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**LIFE CYCLES:
APPROACHES TO FRANCHISEE TRANSFERS**

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LIFE CYCLES:
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I. INTRODUCTION: THE ARGUMENT FOR FAIRNESS

Franchisors typically want to control the transfer by franchisees of their franchise agreements or the ownership of the franchisees' businesses in order to maintain the quality of their systems. A franchisor has an obligation to its franchisees to screen new franchisees in accordance with the franchisor's criteria for success. Almost invariably, franchise agreements provide that the franchisee may only transfer the franchise agreement or the ownership of the franchise business with the prior written consent of the franchisor. Typically, the agreement sets forth numerous conditions to such consent.

Franchisees typically want the ability to transfer freely in order to maximize gains on the businesses they developed, sometimes over many years, often with an investment of considerable time, effort and money. Franchisees seek freedom and flexibility so they may sell their franchises with as little interference as possible from the franchisor.

This inherent tension between the interests of the franchisor and the franchisee can create conflict over the language of the franchise agreement when the franchisee is considering purchasing the franchise. Also, it can lead to potential disputes when the franchisee seeks to transfer the franchise, and may raise the question of whether the contractual transfer restrictions are enforceable.

The first part of this paper will review the statutes and case law surrounding franchisee transfers. The second part of this paper will explore various contractual approaches to franchisee transfers, taking into consideration the points of view of both franchisor and franchisee, and suggesting specific approaches that the authors feel are fair and reasonable. In doing so, we start with the premise that the franchisor's interest in an orderly transition from the franchisee to a qualified transferee is no more and no less important than the franchisee's interest in obtaining fair value for the franchised business.

The authors believe that a contract draftsman can prepare a transfer provision that is favorable to the client while at the same time being fair. Why should the attorney for the franchisor, who is drafting the franchise agreement, take the position that the agreement should be fair and reasonable? Many franchise attorneys feel that because they represent the franchisor, the agreement should be as favorable to the franchisor as possible. According to this line of thinking, it is best to include in the agreement as much "ammunition" as possible to protect the franchisor, even if some of the pro-franchisor provisions may not be enforceable. The authors disagree for the following reasons:

- A one-sided agreement may create unrealistic expectations on the part of the franchisor client. Contractual provisions that are unenforceable make for a "bad agreement" in the same sense that laws that cannot be enforced make for "bad law".

- This attitude may be partially responsible, or at least symptomatic, of the reasons for the increase in proposed franchisee protection legislation in recent years.
- It is in the interest of a franchisor to have a uniform agreement that varies little, if at all, from one franchisee to another. Contract variations make it difficult for the franchisor to know its rights and obligations with respect to all franchisees without checking individual contracts, and changes may require franchisors to amend their offering circulars. Because the agreement will be negotiated minimally, if at all, a one-sided approach may affect an entire class of contracting parties, not just one. The fact that the agreement is unlikely to be negotiated also means that the drafting attorney may miss issues that would otherwise arise in negotiations, which often result in a better agreement than either party alone would have produced, no matter how skilled the drafting attorney may be. In a franchise system, the drafting attorney does not have the benefit of input from the franchisee's counsel before the uniform document is prepared and filed.
- Franchising is a highly regulated and litigated field. Given this setting, a fair and reasonable franchise agreement should increase the likelihood that the standard agreement will be enforceable in all jurisdictions.
- A fair agreement, especially in a new franchise system, may sell more franchises than a one-sided agreement.
- For large franchisors with proven records of profitability and high profiles, fairness makes for good public relations. Franchise agreements are public documents and larger franchise systems are subject to more public scrutiny.
- A fair agreement should go a long way toward improving franchisee/franchisor relations, avoiding disputes later on and putting the franchisor in a better light when disputes do arise.

II. THE LAW OF FRANCHISE TRANSFERS

A. Contractual Silence on the Question of Transfer

Is consent of the franchisor required if the agreement is silent on the issue? The answer depends on whether the agreement is one for the services of a particular person. Where the franchise agreement is a contract for personal services, the requirement of consent may be implied. *See Berliner Foods Corp. v. Pillsbury Co.*, 633 F. Supp. 557, Bus. Franchise Guide (CCH) ¶8566 (D. Md. 1986). Many franchisees are corporations, rather than individuals. With a corporate franchisee, it may be difficult to argue that the parties contemplated an agreement for personal services. *See Sally Beauty Co. v. Nexxus Products Co.*, 801 F.2d 1001, 1009 (7th Cir. 1986) (Posner, J. dissenting).

If, instead of being silent altogether on the subject of transfers, the franchise agreement provides only that the franchisor's consent to a franchisee transfer is required, without more, state statutes and courts will generally impose a reasonableness or good faith standard. *See Larese v. Creamland Dairies, Inc.*, 767 F. 2d. 716, Bus. Franchise Guide (CCH) ¶8398 (10th Cir. 1985). *See also Prestin v. Mobil Corp.*, 741 F.2d 268, Bus. Franchise Guide (CCH) ¶8217 (9th Cir. 1984).

A franchise agreement itself might specifically provide only that the franchisor's approval of a proposed transfer will not be unreasonably withheld. While this may be a fair approach, it is really a shorthand solution to the issue. Most agreements spell out in detail the criteria to be considered in determining the acceptability of the proposed transferees. Various drafting approaches are discussed in the second part of this paper.

B. Prohibition or Arbitrary Right to Withhold Consent to Transfer

At one end of the spectrum is a clear and unequivocal provision prohibiting transfers of any kind. A provision allowing the franchisor to withhold consent arbitrarily would put the franchisee at virtually the same disadvantage as a provision that completely prohibits transfer.

Some cases indicate that such a provision prohibiting transfers may be upheld. See, e.g., *James v. Whirlpool Corp.*, 806 F. Supp. 835, Bus. Franchise Guide (CCH) ¶10,205 (E.D. Missouri Oct. 26, 1992) (an agreement giving the manufacturer unlimited authority to disapprove a transfer and not requiring the manufacturer to explain its decision was not unconscionable); *C. Pappas Co., Inc. v. E & J Gallo Winery*, 610 F. Supp. 662, Bus. Franchise Guide (CCH) ¶8378 (E.D. Cal. 1985), *aff'd* 801 F. 2d 339, Bus. Franchise Guide (CCH) ¶8671 (9th Cir. 1986); *Crow v. Mobil Oil Co.*, Bus. Franchise Guide (CCH) ¶7793 (C.D. Cal. 1981). Under the law of several states, however, such provisions would be unenforceable, as explained below.

C. Laws Limiting the Franchisor's Right to Withhold Consent

The franchise relationship laws of several states do not permit the absolute or arbitrary withholding of consent to a transfer. These states include Arkansas, California, the District of Columbia, Hawaii, Indiana, Iowa, Michigan, Minnesota, Nebraska, New Jersey and Washington.

Hawaii, Iowa and Michigan allow the franchisor to withhold consent when the franchisee or proposed transferee fails to pay any sums owing to the franchisor and to cure any default.

Hawaii, Iowa and Michigan allow the franchisor to withhold consent when the proposed transferee fails to meet the franchisor's reasonable qualifications. Hawaii and Michigan also specifically allow the franchisor to withhold consent when the proposed transferee is a competitor of the franchisor. In Arkansas, Nebraska and New Jersey, the franchisor may reject a transfer based on a material reason relating to the character, financial ability or business experience of the proposed transferee. In the District of Columbia, Minnesota and Washington, the franchisor may not withhold consent to a proposed transfer where the proposed transferee meets the criteria for the purchase of a new franchise.

The franchisor's right to withhold its consent to an assignment based on the transferee's lack of business experience and poor capitalization was upheld in *Town and Country Ford, Inc. v. Ford Motor Co.*, Bus. Fran. Guide (CCH) ¶8660 (N.D. Ga. 1985). *aff'd*, 800 F.2d 266 (11th Cir. 1986), and in *Portaluppi v. Shell Oil Co.*, 869 F.2d 245 (4th Cir. 1989).

In *In re Pioneer Ford Sales, Inc.*, 729 F.2d 27 (1st Cir. 1984), the court found that the franchisor's disapproval of a bankrupt franchisee's assignment was reasonable under

the applicable state motor vehicle dealer law, since the proposed assignee lacked the required capital, had a poor sales record with its other franchise, and could not adequately assure future performance of the franchise agreement. *See also Bishay v. Foreign Motors Inc.*, 416 Mass. 1, 616 N.E.2d 96, Bus. Franchise Guide (CCH) ¶10,287 (Mass. 1993), where the court ruled that Mercedes-Benz of North America's refusal to consent to a transfer of an auto dealership was reasonable and not an unfair act in light of the proposed purchaser's prior unauthorized use of the Mercedes-Benz trademarks.

In one recent case, the court upheld the withholding of consent to a proposed transfer of a North Carolina beer distributorship, in part because the proposed transferee was a high volume distributor of a competing brand. *Brittain v. The Stroh Brewery Co.*, Bus. Franchise Guide (CCH) ¶10,199 (4th Cir. April 26, 1993). Other courts also have upheld the right of a franchisor to refuse to consent to the transfer of a franchise to a competitor. *See Rickel v. Schwinn Bicycle Co.*, 144 Cal. App. 3d 648, 192 Cal. Rptr. 732 (1983); *Sally Beauty Co., Inc. v. Nexxus Products Co., Inc.*, 578 F. Supp. 178 (N.D. Ill. 1986); *Berliner Foods Corp. v. Pillsbury Co.*, 633 F. Supp. 557, Bus. Franchise Guide (CCH) ¶8566 (D. Md. 1986).

In Arkansas, Hawaii, Nebraska, Michigan and New Jersey, the franchisor may reject a transfer when the proposed transferee does not agree to comply with all of the obligations or requirements of the franchise. Iowa allows the franchisor to condition consent on the new franchisee's successful completion of a "reasonable" training program and the payment of a "reasonable" transfer fee, which relates to expenses "directly attributable to the transfer". Washington also has a policy restricting transfer fees to such expenses. In Iowa, however, if there is an unexpired term in the original franchise agreement, the franchisor cannot require, as a condition of its approval of the transfer, that the transferee execute a "new or different franchise agreement". In one case, the court found under the Florida auto dealership law that the manufacturer had a right to withhold consent to a transfer that contemplated relocation of the dealership, because relocation meant that the proposed franchisee could not agree to comply with all the requirements of the franchise then in effect. *Gus Machado Buick-GMC Truck, Inc. v. General Motors*, Bus. Franchise Guide (CCH) ¶10,355 (Fla. Dist. Ct. App., 1st Dist., Aug. 30, 1993).

In *Kestenbaum v. Falstaff Brewing Corp.*, 514 F.2d 690 (5th Cir. 1975), *cert. denied*, 424 U.S. 943 (1976), and *Walner v. Baskin Robbins Ice Cream Co.*, 514 F. Supp. 1029 (N.D. Tex. 1981), the courts upheld a franchisor's right to restrict the sale price of a franchise to a reasonable value in order to protect the transferee's financial viability.

The franchisee also has the procedural obligation of notifying the franchisor of its intention to transfer the franchise in Arkansas, the District of Columbia, Iowa, Nebraska and New Jersey. The franchisor then has sixty days to reject the proposed transfer. In Hawaii, the franchisor has thirty days after notice of a proposed transfer to approve or disapprove a transfer.

Limitations on withholding consent to transfer of the franchise agreement also apply to ownership of the franchisee's business under the franchise relationship laws of Arkansas, the District of Columbia, Iowa, Hawaii, Nebraska and New Jersey.

Upon the death of the franchisee or the principal owner of the franchise, the franchisor must permit the transfer to his or her heirs in Arkansas, California, the District of Columbia, Indiana, Iowa, Nebraska and New Jersey. The California franchise

relationship law provides that after a "reasonable" period of time after a franchisee's death, the failure of the heirs to qualify or locate a suitable transferee will operate to terminate the franchise. The Indiana Deceptive Franchise Practices Act also provides that the heirs of a deceased franchisee must be allowed to participate in the ownership of the franchise for a reasonable time, conditioned upon their maintenance of certain standards and obligations. In Washington, such transfer must be permitted except where the franchisor relied on the unique talents of the franchisee.

Where the franchise agreement is signed by one or more individuals, the absence of a provision dealing with divorce, can lead to an unintended result. One California court, for example, awarded a franchise, previously operated solely by the husband, to the wife. The wife had no business experience. The franchisor had agreed to accept the wife as the new franchisee if the court awarded her the franchise. The court specifically held that the wife's lack of business experience would not bar her award of the franchise. *Kozen v. Kozen*, 185 Cal. App. 3d 1258, 230 Cal. Rptr. 304, Bus. Franchise Guide (CCH) ¶8708 (1986).

The Bankruptcy Code also may limit the franchisor's ability to refuse to approve a transfer. Even if the franchise agreement requires the prior approval of the franchisor to any assignment or other transfer of the franchise, and provides for automatic termination if such approval is not obtained, the Bankruptcy Code specifically provides that the agreement may *not* be terminated upon assignment or assumption by the trustee. 11 U.S.C. §365(f)(3). In other words, unlike most transferees, a trustee in bankruptcy has the power to override such restrictions in the franchise agreement under certain conditions. *See, e.g., In re Old South Coors*, 27 B.R. 923, Bus. Franchise Guide (CCH) ¶7955 (Bankr. N.D. Miss. 1983).

In addition to statutes that apply generally to business format franchises, many states have laws that govern relationships between service station dealers and petroleum companies, between auto manufacturers and their dealers, between liquor companies and their distributors, and between farm equipment manufacturers and their dealers. These laws generally also require good cause for the withholding of consent to a transfer.

D. Objecting to the Franchisor's Withholding of Consent

In the event that the franchisor withholds consent to or rejects a transfer, courts generally hold that the disappointed potential successor franchisee does not have standing to bring an action against the franchisor. *See, e.g., David Glen, Inc. v. Saab Cars USA, Inc.*, Bus. Franchise Guide (CCH) ¶10,392 (N.D.Ill. Oct. 20, 1993); *Horn v. Mazda Motors of America, Inc.*, Bus. Franchise Guide (CCH) ¶10,241 (N.J. Sup. Ct. May 28, 1993); *Tynan v. General Motors Corp.*, Bus. Franchise Guide (CCH) ¶9850 (NJ Superior Court, App. Div., June 12, 1991) (the prospective purchaser is also not a third party beneficiary); *Roberts v. General Motors Corp.*, Bus. Franchise Guide (CCH) ¶9716 (NH Superior Ct., July 16, 1990); *Gans v. Miller Brewing Co.*, Bus. Franchise Guide (CCH) ¶9601 (Fla. Dist. Ct. of App. 1990).

Courts in several cases have held that the franchisor's exercise of its contractual rights in withholding consent to a transfer will not constitute a violation of a covenant of good faith and fair dealing. *See, e.g., Woody v. General Motors Corp.*, Bus. Franchise Guide (CCH) ¶10,336 (4th Cir. Nov. 23, 1993). *But see Flint Davis v. Sears, Roebuck and Co.*, Bus. Fran. Guide (CCH) ¶9384 (6th Cir. 1989).

Sometimes, franchisees will allege tortious interference with their contractual relations when the franchisor withholds consent to a transfer. Generally, the courts will not find such interference if the franchisor acted within its rights under the agreement. See, e.g., *Popeyes, Inc. v. Yuzo M. Tokita*, Bus. Franchise Guide (CCH) ¶10,384 (E.D. La. Sept. 21, 1993); *Reyes v. Atlantic Richfield Co.*, Bus. Franchise Guide (CCH) ¶10,375 (9th Cir. Dec. 8, 1993); *Tynan v. General Motors Corp.*, Bus. Franchise Guide (CCH) ¶9850 (NJ Superior Court, App. Div., June 12, 1991); *Constant v. Hallmark Cards, Inc.*, Bus. Franchise Guide (CCH) ¶9828 (NY Sup. Ct., App. Div. 2nd, April 15, 1991). However, there may be a real issue of tortious interference when the franchisor withholds approval of a sale without good cause, allows the agreement to expire and then turns the location into a company store. *Kendall v. Tom Thumb Food Markets, Inc.*, Bus. Franchise Guide (CCH) ¶10,136 (Minn. Dist. Ct., 4th Judicial Dist., June 1, 1992).

E. Franchisor's Right of First Refusal

The franchisor's right of first refusal is a generally accepted contract right. A right of first refusal is specifically permitted in California in the event of the death of the franchisee, and in Iowa in all cases. A franchisor's right of first refusal was also specifically upheld in *Roberts v. General Motors Corp.*, Bus. Franchise Guide (CCH) ¶9716 (NH Superior Ct., July 16, 1990). Where the franchisor assigns its right of first refusal to a third party, however, one court has held that the exercise of such first refusal right by the assignee of the right would frustrate the franchisee's freedom to transfer under the District of Columbia Retail Service Station Act of 1976. *Dege v. Milford*, Bus. Franchise Guide (CCH) ¶9614 (D.C. Court of Appeals, May 10, 1990).

A right of first refusal may have the effect of making it impossible for the franchisee to transfer the franchise. Potential buyers will not want to go to the trouble of negotiating a purchase when it is likely that their deal will be taken away from them by the franchisor. Even if the deal is not taken away, the prospective buyer will have to wait while the franchisor is given the opportunity to act. A few franchisees have dealt with this problem in a questionable manner by disclosing a higher price to the franchisor than the actual price that the prospective buyer is willing to pay. Then, if the franchisor exercises its right of first refusal, the franchisee would pay the difference over to the "disappointed" suitor. The franchisee and its suitor each would receive, in essence, a premium when the franchisor exercises its right of first refusal. While this scenario is rare, there is no ideal way to guard against it. One way to deal with the problems inherent first refusals is to provide for reasonably short time periods, so that the franchisor does not have the ability to delay the sale unreasonably.

F. The IFA Code of Conduct

The International Franchise Association issued a new Code of Principles and Standards of Conduct for franchisors (the "IFA Code of Conduct") in the Spring of 1994. On the subject of transfers, the IFA Code of Conduct provides as follows:

The great majority of franchise agreements grant to the franchisee a qualified right to transfer the franchise in connection with the sale of his or her business. Transfer rights are important to franchisees, because transferability is an important element of the value of the franchise and the franchisee's business. Restrictions on transferability are equally important to the franchisor, which has a compelling interest in the right to determine the persons who operate under its franchise and the terms on which its franchises are acquired.

Therefore, except with respect to franchises that are expressly nontransferable personal service contracts, a franchisor shall not withhold approval of a proposed transfer of a franchise when the following criteria are met:

- (a) The transferring franchisee is in compliance with the terms of the franchise agreement;
- (b) The proposed transferee meets the then-current qualifications of the franchisor;
- (c) The terms of the transfer meet the then-current requirements of the franchisor and the transfer provisions of the franchise agreement;
- (d) The franchisor determines not to exercise a right of first refusal in accordance with the franchise or other agreement.

The IFA Code of Conduct would allow franchisors to withhold consent to the transfer of "expressly nontransferable personal service contracts". In other words, the franchisor would have the right to withhold consent when the agreement specifically indicates that it is not transferable because it is for the services of a particular person. Presumably, where the agreement is silent on this issue, the IFA Code of Conduct would not allow for an implied personal service obligation, which a court might otherwise imply under the right set of facts. Thus, unless there is a personal service obligation, the IFA Code of Conduct would not permit a provision prohibiting transfers of any kind, and it would not allow a franchisor arbitrarily to withhold its consent to a proposed transfer.

The IFA Code of Conduct's condition precedent that the "terms of the transfer meet the then-current requirements of the franchisor and the transfer provisions of the franchise agreement" is vague. The franchisor can assert new conditions at any time and simply claim that they are among its then-current requirements. Moreover, conditioning the withholding of consent on compliance with the "transfer provisions of the franchise agreement" begs the question of what types of transfer provisions are acceptable and would effectively render all such provisions acceptable regardless of their reasonableness. Procedural issues, such as notice periods and the content of the notice, would be reasonable requirements that might fall under this provision of the IFA Code of Conduct. On the other hand, there are endless possible specific conditions for consent to transfer that a franchisor could impose. As discussed below, some of these are more reasonable or more fair than others.

The IFA Code of Conduct also allows the franchisor to withhold consent to a transfer if the franchisor decides to exercise a right of first refusal in accordance with the franchise or other agreement. This is consistent with existing law.

G. Franchisor Disclosure Obligations in Franchisee Transfers

Even though the franchisor is not the primary seller of a franchise to a transferee, the franchisor must sometimes comply with the franchise disclosure laws as if the franchisor itself were offering and selling the franchise. These include transactions in which the franchisor participates substantially in the sales process beyond merely approving the prospective transferee, and transactions in which the prospective transferee must execute the franchisor's then-current form of franchise agreement. The requirement to make disclosures in such cases can be especially difficult for a franchisor who no longer has a current offering circular or who is no longer registered in those states in which such registration is required.

Under the FTC Franchise Disclosure Rule and most state franchise disclosure laws, there is an exemption from the registration and disclosure requirements for private franchise resales by franchisees where the sale is not "effected by or through the franchisor." See e.g., Calif. Fran. Inv. Law §31102, (CCH) Bus. Franchise Guide ¶3050.26 and similar provisions enacted by Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Washington and Wisconsin. Under these statutes, the franchisor may approve the transferee and charge a reasonable transfer fee without taking on standard disclosure obligations. Under the FTC Franchise Disclosure Rule, a person who buys an existing franchise directly from the franchisee who owns it, without significant contact from the franchisor is not a prospective franchisee entitled to disclosure. *Final Guides to Franchising and Business Opportunity Ventures Trade Regulation Rule*, 44 Fed. Reg. 49,966, 49,969 (1979), Bus. Franchise Guide (CCH) ¶6220.

However, this private resale exemption will be lost if the franchisor actively participates in the sale or transfer. While the mere disapproval or approval of a transfer and the charge of a transfer fee will generally not trigger disclosure obligations, the franchisor's active assistance to a franchisee in selling its franchise may bring the franchisor within the scope of the disclosure requirements, including the rules relating to the first face-to-face meeting, the 10-day waiting period for closing, and so forth.

The question is at what point in the franchise sales process does a franchisor's participation become significant. Thus, if the prospective transferee participates in meetings with franchisor personnel who actively assist with the sale, disclosure must take place and the timing and other applicable disclosure rules will apply. Also, if the franchisor procures the buyer, charges a fee for this service, furnishes the prospect with sales literature or answers a prospect's questions about the franchise, disclosure obligations probably come into play.

Most significantly, merely requiring the prospective transferee to sign the franchisor's then-current form of franchise agreement will trigger franchise disclosure obligations under the FTC Rule and many of the state statutes. This has often been sufficient to result in loss of the exemption. If such disclosure is not made, the franchisor will be in violation of the applicable disclosure regulations and may be held liable for any misrepresentations made to the proposed transferee during the course of the sale negotiations. See *Boca Mara Properties, Inc. v. International Dairy Queen, Inc.*, 732 F.2d 1550 Bus. Franchise Guide (CCH) ¶8173 (11th Cir. 1984), and *Interstate Automatic Transmission Co. v. Harvey*, Bus. Franchise Guide (CCH) ¶8174 (Mich. App. 1984). Some states have additional requirements. For example, New York requires limited disclosure by the franchisee. N.Y. Gen. Bus. Law §684.5(c). The New York law is most constraining because it apparently requires disclosure of the franchisor's currently registered offering circular. Thus, a New York franchisee may be precluded from reselling his or her franchise in the event the franchisor fails to maintain a current registration.

Alternatively, other states, such as California and Hawaii, do not provide that simple usage of the franchisor's current form of agreement will cause the exemption to be lost. Hawaii Rev. Stat. §482-4(7); *Fox v. Ehrmantraut*, 28 Cal.3d 127, 615 P.2d 1383, 167 Cal. Rptr. 595 (1980). In the *Fox* case, the California Supreme Court indicated that franchisor participation in the sale by giving information to prospects or by referring prospects to the franchisee will not, without more, result in the sale being effected by or through the franchisor. The court indicated, however, that receipt by a franchisor of a

substantial portion of the purchase price may constitute sufficient franchisor involvement.

Even if the franchisor has not actively participated in the sale or transfer, it still might be advisable for the franchisor to comply with the disclosure requirements. The rules in this area are still evolving. It is not always clear that a franchisor's involvement in a resale has become significant or that a sale is effected by or through a franchisor. Disclosure also may serve to correct any misinformation given to the prospect by the selling franchisee.

III. APPROACHES TO PARTICULAR TRANSFER RESTRICTIONS

As a practical matter, most franchise agreements contain provisions that limit, but do not prohibit, transfer or assignment. Typically, these limitations are in the form of conditions that must be met. Some common conditions in franchise agreements are more reasonable or fair than others.

Agreements will typically define the term "transfer" broadly as the voluntary, involuntary, direct or indirect assignment, sale, gift or other disposition by the franchisee entity or any of its owners of any interest in: the agreement, the ownership of the franchisee entity or the assets of the franchised business. This may include stock transfers, transfers of partnership interests, mergers, issuance of additional shares, or a transfer resulting from divorce, death, disability, insolvency, corporate or partnership dissolution or other involuntary transfer by operation of law.

The drafter may want to include in the franchise agreement a list of certain types of "pre-approved" transfers which will not be subject to the standard transfer procedures required under the agreement. Such exceptions may include: (1) transfers of interest between principals of the franchisee entity, (2) transfers for estate planning purposes, and (3) change in the business form of the franchisee, e.g., from individual to corporate status, so long as the same parties are controlling the franchisee entity. Even though such excepted transfers or changes will not be subject to the standard transfer requirements, the franchisor will want to receive notice of any such transfer.

The discussion that follows deals with specific conditions to transfer, considers the interests of both the franchisor and franchisee, and suggests specific approaches that the authors believe are fair and reasonable.

A. The Transferee Must Meet the Franchisor's Qualifications

Franchisors commonly require that all transferees meet certain financial, professional and personal qualifications and standards. The franchisor may want to consider the transferee's character, business experience, financial stability and resources, and whether the transferee is affiliated in any way with a competing business.

Because the transferee will be doing business under the franchisor's trademark, it is reasonable for the franchisor to require that the transferee meet certain qualifications regarding character, financial stability, reputation, experience and business acumen. Also in some cases, it may be reasonable to require that the transferee not hold interests in competing businesses. Most franchisees would support a franchisor's evaluation of such qualifications for the benefit of the entire franchise system. They also would demand,

however, that the evaluation be based on objective standards whenever possible, and that the standards be applied by the franchisor consistently in evaluating all prospective franchisees. Many franchisors have established standard criteria for prospective franchisees in most of these areas. Accordingly, a fair approach to this issue would be for the contract to specify the applicable criteria subject to the underlying premise that a transferee who meets the franchisor's reasonable current criteria for new franchisees will satisfy this condition.

B. Payment of Monies Due to the Franchisor

Franchisors commonly require that the selling franchisee be current in its financial obligations to the franchisor before the franchise is transferred. Most franchisees would not object, at least to the extent of undisputed amounts owed. In addition, franchisors frequently require that all required reports be submitted for verification purposes.

While this condition seems reasonable on its face, it fails to recognize that many franchisor accounting departments do not perform flawlessly. Sometimes mistakes are made and franchisees frequently run into difficulty when they try to correct what they believe are accounting errors. Thus, while it is not unreasonable to have all required payments made and reports submitted before the transfer, the contract might envision that certain claims or debts may be disputed and permit the transfer to proceed anyway. For example, a disputed amount could be held in escrow pending resolution of the dispute.

Some franchisors go further, requiring that all of the franchisee's debts to third party creditors be fully paid before the franchisor will consent to a transfer. Most franchisees would object to such a condition. Certain creditors may not be upset with the delay or may have made arrangements satisfactory to them. Certain debts may be disputed. Moreover, usually there is a surviving indemnification clause to protect the franchisor if a creditor proceeds against it for sums owing from a franchisee. Accordingly, while it would be reasonable to require that the franchisee fully inform the franchisor in writing on such matters before the closing, a franchisor does not necessarily need the comfort that all creditors of the franchisee will be paid to the franchisor's satisfaction, as a condition precedent to consenting to the transfer.

C. Compliance with Other Contractual Obligations

Franchisors commonly condition approval of transfer on the absence of a default by the franchisee under the franchise agreement and any related agreements, such as the lease agreement for the premises on which the franchised business is located.

It does not appear unreasonable for a franchisor to require that its franchisee be in compliance with the contract at the time that the franchisor's consent to a transfer is sought. It may not be reasonable, however, to require that the franchisee shall have complied with the contract throughout its entire term. In the "real world", franchisees simply cannot be in full compliance with their franchise contracts at all times.

Franchise relationships are long term arrangements established pursuant to written agreements which typically impose extensive ongoing requirements on franchisees. A payment or a royalty report may come in late. The franchisee might fail an inspection. There are myriad possibilities, including unsubstantiated, disputed or fabricated ones, that may render a reselling franchisee unable to satisfy this condition. A

franchisor should not be permitted to use an event of insubstantial noncompliance as a basis for refusing to approve a transfer.

Accordingly, fairness dictates that this condition be reduced to a requirement that during the term and at time of transfer, the franchisee be in substantial compliance with the contract. The goals are to achieve a long-term relationship where the franchisee generally has satisfied its obligations and to avoid franchisor abuse at the transfer stage by eliminating minor technical requirements that may be seized upon wrongfully to refuse consent, or to grant it subject to harsh or unnecessary requirements.

One might reasonably question whether invoking a cured default as a basis for refusing consent to transfer is ever likely to be fair or reasonable. Defaults are generally curable. If the default is a serious or incurable one, the franchisor's likely remedy would be to terminate the agreement at the time of the default, not at the time of a subsequent request for consent to transfer. Arguably, then, the franchisor should require only that the franchisee be in substantial compliance at the time of the transfer.

D. Requiring the Transferee to Sign a New Franchise Agreement

Requiring the transferee to sign a new franchise agreement is often a hotly contested condition precedent to transfer. Many franchise agreements require the transferee to sign the franchisor's then-current form of franchise agreement.

From the franchisor's point of view, the franchise agreement that was drafted by an earlier management team may not be well-conceived. It may have been poorly drafted, and it may have provisions that make the new owners cringe. Moreover, in any system, the standard form of agreement will improve as it is reviewed from time to time in light of the real life experiences of the franchisor. Franchisors generally seek frequent opportunities to upgrade franchise agreements in order to maintain a uniform approach to all franchisees.

From the franchisee's point of view, however, a transfer that requires the signing of a new and different franchise agreement is not a "transfer" at all, since the "transferee" does not receive an assignment of the existing agreement. The franchisee paid an initial fee for a contract right that frequently lasts for ten years or more. If the franchisor can change the terms of the agreement upon transfer, especially when the franchisor can change material terms such as franchise fees, the franchisee's ability to realize value for the contract right the franchisee purchased will be limited. This type of condition can result in loss of a sale altogether, or a substantial reduction in what a willing buyer might pay.

As an alternative to requiring the signing of the "then-current" form of agreement as a condition to transfer, franchisors should consider making the signing of the then-current form of agreement a condition to renewal of the franchise agreement when its term expires. In this way, the franchisor can keep the system agreements current periodically, regardless of whether there is a transfer. This is usually sufficient protection for the franchisor. It also allows the franchisee, upon a transfer, to assign the actual rights the franchisee has.

Well-conceived franchise agreements normally have provisions (e.g. modification clauses) that permit the introduction of new product lines, operating procedures or requirements so that an entire franchise network can respond to competition and

implement system-wide changes. In most cases, uniformity is never achieved with respect to every detail of the contract and relationship. For example, while it may be desirable for a franchisor to have improved contract rights regarding matters such as increased fees, arbitration, choice of law, venue and jurisdiction, these "improvements" are not essential to its maintaining quality control and sound relationships with all franchisees.

Accordingly, a fair transfer provision should allow a franchisee to transfer the existing contract.

E. Transferee to Complete Franchisor's Training Program

In order to maintain quality control, franchisors necessarily require that transferees either attend and successfully complete the franchisor's basic training program or otherwise demonstrate a required level of know-how necessary to operate the franchised business properly. No reasonable franchisee should object to this requirement if it is administered fairly. A fair clause should permit this requirement to be met by the transferee's managerial personnel except where all franchisees must personally operate the franchise business.

While it is more understandable that the transferee may be required to complete the program to the franchisor's satisfaction, this subjectivity might be replaced with an objective standard based on criteria that all franchisees must meet, such as passing an examination. In some systems, it might be acceptable to allow the franchisee to demonstrate a required level of know-how necessary properly to operate the franchise business, so that no training would be required.

Where a franchisor wants the prospective transferee to undergo the required training prior to the actual transfer, the franchisor may be faced with the problem of disclosing confidential information before the franchisee has signed the franchise agreement, containing confidentiality and noncompete provisions. One solution to this problem would be for the franchisor to require the prospective transferee to sign a short confidentiality and noncompetition agreement prior to training, with an explicit statement to the effect that neither party is obligated to enter into a franchise agreement. Another approach would be to have the assignment actually take place, but to provide in the agreement for a test period, allowing the franchisor to terminate the agreement relatively soon after the training if the transferee cannot meet the franchisor's requirements.

F. Payment of a Transfer Fee

Franchisors may also want to include payment of a transfer fee as a condition of their consent to the transfer. It is reasonable for a franchisor to recover the costs incurred in processing a transfer because they are incurred at the request of the franchisee. It is not reasonable, however, to impose a fee which far exceeds such costs where nothing of value is given in return. This is consistent with the Washington franchise relationship law, which prohibits any transfer fee in excess of an amount necessary to compensate the franchisor for expenses incurred as a result of the transfer.

A fee in excess of such amount would function, in effect, as another initial franchise fee. The reselling franchisee already has paid that fee for the rights which are being sold. In many cases, especially where the value of the franchise business is comparatively modest, an onerous and unnecessary transfer fee can cause a significant

increase in the price for the business or a significant decrease in the net proceeds to the seller. Both serve to "chill" franchise resales to the detriment of the franchisee.

There may be situations where a franchisor is justified in imposing a transfer fee which exceeds its cost to process the transfer. For example, if the franchisor finds the buyer for the franchisee's business, the franchisor will have performed a useful brokerage function. Payment of an additional reasonable fee in the nature of a finder's fee or commission would be acceptable both to franchisor and franchisee. Otherwise however, a fair transfer fee clause should be for a sum certain which covers no more than the franchisor's reasonable transfer processing costs.

G. Releases

Franchise agreements routinely require that the reselling franchisee and its owners fully release the franchisor (and its affiliates and principals) from all claims as a condition precedent to consenting to a transfer. Franchisors have good business reasons for this condition. Both parties generally prefer a complete severance at the end of the relationship, with all "loose ends" addressed. To franchisors, two of the most important loose ends are that all debts be paid and that all disputes be resolved. Thus, in addition to insisting that they be paid all amounts due at closing, franchisors seek to be released from all franchisee claims.

It is reasonable to seek freedom from disputes and litigation with a franchisee, particularly where the relationship ends by way of a resale and the former franchisee has been paid something for the franchise. Conversely however, this condition may act as a club to bludgeon an abused franchisee into giving up valuable damage claims in exchange for salvaging a fraction of his or her investment in the business.

Most franchisees seek to join forces with financially stable franchisors. Such stability would be weakened considerably if franchisors did not routinely require that they be released following a transfer because they would remain vulnerable to substantial claims for damages from former franchisees. Thus, because there is no real "middle ground" on this issue, it seems reasonable that when the relationship ends there should be an agreement that the parties mutually release each other from all claims based on occurrences prior to the date of the transfer. Unless they can successfully negotiate out this condition, most franchisees whose claims are sufficiently serious and meritorious may have to decide between the value of their claims and the value of selling the franchised business.

It should be noted that certain state franchise relationship laws make it unlawful for a franchisor to require a franchisee, at the time of entering into a franchise arrangement, to assent to a release which relieves a person from liability under such laws. *See, e.g.*, Ark. Stat. Ann § 4-72-206(1); Neb. Rev. Stat. § 87-406(1); N.J. Rev. Stat. § 56:10-7(a). Though a statute of this type can arguably be read broadly to include releases required by the franchisor as a condition to its consent at the time of transfer, the authors believe that such statutes are intended to cover only releases required as a condition to entering into the franchise agreement.

H. Right to Approve Purchase Price and Terms

Many franchise contracts impose an additional condition giving the franchisor a right to refuse consent if the franchisor disapproves of the purchase price or other terms

of purchase. Some add a related condition that all financed amounts payable to the seller after the closing be subordinated to royalties and other payments due from the transferee to the franchisor during the term. Franchisors contend that these conditions are necessary so that the financial stability of the franchised business is not jeopardized and the transferee is given a reasonable opportunity to succeed and realize a reasonable investment return. These conditions have caused some reselling franchisees serious harm, however, such as lost sales and substantial decreases in net sale proceeds.

There is a fairer alternative which addresses the franchisor's concern but gives it less discretion. For example, if a transferee meets the franchisor's qualifications and its financial condition is such that ability to pay is not an issue, the franchisor should not be permitted to refuse consent simply because in its view the price is too high. Further, the only purchase terms which should be subject to franchisor approval should be the repayment terms in cases where the transferee finances a portion of the purchase price for the transferred interest. What's more, such terms should be deemed approved if they are substantially similar to those taken on by purchasers of new franchises in accordance with franchisor criteria therefor. Only in cases where financing terms are more burdensome should the franchisor have reasonable discretion to refuse consent based on this ground. Finally, the subordination requirement should be limited to situations where the transferee is not making continuing fee payments on a current basis.

I. Personal Guarantee of Transferee Principals

Just as most franchisors require new corporate franchisees to furnish personal guarantees from their principal owners, many franchisors also require such guarantees from the principal owners of a transferee. There is no middle ground here. While most franchisees predictably would object to personal exposure, it is reasonable for most franchisors to require a guarantee in the absence of other satisfactory security. Moreover, the existence of personally guaranteed franchise agreements adds financial stability to the franchisor and the franchise system, which adds residual value to each franchise. Accordingly, it is not unreasonable for the franchisor to include this condition in the agreement. Franchisees should be aware of this condition and may want to try to negotiate it out or seek a more favorable alternative, such as time limits, dollar amount ceilings or other limits, wherever possible.

J. Refurbishing the Physical Facility

The franchisor also may want to condition the transfer on the proposed transferee's agreement to update and modernize the business to current franchise standards. Transfer can be an opportunity for the franchisor to cause the physical facility to be upgraded to meet its then-current standards. This condition is similar to the requirement that the transferee sign the franchisor's then-current form of franchise agreement.

While franchisors understandably want to update "outdated" facilities, such a condition can be seriously detrimental to a franchisee's resale efforts and have the appearance of being unreasonable absent a valid reason based on quality control. The cost of new equipment, furnishings, signs and fixtures may be prohibitive. Thus, this condition can be a deal-breaker or can result in substantially reduced net sale proceeds to the franchisee. If such refurbishing is not necessary for the existing franchisee to continue to operate in accordance with the franchisor's standards, there is no compelling reason why it should be imposed simply because the business is being sold.

Such a condition is more reasonable and appropriate at the time of renewal. On the other hand, if the franchisor has the ability under the agreement to require refurbishing at periodic intervals and the agreement would allow the franchisor to require it in the absence of a transfer, it would also be reasonable to allow the franchisor to require refurbishing upon transfer. In most cases, however, a reasonable approach would be to eliminate refurbishing as a condition to transfer. The transferee's franchise term would run only for the remainder of the selling franchisee's term and reasonable refurbishing would be required as a condition of renewal.

K. Franchisor's Right of First Refusal

Franchisors frequently require that they be given the right of first refusal to purchase the franchised business on terms identical (or nearly identical) to those offered by a prospective buyer. While this may be an effective device for the franchisor to exert some control over the transfer transaction, it often serves to impede it substantially and unnecessarily. The right of first refusal may make it difficult for the franchisee to procure a serious purchaser and, if one is found, to hold the purchaser's interest during the time the franchisor deliberates over whether to exercise the right. Certain prospects may not be interested in going through what may appear to be a bidding process, with all its transaction costs, only to be thwarted by the franchisor. Moreover, in the great majority of transfers this right is never exercised.

A fair compromise should reflect the interests of both parties. First, the franchisor should be under an affirmative obligation to inform the franchisee at the earliest possible stage of the transfer process that it has no interest in exercising the right of first refusal if that is the case. Such notice would be binding on the franchisor and should relieve the franchisee of compliance with all other requirements dealing with this condition.

Second, if the franchisor is serious about exercising the right, the clause should state clearly the event that triggers it. This is commonly the receipt by the franchisee of a bona fide offer in writing from a third party. The clause should also state clearly the timing and content of the notice to the franchisor, the mechanism for the franchisor's exercise of the right and the consequences of the franchisor's failure to exercise the right.

Third, because delay can result in a lost sale, franchisors should be given a comparatively short time period to exercise the right. Notwithstanding that a few state statutes provide sixty days for such purpose, no more than fifteen days should suffice in most cases. While the franchisor may need more time to prepare for closing, it should be able to make a determination as to whether to exercise the right within that time frame. In any event, the times for exercising the right and for closing thereafter should be clearly stated.

L. Continuing Franchisee Liability After Transfer

Many franchisors include the requirement that the transferring franchisee remain liable for performance of the transferee under the franchise contract notwithstanding the fact that he or she is no longer involved with the franchise business. This gives the franchisor added security. The franchisor can proceed against the former franchisee (and perhaps its principals under a guarantee) if the transferee breaches the franchise agreement and cannot compensate the franchisor for damages caused thereby. While this may be comforting to the franchisor, it defeats one primary objective of the franchisee,

namely, to completely sever the franchise relationship save for a few promises that must be performed thereafter.

In this situation, the needs of the franchisee are likely to outweigh the franchisor's desire for additional security. Just as franchisors seek a "clean break" when the relationship ends with all debts paid and all claims released, franchisees seek the same peace of mind. Therefore, while certain franchisee obligations should survive a transfer (and termination of the old franchise) most rights and obligations of the parties should not. For example, it is reasonable that franchisee obligations under noncompetition covenants, indemnification clauses (for claims arising out of the operation of the franchisee's business) and trademark use restrictions survive termination. Noncompetition covenants, for example, are often reasonable because franchisors are not in the business of training competitors. Upon transfer, the franchisee is getting out of the business, in most cases with sale proceeds. Moreover, most franchises would be considerably less saleable if buyers knew that the sellers could turn around and compete immediately following the sale. Similarly, indemnification provisions are fair because the selling franchisee should remain responsible following a transfer for losses sustained by others as a result of his or her operation of the franchise business.

Accordingly, while it is fair for the selling franchisee to remain responsible for certain obligations as described above following a transfer which pertain to his or her acts and omissions in connection with the franchise business, it is neither necessary nor fair that he or she retain long term residual liability for the acts and omissions of the transferee.

M. Death or Incapacity

When the franchisee is a natural person, the franchisee's death would cause an involuntary, immediate and unplanned transfer, which may technically allow the franchisor to terminate the franchise agreement. The franchise agreement should specifically regulate the procedures for transferring, continuing, or terminating the franchise in the event of the franchisee's death during the franchise term in a manner that does not result in such a forfeiture of the franchisee's investment.

The franchisor will typically require the heirs to sell the franchise either back to the franchisor or to a qualified third party. The franchisor may also allow the heirs or surviving spouse to continue the operations of the franchise, provided that they meet certain personal and financial qualifications. Such a provision is required in some states.

Regardless of the ultimate disposition of the franchise, there will be an interim period during which either the franchisor or the heirs or personal representatives of the franchisee's estate will have to assume responsibility for operating the business.

N. Restrictions on Offerings of Securities

Franchise agreements commonly require the consent of the franchisor to any transfer of shares of the franchisee corporation or the admission of new partners if the franchisee is a partnership. It is not surprising, then, that some franchisors specifically require that the franchisee corporation not offer its shares of stock to the public.

A franchisee that owns a number of franchises, or a number of units within a particular franchise system, may want to place its shares privately or issue shares in an

initial public offering in order to finance its growth. The franchisor may object to a public offering because the franchisor loses some ability to control the franchisee. When the franchisee is a public company, the franchisor cannot control who will take over the ownership of the company. In addition, the stock market may be confused by the fact that the franchisor and franchisee have similar names; they might compete for buyers in the stock market.

While the franchise agreement may restrict franchisee public offerings, there are creative ways in which a franchisor may accommodate the desire of the franchisee to raise money through the issuance of stock while protecting the franchisor's legitimate interests. As a condition to giving its consent, the franchisor might ask for restrictions to keep the current management in place. For example, the current chief operating officer might be required to stay for a specific number of years and then agree personally not to compete for a reasonable period of time, such as two years. The franchisor might then have the right to approve the successor. In order to deal with the franchisor's fear of a takeover, the agreement might provide that any sale of a specified percentage of the franchisee company, such as one third of its shares, would require the franchisor's approval. This restriction might be indicated in a legend on the share certificates. In order to avoid confusion in the marketplace, the franchisor may require that the franchisee not use any part of the franchisor's trademark in the franchisee's business name.

In any event, the franchisor should reserve the right to review the offering documents or exemption documents before they are filed with any government agency. The franchisor will want to make sure that the offering materials do not state or imply that the franchisor is a participating underwriter, issuer or offeror of its or the franchisee's securities. The franchisor's review should be limited to the subject of the relationship between the franchisee and the franchisor. Also, the franchisor may want to be indemnified before it will consent to such an offering by the franchisee.

IV. SHOULD THE AGREEMENT EXPRESSLY REQUIRE GOOD FAITH?

One subject on which the authors disagree is the question of whether the franchise agreement should specifically require that the parties act reasonably and in good faith. Should the agreement provide that there is an implied obligation on the part of both parties to act in good faith and to deal fairly with the other party? If such a provision is included in the contract at all, it will presumably apply to the entire agreement, not just the transfer provisions.

One author feels that since an obligation of good faith and fair dealing is implied in all commercial contracts, there is no need to state this obligation explicitly in the contract. At best, such a provision adds nothing. At worst, it may add uncertainty and lead to needless litigation. The specific obligations of the parties in the various contract sections should be sufficient.

The other author believes, however, that in light of the nature of the franchise relationship and the manner in which it is often described to prospective franchisees, the obligations of reasonableness and of good faith and fair dealing should be made explicit in the agreement. While there are some areas of pure discretion, such as evaluating the aptitude and business acumen of a proposed transferee, a franchisor should be required (a) to have a legitimate business reason for refusing to consent to a transfer, and (b) not to

act arbitrarily or capriciously in connection with a transfer. Whether express or implied, however, these obligations should not serve to override other unambiguous contract terms.

The disagreement between the authors extends to their reading of the case of *Popeyes, Inc. v. Tokita*, Bus. Franchise Guide (CCH) ¶10,384 (E.D. La. Sept. 21, 1993). The authors see the case as standing for contrary propositions. The relevant issue before the court was whether the franchisor's termination of the franchisee's options under certain development agreements breached the implied covenant of good faith. The franchisee alleged that even if the franchisor had the contractual right to terminate the options, the franchisor did so out of ill motives toward the franchisee and should therefore be liable. Because the court denied summary judgment on the good faith and fair dealing claim, one author reads this case to mean that a franchisor's acts, such as a refusal to consent to a transfer, may raise issues of fact as to whether the acts were in bad faith, in violation of the contract. The other author sees the court as holding that specific contractual rights supersede any implied obligations: "I conclude that Popeyes' contractual right to terminate the options supersedes any implied covenant of good faith dealing." This author finds it unusual, but not necessarily contradictory, that the court went on to hold as follows:

Notwithstanding the foregoing analysis, because the evidence related to this claim will be offered and probably admitted at trial in connection with other claims, nothing is gained by granting partial summary judgment on this claim. If no additional evidence is submitted at the trial, this cause of action will not be submitted to the jury, and I will enter judgment as a matter of law pursuant to Rule 50 of the Federal Rules of Civil Procedure.

Because of their disagreement, the authors cannot offer a unified approach to the question of whether an obligation of good faith and fair dealing should be written into the franchise agreement, whether generally or solely with respect to a franchisor's decision on consenting to a franchise transfer. Nevertheless, they agree that all franchisors and all franchisees should act reasonably and in good faith.

V. CONCLUSION

Whatever approach the franchisor may take in drafting the franchise agreement and in dealing with specific transfer scenarios, the franchisor should respect the franchisee's need to obtain fair value for the franchised business. Accordingly, any required consent should not be withheld unreasonably or unfairly so as to deprive the franchisee of the fruits of the franchisee's contract and hard work. Similarly, the franchisee should respect the franchisor's need for an orderly transition to a qualified transferee. The franchisee should act reasonably and in good faith to satisfy the conditions precedent to transfer in timely fashion.

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