court of Appeals of Michigan held that it is commercially reasonable for a franchisor to require a franchisee to resolve all non-Michigan Franchise Investment Law disputes that the franchisee has with the franchisor before the franchisor approves a transfer of a franchise.  

Another common condition to transfer requires the payment of a transfer fee. The transfer fee may be a fixed amount, a percentage of the current franchise fee, or a percentage of the purchase price. In theory, this fee covers the franchisor’s expenses relating to the review of the proposed transfer, the preparation of related documents, and training the new franchisee. In reality, franchisees are increasingly arguing that these fees are a windfall to the franchisor, which may use “canned” documents and push training responsibilities on to local management or area development personnel.

In some instances, the franchise agreement transfer provision specifies that the transfer fee must be paid by the transferor. As a result, the seller often incorporates the transfer fee into the purchase price. This brings us then to the price.

1. The Price

Franchisees bristle at the notion that the franchisor has any right to see, never mind approve, the purchase price and terms of the transfer. Franchisors argue that they have an interest in ensuring that the purchaser can survive; if the purchase price and related terms are too burdensome, the new franchisee will not thrive and may even fail.

Another condition of transfer that may be incorporated into a franchise agreement, therefore, is a guaranty of performance. Particularly where the purchaser is heavily indebted in connection with the purchase, franchisors are increasingly seeking individual guaranties from buyers, investors, and even sellers. Successful franchisees seeking to transfer are increasingly pressured to “take paper” themselves, thus carrying more of the risk of the failure of the franchised business after transfer. Undoubtedly, franchisors hope that the franchisee with proven success will step into a failing unit and generate profits to its own benefit, and that of the franchisor.

By drafting a specific provision in the franchise agreement that allows the franchisor to communicate with prospective purchasers about the purchase price, franchisors can further protect their interests when deciding whether to approve a proposed transfer. In Bill Call Ford, Inc. v. Ford Motor Co., an automobile dealership agreement gave the franchisor privilege to tell the prospective buyer that the asking price for the franchisee’s assets was too high. The contractual right to do so precluded the franchisee’s claim of tortious interference against the

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82 De Walshe v. Togo’s Eateries, Inc., 567 F. Supp. 2d 1198, 1202-03 (C.D. Cal. 2008) (holding that the franchisor’s requirement that prospective buyers pass an English Language Proficiency Assessment was enforceable).


franchisor. A tortious interference claim could only survive if the franchisee put on evidence that the franchisor’s statements were untruthful, malicious, or did not fall within the plain language of the franchise agreement.

Specifically, the agreement in *Bill Call Ford* provided:

If, in the opinion of the Company, the price to be paid for such assets appears, on the basis of the average operating results of other dealers, to result in an unsatisfactory return on investment so that such prospective purchaser (1) may not remain as a dealer, or (2) may be impelled to sell COMPANY PRODUCTS at high noncompetitive prices with a probable reduction in sales volume, the Company may, without liability to the Dealer, counsel with such prospective purchaser regarding such opinions.

Because of this language, the court granted summary judgment as to the franchisee’s claim against the franchisor for tortious interference with contract.

2. **Issues Related to Disclosure**

Another often imposed condition is that the transferee receives and reads the franchisor’s Franchise Disclosure Document. Increasingly, franchisors are also requiring that the transferee sign the franchisor’s then-current franchise agreement. While it is often in the best interest of the system that new franchisees sign the newest form of agreement, this is an area where disputes arise in the context of transfers. There will likely be a difference between the term remaining on the seller’s contract and the term of the then-current form agreement. This difference may be more of an issue when it comes to area developers and distributors, but the key is how the term affects the value of the asset.

Some franchisors have addressed this issue by indicating in the transfer provision, and elsewhere in the franchise agreement, that the execution of the new agreement by the transferee will not change the term. That is to say, the buyer only receives the amount of time that the seller has remaining on the contract. But, this may not be enough to prevent disputes. For example, consider the following common scenario: A franchisee is close to the end of his term and wants to transfer, perhaps because he wants to retire, and certainly because he wants to maximize his investment and profit as much as possible from having built the business. The question is what can that franchisee sell? Between the buyer and seller, one or both bear the risk that the franchisor will not renew the franchise. If the franchisor will not commit to renewal, or if it is too soon to tell, the value of the franchise is significantly depressed relative to the value of a contract with a renewal. The scenario is further complicated in states where the franchise law compels renewal, absent good cause, and in systems where traditionally franchisees receive renewals and arguably a pattern and practice has developed over time.

Other complications arise in situations where the franchisor is not currently selling and does not have a current Franchise Disclosure Document or is not properly registered in the

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85 Id. at 1064.
86 Id.
87 Id. at 1064.
88 Id. at 1066.
state where the transfer will occur. If a transferee acquires an interest in a franchise and later discovers that the franchisor is not registered, it should not wait to seek rescission.

_Fargo Biltmore Motor Hotel Corp. v. Best Western International, Inc._ is instructive. Best Western offers memberships to individuals. Members have the right to use the Best Western name and marks and receive room reservations through the franchisor's reservations center. If the hotel property is owned by a corporation, then the corporation designates an individual to be the member. Membership automatically terminates when fifty percent or more of the stock of a corporation owning the hotel property is transferred. Plaintiff John Olness acquired ninety-five percent of the stock in Fargo Biltmore. Best Western informed Olness that the change in ownership resulted in automatic termination of the Best Western membership and Olness would have to apply for membership. Best Western accepted Olness' membership application but repeatedly told him that his hotel was deficient and needed to be corrected.

Olness' attorney learned that Best Western was not registered to sell franchises in North Dakota. When Best Western cancelled Olness' membership, Olness alleged that Best Western violated the North Dakota Franchise Investment Law (NDFIL) when it sold an unregistered franchise, failed to provide Olness with a prospectus, failed to have registered sales persons, and failed to disclose necessary facts.

Nevertheless, Olness was estopped from asserting his claims against the franchisor under the NDFIL because he did not seek rescission of his membership agreement when he first learned that the franchisor was not registered. Instead he informed the franchisor that he intended to continue improving the hotel and continued to take advantage of membership benefits even though he stopped paying for them. Accordingly, a transferee with grounds to seek rescission should do so immediately upon learning of the facts that support the claim.

Franchisors are also cautioned against orally consenting to transfer. In most cases where a franchisee or prospective franchisee sues the franchisor for withholding consent to franchise transfer, the plaintiff brings an action for tortious interference with contractual relations, tortious interference with prospective business advantage, or both. In _Superlease Rent-A-Car, Inc. v. Budget Rent-A-Car of Maryland, Inc._, the plaintiff had an oral agreement with

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89 Fargo Biltmore Motor Hotel Corp. v. Best Western Int'l, Inc., 742 F.2d 459 (8th Cir. 1984).

90 _Id._ at 461.

91 _Id._

92 _Id._

93 _Id._

94 _Id._

95 _Id._ at 462.

96 _Id._

97 _Id._

the existing franchisee for the purchase of the franchise. The franchise agreement provided that sale or transfer could occur only with Budget’s consent, and that consent could not be unreasonably withheld. Budget asked for additional information which the plaintiff claimed Budget knew was confidential. The plaintiff alleged that Budget used the nondisclosure of this confidential information to deny approval. Budget argued that supplying the financial information was a condition precedent to approval. Nevertheless, the court rejected this argument holding that when a condition requires the satisfaction or approval of the obligor, then the obligor’s exercise of judgment must be in accordance with the implied duty of good faith and fair dealing. Thus, franchisors are cautioned against orally consenting to transfer because even oral agreements require adherence to the implied duty of good faith and fair dealing and it is wise therefore to have a written record.

3. Releases and Waivers

Franchise agreements sometimes require releases and/or waivers from the transferor franchisee. Releases in connection with the transfer of a franchise are increasingly the subject of litigation. The fact that the underlying franchise agreement calls for the execution of releases at the time of renewal, transfer, or termination may support a franchisor’s claim that a release in its favor is valid.

It is important to consider the applicable law in this regard. At least one state prohibits franchisors from obligating a franchisee, as a condition to a transfer of a franchise, to relinquish any rights unrelated to the franchise proposed to be transferred or to enter into a release of claims that is not mutual. The Iowa Franchise Act states, “[a] franchisor, as a condition to a transfer of a franchise, shall not obligate a franchisee to undertake obligations or relinquish any rights unrelated to the franchise proposed to be transferred, or to enter into a release of claims broader than a similar release of claims by the franchisor against the franchisee which is entered into by the franchisor.” Most franchise acts prohibit releases or waivers of claims arising under the act itself.

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100 Id. at *1.
101 Id.
102 Id. at *2.
103 Id. at *5.
104 Id.
105 Nicole L. Micklich & Michael V. Pepe, Can’t Give It Away: Statutory Prohibitions That Protect Franchisees From Releases, FRANCHISE L.J., 138, 144 (2011). Most statutes that prohibit franchisors from requiring releases seem designed to protect prospective or new franchisees from waiving claims that arose during the disclosure process. Id. at 148.
107 Id.
Assuming the release is not prohibited by statute, courts are likely to uphold releases where the release at issue appears to be “mere enforcement of terms to which [the franchisees] agreed when originally signing their franchise agreement.”

In a case involving former owners of a West Coast Video franchise outlet in Maryland, the federal bankruptcy court in the Eastern District of Pennsylvania suggested in dicta that a general release by the former franchisees of the debtor West Coast Video was valid and barred the franchisees’ claims against the franchisor. The release in the West Coast Video case was executed as part of the franchisees’ assignment of their West Coast Video franchise to a buyer who assumed the franchisees’ debt. In the Release, the franchisees agreed to:

Release absolutely, unconditionally and forever discharge Franchisor and its officers, directors, affiliates, shareholders, agents and servants from any and all claims, actions, causes of action, damages, costs, debts, obligations, responsibilities, and liabilities of every name, nature, kind and description whatsoever, whether in tort, in contract, or under statute, arising directly or indirectly out of the negotiation of, execution of, performance of, non-performance of, or breach of the Franchise Agreement.

The Bankruptcy Court specifically took note that there was no evidence of coercion, direct consideration was received, and language contained in the original franchise agreement executed by the franchisee supported the franchisor’s insistence that the franchisees execute a general release in favor of the franchisor as an absolute condition to its approval of the sale.

The Bankruptcy Court made the observations “as guidance to the parties and to possibly assist the overburdened state court in assessing the merits” of the matter.

As the bankruptcy court anticipated, the release was later held valid and enforceable against the franchisees and a bar to the franchisees’ RICO Act claims against the franchisor. The franchisees argued unsuccessfully that the Maryland Franchise Registration and Disclosure Law (“MFRDA”) applied to their case. The district court held that Pennsylvania law applied

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109 In re W. Coast Video Enters., Inc., 174 B.R. 906, 913 (E.D. Pa. 1994) (reopening case to determine rights of former franchisees of debtor and holding the franchisees were unknown creditors and the releases of non-debtors included in the reorganization plan could not be enforced against them).

110 Id.

111 Id. at 909.


113 W. Coast Video, 174 B.R. at 913.

114 Id.

115 Id. at 912.

116 Section 14-226 of the MFRDA provides: “As a condition of the sale of a franchise, a franchisor may not require a prospective franchisee to agree to a release, assignment, novation, waiver, or estoppel that would relieve a person from liability under this subtitle.” MD. Code Ann. Bus. Reg. § 14-226 (West 1992).
but found that even assuming Maryland law applied to the case, the MFRDA did not invalidate the release at issue because the parties’ franchise agreement did not require the *prospective* franchisee to assent to a release; rather, it said that the franchisor may require a release as a condition of providing consent to a transfer or other such act.\textsuperscript{117} The District Court found that by the time the franchisees were required to sign the release, they were no longer prospective franchisees protected by the relevant provisions of the MFRDA.\textsuperscript{118}

On appeal, the Third Circuit Court of Appeals affirmed and held that assuming the Maryland law applied, the release bars the plaintiffs from bringing their federal RICO action because the MFRDA invalidates the release only as to causes of action “grounded in the MFRDA.”\textsuperscript{119} Maryland could have forbidden franchisors from requiring franchisees to agree to a release that would relieve a person from liability generally, as other states have done, invalidating releases of any claims or liability, but instead limited the scope of its prohibition to liability “under this subtitle.”\textsuperscript{120} Thus, the RICO action was barred by the release.

In another noteworthy case, the Michigan appellate court held that the franchisor had good cause not to consent to the transfer of a franchise where the transferor franchisees refused to execute a general release that the franchisor required as a condition to its consent to the transfer.\textsuperscript{121} America’s Favorite Chicken franchisees refused to execute a general release to accomplish a transfer of their franchise even after the franchisor modified the release so that it did not encompass any claims the franchisees had under the Michigan Franchise Investment Law (MFIL).\textsuperscript{122} As a result of the franchisees’ refusal to execute the release, the franchisor refused to consent to the transfer.\textsuperscript{123} The franchisees claimed their refusal to sign a release was not good cause for the franchisor to refuse to consent to the transfer of their franchise.\textsuperscript{124} The court disagreed with the franchisees and held that provisions of the franchise agreement entitled the franchisor to demand release of any and all claims as a condition of approving the transfer of the franchise were valid.\textsuperscript{125} The franchisees’ refusal to provide the release at the time of the transfer was a default of the franchise agreement, and failure to cure that default was good cause under the MFIL for the franchisor not to approve the transfer.\textsuperscript{126}

The court determined that the release sought by the franchisor did not encompass any claims the franchisees had against the franchisor under the MFIL and did not deprive the franchisees of any protections provided for by that statute and therefore was not void or

\textsuperscript{118} Id.
\textsuperscript{120} Id.
\textsuperscript{122} Id. at 125.
\textsuperscript{123} Id.
\textsuperscript{124} Id.
\textsuperscript{125} Id. at 126.
\textsuperscript{126} Id. at 127.
unenforceable. The court further concluded that it was commercially reasonable for the franchisor to require resolution of all non-MFIL claims before the franchisor approved a transfer.

Despite the public policy issues that underscore the prohibitions on prospective releases in favor of franchisors, at least one case has nevertheless upheld a prospective release of a franchisor by a franchisee where adequate consideration was given and the terms of the release were unambiguous. Under Louisiana law, the Eastern District of Louisiana held that an unambiguous provision in an assignment agreement releasing a franchisor from future claims by its franchisee, following assignment of franchise rights to a third party, was valid and supported by adequate consideration despite the franchisee’s claim that the franchisor unreasonably withheld consent to transfer by requiring the franchisee to sign the release.

**B. Conditions Subsequent**

Finally, the transfer provision might appropriately include conditions subsequent to transfer, including not only the guaranties suggested above, but also non-compete language and any continuing or successor liability language the franchisor will require as a condition of transfer.

**IV. RIGHT OF FIRST REFUSAL AND ITS IMPACT ON THE FRANCHISOR-FRANCHISEE RELATIONSHIP**

Many franchise agreements grant the franchisor a right of first refusal ("RFR") in connection with the proposed transfer of a franchise. Typically, such a provision requires the franchisee to present every offer to purchase the franchise to the franchisor, along with all material terms and conditions of the offer, and to give the franchisor a specified period of time in which to match the offer made by the third party to become itself the transferee. Some more sophisticated or complex RFR provisions may also accord the franchisor the right to negotiate different terms than those presented by the third party offer. Where the franchisor declines to exercise its RFR, the franchise agreement will usually require that the proposed franchise transfer be subject to the same standard approval process for all transfers (see supra), including, but not limited to, that the franchisor approve the transfer.

There are several reasons why a franchisor may (and often does) want a RFR. Primarily, a RFR enables a franchisor to ensure that it can prevent undesirable franchisees (who may not otherwise be disqualified) from joining its system. A RFR also allows a franchisor

127 Id. at 126.
128 Id. at 127. For a discussion and comparison of releases construed under Michigan law that are limited to claims relating to the surrender of a franchise and therefore not general releases of liability between franchisor and franchisee, and releases that apply to all claims, both known and unknown, and therefore a general release that applies to all conduct between the parties, see Pinnacle Pizza Co., Inc. v. Little Caesar Enters., Inc., 560 F. Supp. 2d 786 (D.S.D. 2008).
130 Id. at 919.
131 JTH Tax, Inc. v. Lee, 514 F.Supp.2d 818 (E.D. Va. 2007) (the public interest supported grant of a permanent injunction requiring franchisee of tax preparation business to comply with the terms of the franchisor’s non-compete clause and non-solicit covenants because enforcing non-compete obligation would prevent customer confusion).
to obtain attractive locations for itself and to obtain and then resell the franchises if and when market prices so dictate.

A corollary to the franchisor’s RFR is that it can make selling the franchise to a third party more difficult. For example, a prospective transferee of a franchised business subject to a RFR may be hesitant to devote significant time and effort into due diligence and negotiating a deal with a franchisee because the franchisor may prevent the deal by exercising its RFR. In addition, a RFR can get in the way of selling the franchised business at a below market price.\(^\text{132}\)

Some of the common substantive issues that arise with the RFR process are as follows: (1) what constitutes sufficient notice to the franchisor, (2) what constitutes sufficient detail of the proposed transaction between the franchisee and the proposed transferee, (3) how and when is the RFR to be exercised, and (4) must the RFR be exercised on terms identical to the offer or can the parties negotiate different terms after the franchisor initially offers to match. The cases discussed below attempt to answer some of these important questions.

Unless the franchise agreement specifies otherwise, complete notice, containing all material terms, is not required; rather, only sufficient notice of the terms, so as to allow the franchisor to make a considered choice and make reasonable efforts to clarify the deal if necessary, is needed.\(^\text{133}\) In *Paccar Inc. v. Elliot Wilson Capitol Trucks LLC*, the franchisee attempted to transfer its franchise to a third party, but the plaintiff franchisor refused to approve the transfer.\(^\text{134}\) The franchisor’s RFR provided that the franchisor was required to advise the franchisee of its intent to exercise its RFR within 30 days of receiving the franchisee’s written request for approval of a sale to a bona fide buyer, the sale agreement had to be a bona fide arms length agreement, and the purchase price and other terms of sale were required to be those set forth in such agreement and any related documents.\(^\text{135}\) The case rested on whether the franchisee’s notifications were sufficient to trigger the franchisor’s option to purchase and start the RFR’s thirty-day clock.\(^\text{136}\) The court found that, at minimum, the franchisor had sufficient notice to trigger its duty of inquiry based on the compilation of notices given.\(^\text{137}\) The court stated that the franchisee’s letter, supplemented by later communications, was not a cursory or vague document, but rather a written, arms-length, binding agreement which contained a clear statement as to the price and other terms of the deal.\(^\text{138}\) Additionally, the court found the franchisor’s exercise of its RFR presented a strong inference that it had in fact received sufficient information with which to make a reasoned choice as to whether to accept

\(\text{132}\) For more information on the implications of a right of first refusal provision, see Brian Balconi & Kevin M. Shelley, *Legal Issues Surrounding Transfers, Assignments, and Resale Programs*, in ABA 32nd Annual Forum on Franchising 27-30 (2009).


\(\text{134}\) *Id.* at *6-7.

\(\text{135}\) *Id.* at *7.

\(\text{136}\) *Id.* at *7-8.

\(\text{137}\) *Id.* at *32. The franchisor had the following information in its possession: (1) the identity of the buyer, (2) the terms of payment, (3) the operating structure of the new entity, including details regarding staffing, administration, and management structure, and most significantly, (4) all assets, including sales and services, that would be transferred to the new entity under the agreement. *Id.* at *32-33.

\(\text{138}\) *Id.* at *33.
the proposed deal. Although the court agreed with the franchisor that it had not received a model or detailed buy/sell agreement and certainly could have received a clearer and more detailed description of the terms of the deal according to industry standards, the court still held that the issue was not whether the notice was “perfect,” but rather whether the notice was sufficient, and it was.

A franchisor must exercise its RFR within the contracted specified time period regardless of whether it requests additional information. In Cavaliere v. Dunkin’ Brands, Inc., the franchisor and franchisee agreed that the franchisor had forty-five days from its receipt of a “complete copy” of a signed, bona fide written offer from a third party to purchase the franchisee’s rights, to exercise its RFR. At issue was what date was the RFR triggered, specifically what was meant by the requirement that the franchisor receive a “complete copy of such offer” such that it had 45 days from receipt of the offer to exercise its RFR. The court found the language “a complete copy of such offer” to be ambiguous, and therefore, construed the clause against the franchisor because it had been the drafter of the operative language.

The court agreed with the franchisee that a “complete copy” meant a copy of the agreement, not a copy of the agreement with all additional requested documents and schedules. The court determined that the agreement alone provided the basic information necessary for the franchisor to analyze the transaction and exercise its RFR. Moreover, the court stated that to adopt the franchisor’s interpretation of “complete copy” as including the agreement plus all of the voluminous information listed in the schedules would render the specified time period “meaningless,” leaving the franchisee without knowledge of when it could proceed with its purchase and the franchisor with an indefinite amount of time to perform its due diligence in requesting additional information and time.

Similarly, the franchisor must exercise its contractual RFR within the statutorily-designated period or conditions, if applicable. In Bowser Cadillac, LLC v. GMC, the plaintiff prospective franchisee alleged that the defendant franchisor violated the Pennsylvania Board of

139 Id.
140 Id. at *34.
141 Id. at *19.
143 Id. at *3-4.
144 Id. at *10-11.
145 Id. at *17-18.
146 Id. at *18-19.
147 Id. at *18.
148 Id. at *19.
Vehicles Act\textsuperscript{150} when it refused to approve a proposed sale between the franchisee and prospective franchisee, exercising its right of first refusal in an untimely manner.\textsuperscript{151} The franchisor insisted that a disappointed prospective franchisee could not sustain such an action simply because the franchisor exercised its contractually based right of first refusal, and sought dismissal on this basis.\textsuperscript{152} Although the court agreed that generally a franchisor may freely exercise a contractually provided right of first refusal without subjecting itself to liability, the court stated that such a right must still be exercised in an effective and timely manner.\textsuperscript{153} Therefore, the court determined that the issue was not whether the franchisor had a right of first refusal; but rather, whether the franchisor effectively exercised its right of first refusal in a timely manner.\textsuperscript{154} The court concluded that such an issue could easily be determined during discovery.\textsuperscript{155} Moreover, the court held that despite the franchisor’s plea, the prospective franchisee had standing to raise its claim against the franchisor from the fact that the franchisee had a “substantial, immediate, and direct interest in the subject matter.”\textsuperscript{156}

And in \textit{In re Chicago Investments, LLC}, the franchisor argued that the debtor franchisees failed to meet their burden for confirmation, and the franchisees and creditor argued that the franchisor never exercised its RFR.\textsuperscript{157} The court agreed with the franchisees and creditor, stating that the franchisor waived its objection to the acquired entities.\textsuperscript{158} The court reasoned that in the franchisor’s attempt to assert its RFR\textsuperscript{159} it intended on renegotiating the deal, trying to

\textsuperscript{150} The Act generally governs the relationship between automobile manufacturers and franchise distributors. 63 P.S. § 818.1. In particular, section 12(b)(3) of the Act makes it unlawful for any manufacturer or distributor to unreasonably withhold consent to the sale of a franchise to a qualified buyer capable of being licensed as a new vehicle dealer in the Commonwealth of Pennsylvania, who meets the reasonable requirements for appointment as dealer. 63 P.S. §818.12(b)(3). Further, section 12(b)(5) of the Act makes it unlawful for any manufacturer or distributor to fail to respond in writing to a request for consent to the sale of a franchise within 60 days of receipt of a written request on the forms, if any, generally used by the manufacturer or distributor for such purposes and containing the information required. 63 P.S. § 818.12(b)(5). In addition, this section states that failure to respond by the manufacturer or distributor within the time period set forth, therein, shall be deemed approval of the request and the manufacturer or distributor shall execute and deliver a franchise to the applicant within 30 days of the expiration of this time period. 63 P.S. § 818.12(b)(5).


\textsuperscript{152} \textit{Id.} at *9.

\textsuperscript{153} \textit{Id.} at *10.

\textsuperscript{154} \textit{Id.} at *14.

\textsuperscript{155} \textit{Id.} at *12.

\textsuperscript{156} \textit{Id.} at *11-12.


\textsuperscript{158} \textit{Id.} at 88.

\textsuperscript{159} The relevant franchise agreement provision stated that:

\begin{quote}
\text{[R]eceipt of a \textit{bona fide} offer entitles the Franchisor to exercise a [RFR] to purchase the franchise…}
\end{quote}

We have the right, exercisable by written notice delivered to you or your selling owners within thirty (30) days from the date of the delivery to us of both an exact copy of such \textit{bona fide} offer and all other information we request, to purchase such interest for the price and on the terms and conditions contained in such \textit{bona fide} offer, provided that: . . . we may substitute cash for any form of payment proposed in such offer; our credit will be deemed equal to the credit of any proposed
reduce the price by preventing the franchisees from realizing the full value of the proposed settlement with the creditor.\textsuperscript{160} The court ruled that this was not a right the franchisor held and that, at best, the franchisor had only the right to match the current offer.\textsuperscript{161} Therefore, the court held that the franchisor’s RFR was unenforceable under section 365 of the Bankruptcy Code unless the franchisor consummated the amended plan on the same terms as provided by the franchisee.\textsuperscript{162}

In addition, a franchisee must fulfill all conditions of a franchise agreement. Therefore, a franchisor’s RFR will be read in the context of the franchise agreement as a whole.\textsuperscript{163} However, even of the franchisor elects not to exercise its RFR, it still may withhold consent to the transfer if the prospective transferee is not approvable. In \textit{Mason County Drugs, Inc. v. Medicap Pharmacies, Inc.}, the plaintiff franchisee filed suit against the defendant franchisor, arguing that the franchisor breached the franchise agreement when it refused to consent to a third party transfer.\textsuperscript{164} The franchisee argued that the franchise agreement permitted it to consummate the transfer contract or a similar agreement without interference because the franchisee had notified the franchisor of the proposed agreement and the franchisor had not exercised its RFR.\textsuperscript{165} Put differently, the franchisee argued that the franchisor had no basis to object to the third party transfer once the franchisor declined to trigger its right of first refusal (i.e., that it essentially waived its right to withhold consent to the proposed transfer).\textsuperscript{166} The court disagreed, reasoning that since the franchise agreement provided that remedies in favor of the franchisor “shall be cumulative”, it was not enough for the franchisee to fulfill its obligations under one section of the franchise agreement concerning the franchisor’s RFR but not another section. All conditions and requirements had to be satisfied under the agreement before a transaction could occur.\textsuperscript{167} Thus, the court ruled that the franchisor did not act outside its rights in connection with the proposed transfer, and the franchisee was not free to consummate the proposed transfer without the franchisor’s consent.\textsuperscript{168}

purchaser; we will have not less than sixty (60) days after giving notice of our election to purchase to prepare for closing; and we are entitled to receive, and you and your owners agree to make, all customary representations and warranties given by the seller of the assets of a business or the capital stock of an incorporated business, as applicable . . . . If the franchisor does not exercise the RFR, the franchisee may complete the sale pursuant to the exact terms of the bona-fide offer. \textit{Id.} at 49.

\textsuperscript{160} \textit{Id.} at 90.

\textsuperscript{161} \textit{Id.}

\textsuperscript{162} \textit{Id.}

\textsuperscript{163} \textit{Mason County Drugs, Inc. v. Medicap Pharmacies, Inc.}, No 05 C 1115, 2006 U.S. Dist. LEXIS 5509, at *17-18 (N.D. Ill. Feb. 8, 2006).

\textsuperscript{164} \textit{Id.} at *9-10.

\textsuperscript{165} \textit{Id.} at *8, *14-15.

\textsuperscript{166} \textit{Id.} at *15.

\textsuperscript{167} \textit{Id.} at *17-18.

\textsuperscript{168} \textit{Id.} at *28-29.
All in all, clear communication between the franchisor and franchisee is critical to avoiding disputes concerning transfer and the franchisor’s RFR.

V. BANKRUPTCY AND ITS IMPACT ON FRANCHISE TRANSFERS

In a bankruptcy of a franchisee, the franchisor faces the possibility of transfer by operation of law. The aim of bankruptcy law is to rehabilitate the debtor and allow the sale of assets at the highest price possible for the benefit of the creditors. In light of this overriding concern, franchise agreements requiring the franchisor’s prior approval of an assignment and providing that failure to obtain said approval may result in termination of the agreement are largely limited and not enforceable in bankruptcy. The general rules governing transfer may be suspended as long as the franchisor cannot claim it has been materially damaged.169

Under section 365 of the Bankruptcy Code170, an executory contract,171 such as a franchise agreement,172 cannot simply be sold to a third party in a bankruptcy case.173 The franchisee-debtor must first meet the requirements for assumption of the contract and then meet the requirements for assignment. For instance, the proposed assignee must demonstrate “adequate assurance of future performance” pursuant to Section 365(f)(2).174 Further, under section 365(f)(3), a contract may not be terminated merely as a result of the assignment or assumption by a trustee.175

Franchise agreements often contain provisions granting franchisors veto power over the assignment of franchise agreements; however, such provisions are often not enforceable in bankruptcy.176 The bankruptcy court has the authority to permit the assignment of a franchise, in spite of the franchisor’s objections authorized under restrictive language in the franchise agreement, if the conditions of §365(f)(2) are met.177

169 Carolyn J. Johnsen et al., Managing the Franchise Relationship through Franchisee Receivership and Bankruptcy, 35th Annual A.B.A. F. on Franchising, Oct. 3-5, 2012.


171 Although the term “executory contract” is not defined in the Bankruptcy Code, the legislative history of Section 365 provides that executory contracts “generally include contracts on which performance remains due to some extent on both sides.” H.R. Rep. No. 595 at 340, 347 (1997).


173 In re Caribbean Petroleum Corp., 444 B.R. 263, 268 (Bankr. D. Del. 2010) (stating Bankruptcy Code Section 365 was enacted to provide debtors the authority to reject executory contracts; and therefore, any law such as PMPA that frustrates the purposes set forth in the Bankruptcy Code is preempted).


176 In re Caribbean Petroleum Corp., 444 B.R. at 269 (recognizing that courts leave the decision to reject a contract to the debtor’s sound business judgment, stating even “local laws designed to protect public health or safety, without imminent harm present, do not give rise to application of a heightened standard for contract rejection.”); see also In re Pilgrim’s Pride Corp., 403 B.R. 413, 424-25 (Bankr. N.D. Tex. 2009); In re Trans World Airlines, Inc., 261 B.R. 103, 121 (Bankr. D. Del. 2001).

177 In re Adelphia Commc’ns Corp., 359 B.R. 65, 85, 87 (Bankr. S.D.N.Y. 2007) (finding that “among the types of provisions that have been held to be unenforceable under §365(f) are rights of first refusal, and for good reason” because enforcing such rights “with respect to a subset of a multi-asset purchase [would] be destructive to
Nevertheless, assignments might not be approved if applicable non-bankruptcy law allows the franchisor to withhold consent. In In re Pioneer Ford Sales, Inc., the bankruptcy court ruled that the franchise agreement for an automobile dealership was assignable, even though a clause in the franchise agreement prohibited assignment and a state statute prohibited assignment of automobile dealerships without dealer consent. In so ruling, the bankruptcy court held that the Bankruptcy Code’s prohibition on assignment of contracts only applied to personal services contracts, and an automobile franchise is not a personal services contract. The district court affirmed, but the First Circuit Court of Appeals reversed and sided with the franchisor, stating the franchise was non-assignable. In so ruling, the bankruptcy court held that the Bankruptcy Code’s prohibition was not limited to cases involving personal services contracts, but applied where the contract was the type that “contract law ordinarily makes non-assignable.”

The applicable state statute declared that dealers could not assign automobile franchises without dealer consent, but that consent could not be “unreasonably withheld.” Applying this statute, the First Circuit held that consent had not been unreasonably withheld because the assignee could not meet the franchisor’s working-capital requirements.

More recently, in In re Wellington Vision, Inc., Pearle Vision sought relief from an automatic stay to terminate a franchise agreement with Wellington Vision, the franchisee-debtor, arguing that Wellington could not assume the agreement because it included a non-exclusive license of Pearle Vision trademarks (as do almost all franchise agreements). The district court affirmed the bankruptcy court findings that Pearle Vision had granted Wellington a

maximizing value, and have a chilling effect on future bankruptcy auctions.”); In re Old South Coors, 27 B.R. 923 (Bankr. N.D. Miss. 1983); see In re Headquarters Dodge, Inc., 13 F.3d 674 (3d Cir. 1993), BUS. FRANCHISE GUIDE (CCH) ¶ 10,487 (holding that in refusing to approve the sale of a bankrupt dealership, an automobile manufacturer may have violated the New Jersey Franchise Practices Act; although the manufacturer had responded in the prescribed amount of time with the reasons for its refusal of the sale, the manufacturer later gave additional reasons that raised a genuine issue regarding whether the manufacturer had acted unreasonably or in bad faith when it first refused to approve the sale); In re Sunrise Restaurants, Inc., 135 B.R. 149, BUS. FRANCHISE GUIDE (CCH) ¶ 9,939 (Bankr. M.D. Fla. 1991) (rejecting franchisor’s objections to the proposed sale, even though the assignee might not be able to provide adequate assurance of future performance and was not as strong as franchisor would otherwise require, because the franchisor’s legitimate concerns were outweighed by the fact that the franchisor “will be in no worse a position than it is today since it might very well have an economically viable franchise operation which would certainly enhance the good will and image of the Burger King name”).

178 In re Adelphia Commc’ns Corp., 359 B.R. at 77 (holding that the local franchising authorities’ rights of consent were enforceable, saved by the §365(c)(1) exception for arising under applicable law, “but only the extent, to which the ordinances impose prohibitions or restrictions that are of general application, and that are independent of any restriction contained within the franchise agreement itself.”).


180 Id. at 28-29.

181 Id. at 31.

182 Id. at 28.

183 Id.

184 Id. at 30.

nonexclusive trademark license, and therefore the license was governed by federal trademark law, which granted Pearle Vision certain protections, including permitting restrictions on assignment, and prohibited Wellington from assuming or assigning the franchise agreement without Pearle Vision’s consent. Following the Court of Appeals for the Third, Fourth, Ninth, and Eleventh Circuits’ interpretation of the language of Section 365(c)(1), the Wellington court asked whether a debtor could “hypothetically” assign the license even if it is only proposing to assume the contract, concluding that the franchisee-debtor could not assume and assign its executory trademark license. The court also addressed whether the word “trustee” excludes a debtor or a debtor-in-possession and held that Section 365(c) applies to trustees and debtors in possession equally. As a debtor in possession, Wellington was therefore in the same position as a trustee and was prohibited from either assigning or assuming the franchise agreement absent Pearle Vision’s consent. Because Pearle Vision would not consent, the court held that Wellington was legally barred from assuming or assigning the agreement.

VI. PUBLIC OFFERINGS BY FRANCHISEES

Issues related to a franchise transfer also arise in the context of securities offerings. A franchisor has a legitimate business interest in examining any franchisee’s offer or stock or a partnership interest in his or her franchise. However, public offerings by franchisees are rare due in large part to the fact that many franchise agreements prohibit a franchisee from going public. Not surprisingly, there is little to no reported case law instructive on this issue.

Nevertheless, the franchisor should consider whether it is appropriate to include the conditions applicable to a franchisee securities offering. Such a provision will likely not be appropriate to many franchise agreements due to the type of business franchised, legal constraints, and economic factors. However, if it is practicable for a franchisee to make a public (or private) offering, the franchise agreement should include express language allowing for the offer and sale of securities upon written consent of the franchisor. The franchisor may condition

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186 Id. at 134.
187 Id. at 132-33, 134-35; see also In re N.C.P. Mktg. Group, 337 B.R. 230, 237 (D. Nev. 2005) (finding that “under applicable trademark law, trademarks are personal and non-assignable without the consent of the licensor”).
188 In re N.C.P. Mktg. Group, 337 B.R. at 236 (stating that the “Ninth Circuit and other circuits have come to the conclusion that two other forms of intellectual property, copyrights and patents, are personal and assignable only with the consent of the licensor and therefore unassumable under section 365(c)(1).”).
189 In re Wellington Vision, Inc., 364 B.R. at 136-37. The “hypothetical” test gives most licensors a veto over a proposed assumption of the contract by a Chapter 11 debtor; if the contract proposed to be assumed could be “hypothetically” assigned, then the licensor can object at the time of assumption because it does not want to “hypothetically” deal with strangers to the contract as assignees in the future. In re Catapult Entm’t, 165 F.3d 747, 749-50 (9th Cir. Cal. 1999). On the other hand, the “actual” test used by courts in the First and Eighth Circuits permits a trustee or debtor-in-possession to assume an executory contract or unexpired lease if the trustee or debtor-in-possession does not actually intend to assign the same. Id. Because under the actual test, the licensor will not be forced to deal with new parties, the licensor cannot veto the assumption, as the parties remain the same. Id.
190 In re Wellington Vision, Inc., 364 B.R. at 136-37. A contrary interpretation would mean that the right of the non-debtor party to object to assignment would not affect the right of a debtor-in-possession to assume an executory contract, although it would affect the right of a trustee to assume the contract. Id.
191 Id. at 137.
192 Id.
its consent on (1) the franchisee remaining the majority shareholder; (2) the franchisee giving the franchisor written notice in advance of the date (30 to 90 days is suggested) of any offering or other transaction contemplated by the securities offering provision; (3) the franchisor being given the right to review the offering materials for accuracy prior to their filing with any governmental agency or distribution to the public; (4) the franchisee agreeing to fully indemnify the franchisor for any claims in connection with the securities offering; and (5) the franchisor’s ability to charge the franchisee a reasonable offering fee and its actual costs, including reasonable attorneys’ fees. Additionally, and perhaps most important, the provision should include disclaimer language that the offering shall not expressly state or imply that the franchisor is participating in the underwriting, issuance, or offering of the franchisee’s securities, that the franchisor has endorsed the offering, or that the franchisor is furnishing legal or accounting advice. This provision is important given the securities laws’ implications of providing legal or accounting advice.  

VII. BRINGING AND DEFENDING CLAIMS RELATED TO UNAUTHORIZED TRANSFER OR TRANSFER PRIOR TO APPROVAL

When the franchise agreement contains a transfer provision that makes a transfer conditional upon obtaining the franchisor’s consent, franchisees must be wary of transferring absent that consent. A Burger King franchisee learned this lesson after he called Burger King to obtain consent to a transfer, apparently after consummating the sale and transferring the franchise twice. Burger King refused to consent to the transfer and refused to renew the franchise. The franchisee sued. In the meantime, though, the apparent purchaser, Western Convenience Stores, paid royalties to and received products from the franchisor. Nevertheless, the court granted Burger King summary judgment. While the prospective transferee was hoping to receive franchise rights, Burger King justifiably exercised its right to disapprove of the transfer. The court found that even though the prospective transferee operated the business after learning of the denial, it did so at its own risk.

It is not uncommon for franchisors of large systems to learn that units were transferred without the franchisor’s knowledge or consent. It is more unusual for the franchisor to then bring legal action. Of course, the franchisor has claims against its franchisee - the original and probably still actual, franchisee. The claims include breach of contract and/or abandonment of the franchise. The franchisee’s defenses may include that the transfer provision is


195 Id.

196 Id. at *1.

197 Id. at *3.

198 Id. at *11.

199 Id.

200 Id.
unconscionable, which will likely be difficult to prove, especially if the franchisee did not make any attempt to comply with its terms. Still, the franchisor must consider its damages, if any, and the relief it can seek and recover. In some of these situations, it may make more sense for the franchisor to ratify the transfer.

In Precision Franchising, LLC v. Pate, the franchisor, Precision, took an unusual step and sued the purchaser of one of its auto repair franchises for breach of a purchase agreement, on the theory that the franchisor was a third party beneficiary of the agreement between the purchaser and the franchisee and the purchaser’s refusal to sign a new franchise agreement violated the purchase agreement. The franchisee and his manager negotiated a purchase agreement which was sent to Precision with a franchise application. The application was approved and Precision sent Pate a franchise agreement. But, when Pate could not work out a lease extension with the landlord of the franchise site and Precision did not help Pate with the lease problem, Pate decided not to execute the franchise agreement. Instead, Pate bought the business from the franchisee and began operating under a different name.

The court found that the purchase agreement did not reflect intent to confer a direct benefit on the franchisor. On the contrary, it made the transaction contingent upon Precision foregoing its right of first refusal under the franchise agreement, which it did. None of Pate’s actions could be considered representations that he would sign a franchise agreement. The court stated, “a reasonable company would be expected to understand that an unconsummated business relationship can sour at any moment...” A promise of future conduct that does not occur cannot alone be the basis for a claim of fraud.

The court pointed out that Precision did not explain how the franchisee circumvented any of its liabilities under the franchise agreement by selling to Pate. Precision was granted summary judgment on its trademark infringement claims, but neither alleged nor offered

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202 Id. at *1.
203 Id.
204 Id.
205 Id. at *2.
206 Id.
207 Id. at *5.
208 Id.
209 Id. at *4-5.
210 Id. at *5.
211 Id.
212 Id. at *7.
sufficient facts to support its claims of breach of contract, tortious interference and fraudulent transfer.\textsuperscript{213}

Courts tend to bring a practical approach to the analysis of whether a transfer of a franchise complies with the franchise agreement. The case of \textit{Paccar Inc. v. Elliot Wilson Capitol Trucks}\textsuperscript{214} arose out of a Peterbilt distributor's attempt to transfer the dealership.\textsuperscript{215} George Wilson III managed two franchisees of Peterbilt, Elliot Wilson Capitol Trucks LLC and Elliot Equipment Company (collectively “Wilson”).\textsuperscript{216} The dealerships were non-exclusive franchises and sold Peterbilt and other lines of trucks and auto-parts, including Ford.\textsuperscript{217} In 2011, Wilson sold their Ford franchise to Norris Automotive Group (“Norris”).\textsuperscript{218} As a result of the sale, Norris assumed control over some aspects of the operation of one of the Wilson dealerships.\textsuperscript{219} Peterbilt filed a suit against Wilson, alleging that the sale to Norris constituted a material breach of Peterbilt's dealership agreement with Wilson.\textsuperscript{220} While that lawsuit was pending, Wilson expanded the deal with Norris to include the Peterbilt franchise.\textsuperscript{221} Wilson submitted the proposed deal to Peterbilt and in response Peterbilt rejected the proposed transfer and terminated Wilson's franchise.\textsuperscript{222} Wilson, however, proceeded with the transfer and executed a binding Letter of Intent, which Wilson then submitted to Peterbilt.\textsuperscript{223} Peterbilt rejected the proposal again, but then tried to exercise its contractual right of first refusal and withdrew the termination notice.\textsuperscript{224}

Peterbilt's suit against Wilson specifically alleged that Wilson entered into the partnership with Norris without Peterbilt's consent in violation of the distributorship agreement.\textsuperscript{225} Peterbilt also sought declaratory relief as to whether it properly executed its right of first refusal.\textsuperscript{226} Wilson counterclaimed asserting that Peterbilt acted in contravention of the Maryland Transportation Code (MTC), including the statutory duty to deal in good faith, and the Federal Automobile Dealer's Day in Court Act, which establishes a private cause of action

\begin{itemize}
\item \textsuperscript{213} Id. at *1.
\item \textsuperscript{215} Paccar Inc., 2013 WL 509682, at *2.
\item \textsuperscript{216} Paccar Inc., 905 F.Supp.2d at 679.
\item \textsuperscript{217} Id.
\item \textsuperscript{218} Id.
\item \textsuperscript{219} Id.
\item \textsuperscript{220} Id.
\item \textsuperscript{221} Id.
\item \textsuperscript{222} Id.
\item \textsuperscript{223} Id.
\item \textsuperscript{224} Id.
\item \textsuperscript{225} Id.
\item \textsuperscript{226} Id.
\end{itemize}
against a manufacturer that fails to act in good faith in performing or complying with any of the terms or provisions of the franchise or in terminating the franchise. Specifically, Wilson alleged that Peterbilt terminated the franchise without a factual basis, failed to use its best efforts to approve the Norris transaction, and untimely exercised its right of first refusal for the Norris deal when it withdrew the termination notice.

Peterbilt moved to dismiss Wilson’s counterclaims and the court held that Wilson had stated plausible claims against Peterbilt under the MTC as well as for breach of contract and breach of the implied covenant of good faith and fair dealing. On further cross-motions for summary judgment, the issue of whether Peterbilt timely exercised its right of first refusal centered on the sufficiency of Wilson’s notice of the proposed Norris transaction to Peterbilt. The court held that Peterbilt had sufficient notice of the proposed transfer but that Peterbilt’s refusal to consent to the transfer was reasonable under the circumstances. The court, therefore, granted Wilson’s motion for summary judgment on the issue of whether Peterbilt timely exercised its right of first refusal and granted Peterbilt’s motion for summary judgment as to Wilson’s counterclaims arising from Peterbilt’s refusal to consent to the Norris transfer.

In another decision in which the court employed a practical approach, a Virginia federal court held that a franchisor lacked cause to terminate an agency contract assigned without prior approval by one company to a second company, where the two companies were substantially controlled by the same individuals. The court reasoned that because the control over the agency was substantially unchanged, the unauthorized assignment did not deprive the franchisor of its original bargain. The court, therefore, permitted the assignee to sue on the assigned contract.

If a transfer is unauthorized, it is possible that the franchisor can recover from both the franchisee and the transferee. Recovery might include lost royalties, lost profits, and attorney’s fees. Non-monetary relief could include declaratory relief terminating the franchise agreement as to both the franchisee and transferee, thus allowing the franchisor to place a new franchisee in a potentially profitable location. But, if the franchisor is in the same or better

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227 Id. at 682, 688.
228 Id. at 679.
229 Id. at 683–84.
231 Paccar Inc., 2013 WL 509682, at *10, *16; see also supra notes 133-41 and accompanying text.
232 Id. at *17.
234 Id.
235 Meineke Car Care Centers v. RLB Holdings, LLC, 423 Fed.Appx. 274, 287 (4th Cir. 2011) (holding that a franchisor could recover lost profits for franchisees’ material breach if they were contemplated by the parties); Kissinger, Inc. v. Singh, 304 F.Supp.2d 944, 952-953 (W.D. Mich. 2003) (holding that a franchisor was entitled to past due royalties and reasonable attorney fees for breach of franchise agreement).
236 Prudential Real Estate Affiliates, Inc. v. PPR Realty, Inc., 204 F.3d 867, 877 (9th Cir. Cal. 2000) (Termination was not franchisor’s sole remedy for franchisee’s attempt to transfer shares in breach of the franchise agreement, franchise agreement provision which stated that a transfer of equity interest in the franchisee that was not in
position after the purported transfer than it was before, it might consider ratifying the transfer and moving on.

VIII. BRINGING AND DEFENDING CLAIMS FOR WRONGFUL WITHholding OF CONSENT

As a general rule, contracts are freely assignable. Therefore, if a franchisor wants control over transfers, including the right to prevent a transfer, the transfer provision in the franchise agreement is critical. If the transfer provision in the contract is well drafted, a franchisee’s claim for wrongful refusal to permit a transfer becomes a very fact-specific inquiry. As explained, infra, if the transfer provision includes a list of conditions that is exclusive, approval should be a rubber stamp once those conditions are met. Whether the contract specifies or not, the formal approval cannot be unreasonably withheld without significant risk of breach of contract and bad faith claims, among others.

By the time a franchisor reaches a decision with respect to a proposed transfer, it likely has considered numerous factors and considered the reports and opinions of those on its team. It is important to keep a record of the decision-making process because the contract or a statute may require the franchisor to provide the franchisee with the decision to deny the transfer in writing with an explanation of the reasons for the decision. In doing so, the reasons should be clear and succinct. Pretext should be avoided. Decisions based on personal bias or animosity, or motivated by ill-will or spite could draw allegations of bad faith.

It has become more common for franchisees to challenge a franchisor’s refusal to approve a transfer. Typically, the claims asserted include breach of contract, breach of the implied covenant of good faith and fair dealing, and tortious interference. Whether or not the franchisor acted in bad faith often becomes the crux of these cases. If the franchisor can prove it had legitimate business reasons for declining to approve the transfer, the franchisee’s claims for bad faith or tortious interference may fail.237 Also, as discussed, infra, if the franchise agreement expressly permits the franchisor to withhold consent for any reason or no reason at all, the franchisee’s claims may similarly fail. Likewise, if the franchisee comes to court with unclean hands or has not suffered any damages as a result of the franchisor’s refusal to consent to the transfer, its claims are unlikely to survive.238

In Brock v. Baskin Robbins, USA, Co., the plaintiff franchisee alleged tortious interference with contract after the franchisor, Baskin Robbins, refused to consent to a proposed transfer of the plaintiff’s franchise.239 The parties’ franchise agreement stated as follows: "BASKIN ROBBINS may withhold its consent to transfer of an interest referred to in Section

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238 See Fladeboe v. Am. Isuzu Motors, Inc., 150 Cal. App. 4th 42, 48-49 (4th Dist. 2007) (held plaintiff dealership that court found had unclean hands and had not suffered any damages as a result of manufacturer’s refusal to consent to proposed transfer of dealership was precluded from maintaining claims against franchisor).

18.1 arbitrarily and for any reason whatsoever or may condition any consent in their sole discretion.\textsuperscript{240} The court held that the franchisor had an absolute right to reject a proposed transfer and as such, the plaintiff could not succeed on a claim for tortious interference with contract.\textsuperscript{241} The court noted that under Texas law, there is generally no claim where the interference occurred as the result of the exercise of a contractual right.\textsuperscript{242}

However, in \textit{VW Credit, Inc. v. Coast Automotive Group, Ltd.}, a New Jersey court liberally construed the New Jersey Franchise Practices Act and entered an order directing transfer of a franchise after concluding that the franchisor unreasonably withheld its consent.\textsuperscript{243} Under that Act, the burden is on the franchisor to present credible reasons, supported by substantial evidence, to support a denial of consent to a transfer.\textsuperscript{244} The court recognized the transferee's character, financial ability and business experience as relevant considerations for the franchisor.\textsuperscript{245} The court found that the proposed transferee had standing to compel the transfer and that injunctive relief and specific performance are appropriate remedies where the franchisor unreasonably withheld its consent to the transfer.\textsuperscript{246}

Specific performance may not always be appropriate or available, however. Often these cases take years. During that time, prospective purchasers are likely to move on, invest in other ventures, or decide that the franchisor or its concept is no longer attractive. If the transferor is otherwise in compliance and not in default or termination, the remedy it seeks becomes a problem. While the transferor was deprived of the opportunity to sell its franchise, it still holds the asset. The asset can still generate profit and be sold. Therefore, the franchisee's damages, if any, become difficult to quantify.

There is some support for the idea that if the price or market value of the asset at the time of the proposed transfer was higher than that which the market will bear at the end of the litigation, the franchisee is entitled to collect the difference from the franchisor. But, the franchisor may seek to reduce that amount by the profit the franchisee made running the unit in the interim.\textsuperscript{247} These kinds of difficulties quantifying and proving actual or compensatory damages can add to the attractiveness of a bad faith or tort claim, which might support an award of attorney's fees or punitive damages.

Bad faith claims can also be difficult to prove. Franchisors will maintain that motive is irrelevant if withholding consent was justified by language in the contract. Contract law "does not provide remedies for spiteful conduct or refuse enforcement of contractual provisions

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\textsuperscript{240} \textit{ld.} at *7.
\textsuperscript{241} \textit{ld.}
\textsuperscript{242} \textit{ld.} at *6.
\textsuperscript{244} \textit{ld.} at 337-38.
\textsuperscript{245} \textit{ld.} at 340.
\textsuperscript{246} \textit{ld.} at 345.
\textsuperscript{247} Even where the sale was never consummated, courts have awarded damages based on the reduction in sale price over time. Ilkhchooyi v. Best, 37 Cal.App.4th 395, 412 (1995).
\end{flushright}
invoked out of personal nastiness." Where a contract grants a particular right, the law will not inquire into the motivation behind exercising the right.

In *Taylor Equipment, Inc. v. John Deere Co.*, a former John Deere dealer sued the manufacturer alleging breach of the implied covenant of good faith and fair dealing after the manufacturer refused to consent to the proposed assignment of the dealership. Following a jury verdict in favor of the former dealer, the eighth circuit court of appeals reversed. The court stated that the implied obligation of good faith is a "method to fill gaps" the purpose of which is to "honor the parties justified expectations." The contract granted John Deere an express, unrestricted right to disapprove a proposed assignment. Since the parties bargained for John Deere to have that right, no jury should impose restrictions. The implied covenant could not modify the express contractual term.

John Deere's transfer provision was on display again in *Enfield Equipment Co. v. John Deere Co.* Again, the court noticed that there was no "reasonableness limitation provided in [the] assignment provision." The purpose of the good faith covenant "is to protect the reasonable expectations of the parties and should not be used to override express rights included as part of the contract." John Deere had a right to arbitrarily withhold consent to transfer a distributorship.

Much like bad faith, tortious interference is a difficult claim for franchisees to maintain. In most jurisdictions, a claim for tortious interference requires that an "outsider, which is one who is not a party and who has no legitimate business interest, [has] knowledge of the contract" and interferes in some manner. Courts have found that the franchisor is not an outsider and does have a legitimate business interest in the transfer of the franchise.

Even where the court reaches the factual analysis of a tortious interference claim, the franchisee’s claim is often difficult to maintain. In *Luso Fuel, Inc. v. BP Products North America*,

249 Taylor Equip., Inc. v. John Deere Co., 98 F.3d 1028, 1029-30 (8th Cir. 1996).
250 Id. at 1035.
251 Id. at 1032.
252 Id. at 1033.
253 Id.
254 Id.
257 Id. at *3.
258 Id. at *1.
260 Id.
Inc., the court dismissed a franchisee’s tortious interference claims finding that the franchisee could not demonstrate that the franchisor acted with malice and the franchisor’s exercise of its express contractual right under the franchise agreements was not malicious.

However, under Florida law, a tortious interference claim might succeed if the franchisor used improper methods in refusing to consent to the transfer of a franchise, even if the franchisor’s motive was not purely malicious. In KMS Restaurant Corp. v. Wendy’s International, Inc., an unsuccessful purchaser of a Wendy’s franchise sued the franchisor for tortious interference. The case arose from Wendy’s refusal to approve the transfer of twenty-seven Wendy’s restaurants. The unsuccessful purchase resulted in a number of lawsuits, including one in which the unsuccessful purchaser sued the franchisor in a Florida state court alleging that the franchisor tortiously interfered with the prospective franchisee’s contract to buy the Wendy’s restaurants and that the franchisor also tortiously interfered with advantageous business relationships of the prospective franchisee. The district court granted summary judgment to Wendy’s on both the tortious interference counts and the prospective purchaser appealed.

On appeal, with respect to the claim that the franchisor tortiously interfered with the prospective franchisee’s contract to buy the Wendy’s restaurants, the eleventh circuit concluded that “a franchisor’s privilege to interfere is limited and qualified” and remanded for reconsideration. On remand, Wendy’s again moved for summary judgment as to the tortious interference claim. The district court again granted summary judgment to Wendy’s. Another appeal followed and the eleventh circuit remanded for further proceedings on the prospective purchaser’s claim that Wendy’s tortiously interfered with its contract by using improper methods, specifically by “taking certain steps to destabilize [the prospective purchaser’s] corporate structure” and then using the lack of stability as a basis to withhold its approval of the transfer. In remanding, the court of appeals stated, “Those further proceedings should take as a given that use of improper methods may support a tortious interference claim even when the defendant did not act solely out of malice.” On remand, the

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262 Id. at *7.

263 Id. at 1327.


265 Id. at 1323.

266 Id.

267 Id.

268 Id.

269 Id.

270 Id.

271 Id. at 1325.

272 Id. at 1328.
district court entered judgment in favor of the prospective purchaser.\textsuperscript{273} Cross-appeals followed and the district court judgment was affirmed.\textsuperscript{274} A franchisor may be liable for tortious interference even if its motives were not malicious in refusing to consent to the transfer of a franchise.

\textbf{IX. CONCLUSION}

Franchisee and franchisor counsel should consider the legal and business issues discussed in this paper when counseling clients regarding the transfer of a franchise. Prospective franchisees that seek to invest in a franchise with the intent to eventually transfer the asset should be particularly attentive to the transfer provision in the franchise agreement, the ease with which previous franchisees were able to transfer, and applicable statutes. Franchisors who wish to prohibit most transfers should draft a very restrictive transfer provision into the franchise agreement, but must be cognizant that state laws may affect the implementation of the restrictions.

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{273} KMS Restaurant Corp. v. Wendy’s Intern. Inc., 194 Fed. Appx. 591 (11th Cir. 2006).
\item \textsuperscript{274} \textit{Id}.
\end{itemize}
\end{footnotesize}
BIOGRAPHIES

Fredric A. Cohen

Fredric A. Cohen is a founding member and Partner with Cheng Cohen LLC and is a seasoned litigator and trial lawyer. For over two decades, Mr. Cohen has represented many of the nation’s most prominent franchisors in disputes ranging from multi-district class actions to simple enforcement actions. Mr. Cohen has helped franchisors protect and enforce their intellectual property rights, grow their brands, and manage relationships. This includes franchisees, suppliers and customers, counseling them through state and federal regulatory inquiries and investigations. When he is not doing what he loves, he likes to cook.

Nicole Liguori Micklich

Nicole Liguori Micklich represents franchisees and master franchisees, development agents, and area managers in all aspects of their franchise business and in litigation. Ms. Micklich represents franchisees in every stage of their relationship with the franchisor. She assists potential franchisees as they review disclosure documents and proposed agreements, routinely handles compliance and royalty disputes and other contract disputes, regularly negotiates sales and transfers of agreements and represents clients in mediation, arbitration and court actions involving contractual and statutory issues including termination. Ms. Micklich has successfully represented Development Agents and unit-owner franchisees in connection with renewals and with transfers of their contracts. She also has worked with numerous franchisees and Development Agents from the United States and Canada to overcome allegations of default and extend the terms of their contracts.

Ms. Micklich successfully moved to dismiss a federal action in which a franchisor sought to compel arbitration as to the principal defendant. Her client was then able to pursue a state court jury action against the franchisor. In another federal case involving a document destruction franchise, Ms. Micklich successfully objected to the franchisor’s motion to dismiss or alternatively to move the case to a court in the franchisor’s home state. As a result, the franchisee was able to favorably settle the case. In other cases arbitration panels and courts awarded money damages to Ms. Micklich’s clients arising from franchisors’ breaches of contract and other illegal behavior, including wrongfully preventing a franchisee from transferring his contracts.

Ms. Micklich was named to the New England Rising Stars list as one of the top attorneys in New England for 2010, 2011 and 2012. Ms. Micklich graduated cum laude from the University of Pittsburgh and earned her J.D. from the University of Connecticut. She is admitted to practice in both Connecticut and Rhode Island and before the District Court for the District of Connecticut and the Second Circuit Court of Appeals.

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