November 21, 2003

Via e-mail to director @ fasb.org

TA&I Director
Financial Accounting
Standards Board
401 Merritt 7
P.O. Box 5116
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Re: File Reference No. 1082-300

Ladies and Gentlemen:

The International Franchise Association recognizes and appreciates the efforts being made by the Financial Accounting Standards Board ("FASB") to address the concerns of its members and others using franchise and distributorship business systems over FASB Interpretation No. 46 ("FIN 46"), as most recently evidenced by the Exposure Draft dated October 31, 2003 (the "Exposure Draft") and the Proposed FASB Staff Position No. FIN 46-f ("FSP 46-f"). Because of the relationship of the Exposure Draft and FSP 46-f, this letter addresses both of those recent statements primarily with respect to direct franchisor and franchisee relationship matters (Paragraphs 4, 5(b) and 16(a)). Because issues continue to evolve from conversations with IFA members and their outside auditors regarding Paragraph 5(a) of FIN 46, we will comment on that Paragraph in a separate letter.

As you know from the numerous communications to the FASB from franchisors and franchisees alike, the implications of FIN 46 to franchise business systems is of deep concern to the franchise community. The Exposure Draft and FSP 46-f begin to provide the clarity sought by our Association. In particular, we appreciate your clarification in the Exposure Draft of the time of initial determination of variable interest entity and primary beneficiary status and the events that would give rise to a reassessment of those matters. We also appreciate that FSP 46-f endeavors to address one of the most significant franchise community concerns. However, further considerations and clarifications are needed to fairly distinguish arm's length franchise and distributorship business relationships from variable interest entities. In this regard, we are sensitive to the need for FIN 46 to be principles driven, but we continue to be concerned that principles, absent clear guidance, will inadvertently capture and disrupt the multi-trillion dollars franchise and distributorship business systems.

1. We concur that the emphasis should be the intentions of the parties in determining whether an entity is a variable interest entity. To clarify the applicability of this concept to Paragraph 5(b), we recommend that an explanatory paragraph be included either in that paragraph of FIN 46 or in Appendix A that defines the phrase "decisions about an entity's activities." Our intention is to add clarity to the concepts embodied in FSP 46-f.
Paragraph 5(b) makes reference to voting rights or similar rights. Applying basic concepts and plain meaning, we assume that attention is to be directed to the fundamental governance rights afforded to corporate shareholders under corporation charters and state laws. These fundamental rights include the election of directors and authorizing mergers, changes in the corporate charter and changes in authorized capital. Thereby, reference to "similar rights" would be to consent or approval rights respecting comparable fundamental governance matters under limited partnership agreements, limited liability company operating agreements, and perhaps bond indentures and loan agreements.

Consistent with the reference to voting rights in Paragraph 5(b), "decisions about an entity's activities" should mean fundamental decisions such as decisions affecting the entity's charter or other governing instrument, business form, election of board level management, and changes in authorized capital. For clarity, these fundamental governance decisions should be distinguished from operating decisions such as hiring and firing of employees, compensating employees, product selection and pricing, location selection, local marketing and advertising, borrowing, and alike, which are not typically subjected to shareholder voting. Limitations upon products to be sold or services to be offered, brand name and trademark use, adherence to design standards, operating standards, and record keeping and reporting requirements as are typically found in contracts and agreements widely used by a party to the enterprise, are business standards, not activities, and, as indicated in FSP 46-f, should be distinguished from "activities," both fundamental and operational. Franchisors are responsible for establishing and enforcing business standards. Equity owners of franchisees make fundamental decisions and management of franchisees make operational decisions, about the entity's activities.

We agree with the staff's views expressed in FSP 46-f that the first test should be to determine who has equity investor voting rights. The focus here should be on fundamental decisions. An absent or dilutive sharing of any such rights would lead to an evaluation of operating decisions. In each instance, business standard decisions would be disregarded.

In light of the foregoing, we propose that the answer in FSP 46-f be modified and expanded to read as follows (modifications are highlighted):

"The evaluation under Paragraph 5(b)(1) should be based in part on the extent to which the total equity investment at risk provides the equity holders as a group the ability to make fundamental decisions about an entity's activities through voting rights or similar rights. The equity group would not lack the characteristic in paragraph 5(b)(1) of Interpretation 46 in situations in which the equity group holds all voting rights or similar rights, and, conversely, the equity group would lack

FSP 46-f introduces a new evaluation concept, "significant impact on the success of the entity," and, per the Exhibit, measures this level of impact by "the equity group's ability to significantly influence the fair value of the franchise." This concept and analysis implies active involvement in day-to-day operational decisions and should only be applicable if the equity group fails to have voting rights or similar rights on fundamental decisions, particularly the election of directors/management.
the characteristic in situations in which the equity group holds no voting rights or similar rights. References to voting rights or similar rights means the rights typically afforded to shareholders of a corporation to vote on fundamental corporate matters such as the election of directors, authorized capital, mergers, and charter changes. There are situations in which both the equity group and the parties outside the equity group hold voting rights or similar rights such that each has the ability to make or participate in fundamental decisions about an entity's activities. In those situations, emphasis should be placed on the ability of the equity group or its elected management to make decisions that have a significant impact on the success of the entity. These are the operational decisions typically vested in directors and officers of corporations, such as hiring, firing and compensating employees, product selection and pricing, business hours, business location, local marketing and advertising, and capitalization.

... "Judgment often will be necessary in evaluating whether the equity group or its elected or appointed management has the right to make decisions that have a significant impact on the success of the entity. It is not possible to create a complete list of decisions that an equity group must be able to make in order to determine whether the equity group lacks the characteristic in paragraph 5(b)(1) since the types of decisions can vary depending on the nature of the activities conducted by an entity. If the equity group or its elected or appointed management has the ability to make decisions that have a significant impact on the success of the entity, then the equity group should be deemed to have the ability to make "decisions about an entity's activities" for purposes of Paragraph 5(b)(1)."

To add further clarity to Paragraph 5(b)(1), we suggest that the explanatory paragraph following the franchisor approval rights in FSP 46-f be modified to read as follows:

"Although many of these decisions are important to the success of the franchise, the FASB staff believes that the franchisor's ability to participate in those decisions, without more, would not result in the equity group lacking the characteristic of paragraph 5(b)(1). The equity group would not lack the characteristic of paragraph 5(b)(1) so long as the equity group of the franchisee maintains control over the fundamental decisions or the decisions that significantly impact the success of the franchise. These would typically include control over the day-to-day operations of the franchise, including, but not limited to, hiring and firing of management, establishing what prices to charge for products or services, and capital decisions of the franchise. This analysis would not change in cases where the franchisor owns a non-controlling equity position in the franchisee, as such ownership position would not affect the decision-making by the persons controlling the equity group or the franchisee's elected management.

2. With respect to Appendix Paragraph A21, we agree with the concept of evaluating the relationship with, and reliance on, other parties, and the use of a "preponderance of evidence" standard. However, we are concerned that the example included in
Paragraph A21 will inadvertently evolve into a roadmap or checklist to determine whether or not an entity is a variable interest entity. First, as written, it appears that all of the elements of the example must be satisfied to avoid variable interest entity characterization. This contradicts the preponderance of the evidence standard. Second, references to “limited life” and “tightly constrained activities,” without further comment, could cause auditors to deem franchise licensees to fail the preponderance of evidence test proposed in Appendix Paragraph A21.

To add clarity to the concepts and standards discussed in Appendix Paragraph A21, we suggest that the example be revised to explicitly serve as a partial list of factors to consider in evaluating the apparent intentions of the parties. If the factor of limited life is retained, we also suggest that it be clear that limited life be measured by the entity charter, articles, operating agreement or partnership agreement, or other formational documents, not by contract terms. Similarly, if the factor of tightly constrained activities is retained, whether or not activities are tightly constrained should be measured by comparable commercial standards.

For example, all franchise agreements have fixed terms; most range from five to 20 years, and many are subject to a series of renewal options. The initial term is necessary to add validity to the license, and allow the franchisor and franchisee to exit the relationship if it is not working to their satisfaction. Applying a term in a franchise or license agreement is no different than a lease having an expiration date. It should not be the determinative factor of the life of the business entity. The formational documents of the entity more clearly express the intentions of the franchisee, often providing for existence well beyond the term of the franchise or license agreement, and should be controlling.

The concept of tightly constrained activities, if retained, also should be based on the formational documents of the entity. Contract covenants that are intended to protect valuable property rights of others, such as those that limit trademark use, conflicting business operations, territorial rights and product offering, should not be deemed constraints so long as substantially the same covenants apply to others in similar contractual relationships (e.g., other franchisees of the same franchisor).

To address these concepts, we suggest that Appendix Paragraph A21 of the Exposure Draft be modified to read as follows:

"A21. The design of the entity (for example, its capital structure) and the apparent intentions of the parties that created the entity are important qualitative considerations for determining whether or not an entity is a variable interest entity. No single factor will be conclusive and the determination will be based on the "preponderance of evidence." Factors to be considered, when relevant, include, without limitation, ratings of the entity’s outstanding debt (if any), the

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2 Even then, if the founders of a franchisee opt to form a general partnership of definitive duration, that should not transform a franchise relationship into a variable interest entity.

3 Some courts have construed a contract without a definite term to be a contract subject to termination at will by either party: an outcome wholly inconsistent with the business objectives of both the franchisor and the franchisee.
commercial reasonableness of the interest rates and other terms of its financing arrangements, its relationship with and reliance on other parties, especially its creators and their related parties, its expected business life as set forth in the entity's formation documents, constraints on activities in comparison to industry standards, unusual arrangements that appear designed to provide subordinated financial support, equity interests that appear designed to require other subordinated financial support, and the availability of commercial financing arrangements on customary terms. For example, an entity that has a very small equity investment relative to other entities with similar activities and has outstanding subordinated debt that obviously is effectively a replacement for an additional equity investment, would be expected to be a variable interest entity."

3. The modification proposed to be made to Paragraph 16(d) (identifying a de facto agent), particularly in light of Appendix Paragraph A32, is quite helpful in mitigating the risk of a franchisee becoming a related party of its franchisor. However, because subparagraphs (a) through (d) of Paragraph 16 are presented in the alternative, we believe that similar clarification is needed for subparagraph (a) of Paragraph 16, which makes a de facto agent a party that cannot finance its operations without subordinated financial support from the enterprise.

Often, a franchisee elects to pursue one franchise opportunity over others on the basis of ease of entry and cost of entry. Franchise disclosure documents enable prospective franchisees to compare these franchise program features. Because of the keen competition among franchisors for franchisees and the desire of franchisors to help to promote the success of franchisees, and thereby their whole systems, many franchisors make financing programs available to their franchisees. Some of these programs are available at the outset of the relationship, such as equipment leasing, floor plan financing and group purchasing. The franchisee is not required to avail itself of the offered financing; it may use other commercial financing or increase its equity. Yet, the franchisor-offered financing may be viewed by the franchisee as more favorable or more accessible. We suggest that it be made clear that as long as the franchisee is not precluded from using alternative financing, the franchisee will be considered as able to finance its operations without subordinated financial support from the franchisor. We believe that this modification will distinguish typical franchise system relationships from the related party relationships that were most prevalent in special purpose entities.

In light of the foregoing, we suggest the following be added to the Exposure Draft:

"The concept underlying Paragraph 16(a) is financial dependence on a variable interest holder. If a variable interest entity or holder cannot obtain debt or equity financing from customary commercial sources absent additional investment, subordinated loans or credit enhancement by another party, the party so providing the additional investment, subordinated loans or credit enhancement will be the de facto principal of the variable interest entity or holder. However, if equity or debt financing from customary commercial sources may be obtained, but the party seeking the financing elects to avail itself of financing offered by or through another party or the enterprise, the other party or enterprise offering such financing will not be the de facto principal of the variable interest entity or holder. For example, a
provider or arranger of floor plan financing, equipment leasing or financing, or group purchasing programs would not be the de facto principal of a participant in such a financing program unless there is not available to the variable interest entity or holder in the commercial markets alternative conventional financing. In this regard, the alternative conventional financing need not be (nor would it be expected to be) available in a like amount or on similar or better terms and conditions to the offered financing program. Such a financing program would be deemed to not be available to the variable interest entity or holder if it could not be obtained without investments, subordinated loans, or credit enhancement by an otherwise unrelated person."

4. As evidenced by the need for the Exposure Draft and FSP 46-f, as well as the temporary partial suspension of FIN 46 announced in FSP 46-e, the fluidity of FIN 46 has made it practically impossible for franchisors to react with document and procedural changes required to enable FIN 46 analyses. The publication of FIN 46 at the end of January, 2003 does not warrant an assumption that beginning February 1, 2003 information would be readily available for FIN 46 analyses. Thus, the February 1, 2003 date used in Paragraph 4(g) should be moved to a more realistic date, no earlier than sixty (60) days after the adoption of the Exposure Draft.

5. Paragraph 3(c) of the Exposure Draft would add new subparagraph (g) to Paragraph 4, placing a continuing burden on franchisors to make an exhaustive effort to obtain information from existing franchisees solely to determine the applicability or inapplicability of FIN 46 to the relationship. This provision seriously strains the typical franchisor-franchisee relationship. The continuing efforts obligation requires that franchisors repeatedly seek information from franchisees that the franchisee either is not contractually obligated to provide or cannot make available without undue burden and expense. It would be highly detrimental to the business relationship were a franchisor obligated to issue notices of breach or default upon franchisees for failing to provide financial statements not needed by the franchisor for any purpose other than a FIN 46 determination or, worse yet, to have to bring legal actions against franchisees to compel provision of financial statements. Additionally, as we have highlighted in prior correspondence, with FASB, in many cases franchisees are small businesses which do not generally have sophisticated financial processes and many do not prepare GAAP basis financial statements. Exception to the continuing exhaustive effort obligation should be made for lack of contractual availability and without the imposition of an undue burden and expense.

In light of this concern, we suggest the following be added to the Exposure Draft:

"It is not the intention of this paragraph 4(g) to require an enterprise to prosecute legal proceedings in an effort to obtain information needed to make determination under FIN 46 or to materially interfere with the business relationship between the enterprise and the party from whom information is sought. Notwithstanding any contractual obligation on the part of either the enterprise or any entity to the contrary, parties shall not be obligated to create, provide or obtain financial, financing, ownership or any other information under FIN 46 if to do so would constitute a hardship or an undue burden or expense."
FIN 46 has the potential of changing the business practices of thousands of businesses. Most franchisees are unaware of the existence and the implications of FIN 46, which implications are still evolving. In light of the need for further revision of the Exposure Draft, we urge that FASB suspend the applicability of FIN 46 in its entirety as it relates to franchise and distributorship systems until there is clarity and certainty for determining its inapplicability.

Representatives of the International Franchise Association would be pleased to meet with members of FASB and/or its staff to review these comments and the impact of FIN 46 to the franchise business system.

Respectfully submitted,

Matthew R. Shay  
Executive Vice President
November 21, 2003

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Re: FASB Interpretation Number 46 ("FIN 46" or the "Interpretation")

Dear Mr. Trott:

The International Franchise Association (IFA) appreciates the opportunity to provide you with additional information and comments to address some of our concerns relative to FIN 46, as a follow-up to (among other things) our meeting with Mr. Mahoney on October 14, 2003. As suggested by Mr. Mahoney during that meeting, we are forwarding with this letter additional information to address a point that we know is of particular interest to FASB and its staff: whether franchisors "control" the operations of franchisees.

IFA respectfully submits that in the truest sense of the word, franchisors do not "control" the actions or the business operations of their franchisees. To illustrate this point, we contrast the typical employment relationship and the typical franchise relationship:

- In a traditional employment relationship the employer can direct the actions of its employee. In the employment context, an employee that fails to abide by the instructions of a superior can and often is simply dismissed from his or her job. An example that is perhaps unconventional, but obvious, would be George Steinbrenner's hiring and firing of managers for the New York Yankees.

- In a traditional franchise relationship, the franchisor and franchisee are independent business entities, and will have contractually agreed upon certain standards relating to business operations (e.g., a requirement that the franchisee keep clean the floors in its restaurant). However, unlike Mr. Steinbrenner, a franchisor frustrated with a franchisee's failure to meet an agreed-upon obligation can not simply "dismiss" the franchisee because the franchisee is an independent entity, operating its business pursuant to the terms of a franchise agreement. Rather, absent cooperation on the franchisee's part, the franchisor would have to enforce the terms of the franchise agreement by filing a lawsuit (or initiating an arbitration proceeding). In such an action, the franchisor could seek an injunction to compel the franchisee to meet its contractual commitment or, alternatively, could seek to enforecement of the franchise agreement due to the franchisee's failure to abide by the lawful terms of the franchise agreement. Examples of this proposition are abundant; some illustrations follow.
Cases involving franchisors seeking to enforce contractual terms are numerous and occur virtually all the time. The issue of control is also quite naturally reviewed by courts in cases where claims are asserted that a franchisor is vicariously liable for a franchisee's actions or failure to act.

Franchisors do, of course, establish a set of standards for businesses operating in their system to follow. Prospective franchisees—after receiving disclosure that is mandated by federal and state law—can decide whether to sign up to become part of a franchise system or to operate their business as a stand-alone concept. Those who do sign a franchise agreement have in effect made an informed decision to operate their business under a common trademark and system, adopting the franchisor's standards for many day-to-day matters (instead of making up and using standards found elsewhere). The decision to accept these standards, however, is a fundamental one made by the franchisee himself or herself. The franchisee will then have countless other decisions to make, such as whether to capitalize by borrowing money or by selling ownership interests in the business, all employment, labor, pension and benefits decisions, when and where the franchisee's principals will work, whether to reinvest profits into the business or take profits out through salaries, dividends, or otherwise, etc.

Vicarious Liability Cases. Under the theory of actual authority, vicarious liability may be imposed where the principal actually exercises authority and control over its agent. In the franchise context, courts have measured the extent of the franchisor's control over the day-to-day operations of the franchised business. There is no clear demarcation of controls that lead a court to find a franchisor vicariously liable. Because certain controls are necessary to protect the licensed trademarks and accompanying goodwill, a franchisor often is caught in the quandary of protecting its trademarks while avoiding excessive controls that might lead to an unwelcome finding of vicarious liability. This legal quandary is classic in franchising and the source of legitimate frustration for both franchisors and their counsel.

- On one hand, the requirements of the federal trademark law, the Lanham Act, 15 U.S.C. §§ 1051-1072, 1091-1096, 1111-1121, 1123-1127, impose upon a trademark owner an affirmative duty to exercise adequate control over the quality of the goods and services sold under the mark. In fact, the trademark owner risks a finding that

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the mark has been "abandoned" if inadequate control is exercised. See 15 U.S.C. § 1127.

Consequently, franchisors have to be vigilant in protecting their marks in order to retain those marks. On the other hand, excessive controls over the day-to-day operation of the franchised business could raise the risk of the franchisor being held vicariously liable for its franchisee’s actions.

Courts time and again wrestle with these legal issues in the ordinary course of resolving matters. Franchisors, in turn, must carefully consider the restrictions to be imposed upon franchisees. See, e.g., Wu v. Dunkin' Donuts Inc., 2001 WL 170639 (2d Cir. 2001) (upholding grant of summary judgment in favor of the franchisor because plaintiff, who was raped while working a graveyard shift at a franchised shop, failed to show either that franchisor had a "right to control" or "actually exercised control" over the franchise such that it could be held vicariously liable for franchisee's alleged acts); and Okocha v. Janik, Inc., Bus. Franchise Guide (CCH) ¶ 12,479 (W.D. Wash. 2002) (franchisor not vicariously liable for acts of its subfranchisee where its subfranchisee retained sole power to hire, fire, and supervise all of its employees, and where subfranchisee owned all of the licenses, permits, and insurance necessary for it to conduct business). Cf. Mini Maid Svcs. Co. v. Maid Brigade Sys., Inc., 967 F.2d 1516 (11th Cir. 1992) (franchisor not vicariously liable for its franchisee's trademark infringement; a licensor's duty to control use of its trademark by licensee "cannot be blindly converted into a duty to prevent a licensee's misuse of another party's trademark"); Ely v. General Motors Corp., 927 S.W.2d 774 (Tex. Ct. App. 1996) (manufacturer was not vicariously liable for fatal accident during test drive related to warranty service, where manufacturer had no right of control over employee's test drive); and Mobil Oil Corp. v. Bransford, 648 So.2d 119 (Fla. 1995) (franchisor not vicariously liable for the assault upon a customer by one of the franchisee's employees).

These determinations are often highly-fact dependent. See, e.g., Font v. Stanley Steemer Int'l, Inc., Bus. Franchise Guide (CCH) ¶ 12,611 (Fla. Dist. Ct. App. 2003) (reversing summary judgment in case brought by estate of person killed in traffic accident with franchisee's employee; issues of fact remained as to the degree of franchisor's control over the franchisee); and Morse v. McDonald's Corp., 2001 Conn. Super. LEXIS 3155 (Conn. Super. 2001) (summary judgment denied where genuine

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2 Practical factors that may bear upon a franchisor's decision whether to start a lawsuit include the merits of the case, likely outcome, anticipated cost, and the potential for disruption to the same or other franchise relationships. Accordingly, while employers can direct employees to address concerns of a small nature, in contrast it is uncommon for franchisors to sue over non-material defaults, since doing so implicates all of the factors noted above — and even more particularly because courts will be loathe to terminate a franchisee's business on account of a non-material breach.
issues of material fact existed over whether franchisor controlled the parking lot where a franchisee’s customer tripped and fell).

Although an employer generally is vicariously liable for the acts of its employees within the scope of their employment, ordinarily, franchisors are not considered to be “employers” of their franchisees (nor, in turn, of their franchisees’ employees). See, e.g., Arquello v. Conoco, Inc., 207 F.3d 803 (5th Cir.), cert. denied, 121 S. Ct. 177 (2000) (franchise agreement included detailed guidelines for treating customers and operational standards, but franchisor did not participate in franchisee’s daily operations or personnel decisions); Evans v. McDonald’s Corp., 1991 WL 52685 (10th Cir. 1991) (franchisor not “employer” liable for sexual harassment of franchisee’s employee even where franchisor’s controls were stringent; franchisor did not exercise control over franchisee’s labor relationship with its employees); Marshall v. Shan-An-Dan, 747 F.2d 1084 (6th Cir. 1984) (franchisor not responsible for franchisee’s violation of Fair Labor Standards Act; franchises are free to control their own labor relations and are independent businesses); Kennedy v. The Western Sizzlin Corp., Bus. Franchise Guide (CCH) ¶ 12,514 (Ala. 2003) (franchisor not vicariously liable for franchisee’s sexual harassment of plaintiffs; franchisor’s control was limited to ensuring that the franchisee complied with the franchise agreement and operations manual, which was intended to ensure uniformity in service among franchisees); Hyde v. Schlotzsky’s, Inc., Bus. Franchise Guide (CCH) ¶ 12,290 (Ga. Ct. App. 2002) (franchisor not liable where it did not involve itself in day-to-day operation of the restaurant); Chelkova v. Southland Corp., Bus. Franchise Guide (CCH) ¶ 12,351 (III. App. Ct. 2002) (franchisor not liable for sexual assault upon its franchisee’s employee; franchisor’s security recommendations were not enforced and franchisee ran her business as she saw fit); and Daves v. Southland Corp., Bus. Franchise Guide (CCH) ¶ 11,779 (Wash. Ct. App. 2000) (franchisor not vicariously liable for franchisee’s harassment of its employees).

Franchisors nonetheless may be held vicariously liable for the torts of their franchisees under agency principles. For example, a franchisor may be deemed liable for its franchisee’s acts if the injured party reasonably believed that the franchisor exercised control over the franchisee and detrimentally relied on that belief. See, e.g., Hoyt v. Dogtor Pet Ctr., Inc., Bus. Franchise Guide (CCH) ¶ 8723 (N.D. Ill. 1986) (franchisor held vicariously liable under doctrine of apparent authority); Read v. The Scott Fetzer Co., 1999 WL 2560 (Tex. 1998) (manufacturer liable for sexual assault on customer by distributor’s independent salesperson because it required in-home demonstrations); Miller v. McDonald’s Corp., Bus. Franchise Guide (CCH) ¶ 11,248 (Or. Ct. App. 1997) (franchisor could be liable for franchisee’s negligence under either actual or apparent agency theories); and J.M. v. Shell Oil Co., 922 S.W.2d 759 (Mo. 1996) (franchisor could be vicariously liable for abduction and assault of a franchisee’s customer by stranger if franchisor possessed contractual right to control franchisee’s security efforts).

Often, decisions on vicarious liability seem tied to a compelling set of facts or the more realistic deep pocket theory of holding liable all parties who benefit from a particular commercial relationship — but most particularly those who are in a financial position to pay the injured victim. Consequently, franchisors are well-advised to remove unnecessary controls on day-to-day operations; to require public notice of the franchise relationship through use of signs and stationery; and, perhaps most importantly, to
assure that adequate levels of liability insurance are maintained both by the franchisor itself and its franchisees.

Transfers. Restraints upon the transfer of a franchised business have long been upheld by courts.

In a mere buyer-seller relationship, a court is not likely to look favorably on an attempt to restrict the buyer's freedom to sell its business. But courts have long recognized that franchisors have a much greater stake in the identity of the other party to the franchise relationship (which is holding itself out using the franchisor's name) and, therefore, franchisors have a legitimate interest in requiring their franchisees to obtain the franchisor's consent before a transfer. One court summarized the point thusly:

A franchisor "has a perfect right to consider the character, stability, reputation, business ability, etc. of those to whom it will entrust its own good name, its mark and its products."


Courts have also recognized that certain controls that may not be required under the Lanham Act are nevertheless "customary" in franchise agreements in order to create uniformity among the franchisees who are part of the system. See, e.g., States v. Int'l House of Pancakes, Inc., 413 N.E.2d 457 (III. App. Ct. 1980); Murphy v. Holiday Inns, Inc., 219 S.E.2d 874 (Va. 1975).

Some state statutes, as discussed below, also recognize franchisor's legitimate interests in reviewing and approving their franchisee's prospective transferees.

Due to the factors recognized in Plum Tree, franchise agreements typically include provisions restricting the franchisee's ability to transfer. Franchisor's use of such provisions to disapprove proposed transfers have generally been upheld when made a unilateral business decision and acted reasonably to protect its interests in the franchise system. The courts have upheld the grounds for disapproved transfers based on, among other things:

- failure to provide financial information about the proposed transferee's major investors (Holt Motors, Inc. v. General Motors Corp., 860 F.2d 1079 (6th Cir. 1988));
- the proposed transferee's criminal record (Carrozza v. Weber Chevrolet Co., 1978-1 Trade Cas. (CCH) ¶ 61,982 (D.R.I. 1978));
- the proposed transferee's failure to complete training as stated in the franchise agreement (Perez v. McDonald's Corp., Bus. Franchise Guide ¶ 11,538 (E.D. Cal. 1998));
• the proposed transferee failing a test used to evaluate the potential success of prospective franchisees (Chu v. Dunkin' Donuts Inc., 27 F.Supp.2d 171 (E.D.N.Y. 1998));

• the proposed transferee's lack of experience in the franchisor's industry (Anheuser-Busch, Inc. v. Natural Beverage Distribs., 69 F.3d 337 (9th Cir. 1995));

• the franchisee's refusal to execute a release of claims at the time of the transfer (Franchise Mgmt. Unlimited v. America's Favorite Chicken, Inc., 561 N.W.2d 123 (Mich. Ct. App. 1997));

• the fact that the proposed transferee had been the subject of numerous consumer complaints (McDaniel v. General Motors Corp., 480 F.Supp. 666 (E.D.N.Y. 1979), aff'd mem., 628 F.2d 1345 (2d Cir. 1980));

• the proposed transferee's other business activities (Hawkins v. Holiday Inns, Inc., 634 F.2d 342 (6th Cir. 1980), cert. denied, 451 U.S. 987 (1981));

• the franchisor's determination that the proposed purchase price was set so high that it would jeopardize the business' ongoing financial stability (Kestenbaum v. Falstaff Brewing Corp., 575 F.2d 574 (5th Cir. 1978), cert. denied, 440 U.S. 909 (1979)); and

• the franchisee's transfer of franchise assets to family members without extending the franchisor a contractually agreed-upon right of first refusal (Victory Lane Quick Oil Change, Inc. v. Hoss, Bus. Franchise Guide (CCH) ¶ 12,188 (E.D. Mich. 2001)).

However, the disapproval of a proposed transfer might not be upheld if the reasons for the franchisor's dissatisfaction are deemed irrelevant to its legitimate interests (Richter v. Dairy Queen Int'l, 643 P.2d 508 (Ariz. App. 1982)) or if its refusal to consent would prevent competition (Ohio-Sealy Mattress Mfg. Co. v. Sealy, Inc., 585 F.2d 821 (7th Cir. 1979), cert. denied, 440 U.S. 930 (1979)).

**State Franchise Relationship Laws.** Twenty states, the District of Columbia, and Puerto Rico have enacted special statutes that apply to the franchise relationship. Among the requirements of these state laws are clauses that require a franchisor to act "reasonably" or with "good cause" in considering a transfer, before denying a franchisee's right to renew a franchise, and before terminating a franchisee's rights under its franchise agreement. Typical of these is the California Franchise Relations Act, Cal. Bus. & Prof. Code §§ 20000- 20043, which requires that:

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\text{Except as otherwise provided by this chapter, no franchisor may terminate a franchise prior to the expiration of its term, except for good cause. Good cause shall include, but not be limited to, the failure of the...}
\]
franchisee to comply with any lawful requirement of the franchise agreement after being given notice thereof and a reasonable opportunity, which in no event need be more than 30 days, to cure the failure.

Id. at § 20020. Conversely, and as noted above, some state laws specifically acknowledge the reasoning recognized by the court in Plum Tree by requiring a franchisee to obtain the franchisor's approval before attempting a transfer. For example, the New Jersey Franchise Practices Act, N.J. Rev. Stat. §§ 56:10-1 through 56:10-12, provides that:

It shall be a violation of this act for any franchisee to transfer, assign or sell a franchise or interest therein to another person unless the franchisee shall first notify the franchisor of such intention by written notice setting forth in the notice of intent the prospective transferee's name, address, statement of financial qualification and business experience during the previous 5 years. The franchisor shall within 60 days after receipt of such notice either approve in writing to the franchisee such sale to proposed transferee or by written notice advise the franchisee of the unacceptability of the proposed transferee setting forth material reasons relating to the character, financial ability or business experience of the proposed transferee. If the franchisor does not reply within the specified 60 days, his approval is deemed granted. No such transfer, assignment or sale hereunder shall be valid unless the transferee agrees in writing to comply with all the requirements of the franchise then in effect.

Id. at § 56:10-6.

These state relationship laws reflect the fact that a franchisor-franchisee relationship is between two independent, arms-length businesses. The substantive provisions of these laws confirm that the restrictions imposed by franchisors upon matters such as transfers are not only consistent with judicial decisions (such as Plum Tree), but also with the legitimate and rightful perspective franchisors and franchisees have in these matters.

**Good Cause Statutes.** Franchisors have to pass a test in order to enforce the terms of their franchise agreements—usually, the test of reasonableness, and the test of "good cause," "just cause," or "reasonable cause."

Some examples of court decisions in which courts found that there is good cause for termination include the following:


failure to meet reasonable sales quotas (L-O Distrs. Inc. v. Speed Queen Co., 611 F.Supp. 1569 (D. Minn. 1985));

use of abusive language by a franchisee in dealing with customers (Aselta v. Radio Shack Div. of Tandy Corp., No. 76-2395 (D.N.J. 1977));

the franchisee’s willful criminal conduct (Dunkin’ Donuts Inc. v. Chetminal, Inc., Bus. Franchise Guide (CCH) ¶ 11,290 (S.D. Fla. 1997));

customer deception and misrepresentation (AAMCO Indus. v. DeWolff, 312 Minn. 95, 250 N.W.2d 835 (1977));

willful overcharging of customers in violation of federal pricing regulations (Amerada Hess Corp. v. Quinn, 143 N.J. Super. 237, 362 A.2d 1258 (1976));

failure to maintain required standards of cleanliness, quality, and service (Dayan v. McDonald’s Corp., 466 N.E.2d 958 (Ill. App. Ct. 1984));

failure to maintain an adequate parts inventory to meet consumer service needs (Tappan Motors, Inc. v. Volvo of Am. Corp., 64 N.Y.2d 1116, 479 N.E.2d 804 (1985));

the franchisee’s insolvency (Open Pantry Food Marts of Wisconsin, Inc. v. Garcia’s Five, Inc., Bus. Franchise Guide (CCH) ¶ 8113 (Wis. Cir. Ct. 1984));

palming off of non-franchisor goods under the franchisor’s trademark (Great Licks, Inc. v. Baskin-Robbins, U.S.A. Co., Bus. Franchise Guide (CCH) ¶ 9252 (D. Minn. 1988));

violation of state environmental regulations (Shell Oil Co. v. Hillary Farmer Serv. Station, Inc., 739 F.Supp. 749 (E.D.N.Y. 1990));

nonpayment of royalty and advertising fees (Heating & Air Specialists, Inc. v. Lennox Industries, Inc., Bus. Franchise Guide (CCH) ¶ 11,653 (8th Cir. 1999) (good cause found for termination based on unauthorized sales outside territory and non-payment for monies owed));

failure to pay for inventory purchased from the franchisor (PPM Chem. Corp. of Puerto Rico v. Saskatoon Chem. Ltd., Bus. Franchise Guide (CCH) ¶ 9706 (D.P.R. 1990), affd. 931 F.2d 138 (1st Cir. 1991));


franchisee’s violation of an in-term covenant not to compete (Deutschland Enters., Ltd. v. Burger King Corp., Bus. Franchise Guide (CCH) ¶ 9609 (E.D. Wis. 1990), affd. 957 F. 2d 449 (7th Cir. 1992));

- a pattern of customer complaints (Early v. Texaco Ref. and Mktg., Inc., 951 F.2d 1059 (9th Cir. 1991)); and

- failure to comply with applicable laws (Adirondack Cycle & Marine, Inc. v. Amer. Honda Motor Co., Business Franchise Guide (CCH) ¶112,283 (N.D.N.Y. 2002)).

Courts have also found that "good cause" was not proven, and therefore struck down (or refused to enforce) termination, in numerous cases, including cases such as:

- statutory notice and cure period was inadequate and should be extended because, in light of the practicalities of the particular business, it was impossible for the dealer to rectify performance in the time allotted (AI Bishop Agency, Inc. v. Lithonia - Div. of Nat'l Servs. Indus., Inc., 474 F. Supp. 828 (E.D. Wis. 1979));

- discontinuing a product line, where the product line was held to constitute a separate franchise (General Motors Corp. v. Gallo GMC Truck Sales, Inc., 711 F.Supp. 810 (D.N.J. 1989));

- acquisition of a competing dealer by the terminated dealer's supplier (Reinders Bros., Inc. v. Rain Bird E. Sales Corp., 467 F.Supp. 438 (E.D. Wis. 1979), aff'd, 627 F.2d 44 (7th Cir. 1980));

- dealer's failure to hire an additional sales representative at the request of the supplier (AI Bishop, supra);

- desire for further penetration of the market by a manufacturer (Chrysler Motors Corp. v. Nebraska Motor Vehicle Licensing Bd., 202 Neb. 239, 274 N.W.2d 862 (1979));

- termination of a dealer as an adjunct to a supplier's sale of business assets (J & S Home Realty, Inc. v. Anaconda Co., No. 13356 (Mont. Sup. Ct. 1977));

- dealer's refusal to increase the volume of its sales (Draft-Line Corp. v. The Hon Co., 781 F.Supp. 481 (D.P.R. 1991), aff'd, 983 F.2d 1046 (D.P.R. 1993));


- franchisee's alleged bad faith in misappropriating money orders (Saeed Rafiei Malek v. The Southland Corporation, Bus. Franchise Guide (CCH) ¶ 11,386 (W.D. Wash. 1998));
franchisee’s failure to comply immediately and strictly with payment terms even though the franchisor had repeatedly waived past defaults (LaGuardia Associates and Field Hotel Associates v. Holiday Hospitality Franchising, Inc., Bus. Franchise Guide (CCH) ¶ 11,832 (E.D.N.Y. 2000));

• failure to meet sales quotas where there was an inadequate opportunity to cure (Wadena Implement Co. v. Deere & Co., Inc., 480 N.W.2d 383 (Minn. Ct. App. 1992)); and

• failure to meet sales quotas where franchisee’s performance was hindered, in part, to the manufacturer’s appointment of three other dealers in the market area (Frieburg Farm Equip., Inc. v. Van Dale, Inc., 978 F.2d 395 (7th Cir. 1992)).

Implied Covenant of Good Faith. Under general principles of contract law, “there is an implied covenant that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract.” Kirke LaShelle Co. v. Paul Armstrong Co., 263 N.Y. 79, 87, 88 N.E. 163, 167 (1933). Application of these principles has been heavily dependent on the facts of a given case, and has turned on whether the dominant party acted in a fair and reasonable manner. Courts have tended to focus on whether one party possesses significant discretion in the performance of its obligations under the contract. If so, its performance must conform to the reasonable expectations of the other party and may not be used to “reclaim” benefits for which the other party has bargained. Nor may one party’s contractual discretion be exercised in an arbitrary and capricious manner. See, e.g., Interim Health Care of N. Ill., Inc. v. Interim Health Care, Inc., 225 F.3d 876 (7th Cir. 2000) (franchisor’s discretion over whether to furnish account leads was governed by the duty of good faith and must be exercised reasonably and with the proper motive); Shree Ganesh, Inc. v. Days Inn Worldwide, Inc., Bus. Franchise Guide (CCH) ¶ 12,341 (N.D. Ohio 2002) (right to use discretion under contract breaches duty of good faith and fair dealing if exercised arbitrarily, unreasonably or capriciously).

In applying these principles, courts have also considered concepts developed under the FTC “unfairness” doctrine (the prohibition against “unfair acts or practices” in Section 5 of the FTC Act) and state laws regulating the franchise relationship. See, e.g., Larese v. Creamland Dairies, Inc., 767 F.2d 716 (10th Cir. 1985) (re termination and transfer); Domed Stadium Hotel, Inc. v. Holiday Inns, Inc., 732 F.2d 480 (5th Cir. 1984) (re competition by the franchisor). Good faith and fair dealing claims are commonplace in franchise litigation, and largely mirror the cases that are already discussed above.

Fiduciary Obligations. Two parties with an extremely close link are sometimes considered to have a fiduciary relationship. This type of relationship is commonly found to exist among partners in a general partnership, to run from a corporation’s employees and officers to the corporation, to flow from an agent to a principal, and so on. Franchisees have, on numerous occasions, attempted to convince courts that a franchise relationship gives rise to a fiduciary relationship; however, the vast majority of
courts have rejected that view. In 1998, the U.S. Court of Appeals for the Fourth Circuit explained why:

The near-universal rejection of imposing fiduciary duties in the franchise setting reflects a recognition that these obligations are out of place in a relationship involving two business entities pursuing their own business interests, which of course do not always coincide. Not only is importing fiduciary concepts into the ordinary franchise relationship unworkable, it is unnecessary. At the outset of the franchise relationship, franchisees are protected by federal regulations imposing mandatory disclosure obligations on franchisors. See 16 C.F.R. Part 436. And during the life of the franchise, franchisees are protected by the panoply of contract remedies for any breach of the franchise agreement. The market imposes a further, overriding restraint on the franchisor. There exists a grapevine among franchisees and franchisors do earn reputations. A franchise system marred by bad franchisor-franchisee relations is unlikely to expand – or survive.

**Broussard v. Meineke Discount Muffler Shops, Inc., 155 F.3d 331, 348 (4th Cir. 1998).**

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A franchise agreement may set in place the legal structure of the franchisor-franchisee relationship and a franchisee may have chosen to operate his or her business under the franchisor’s marks and system in order to attain the benefits of that system. However, there remain myriad practical, real-world, day-to-day aspects of a franchisee’s operations that may be influenced, but cannot be controlled in any manner, by the franchisor. Among these are a franchisee’s right to set the price at which to sell its goods or services, all aspects of employment (e.g., hiring, firing, labor relations, salaries, benefits), determining the source of the franchisee’s financial investment, deciding how much the franchisee’s principals will work, where and when the franchisee’s principals will perform the work needed to manage their franchised business, where to bank, whether to reinvest their profits into the business or take the profits out through salaries or other means (e.g., dividends), whether to obtain additional capital by borrowing or selling additional equity or partnership interests, whether to incur additional costs (e.g., company cars), how to arrange for payment of their corporate taxes, how to go implementing the franchisor’s system once training has been completed, which professionals to retain and on what basis, etc.

Moreover, a relationship of “control” would almost invariably be equated with one in which one of the parties owed a fiduciary obligation to the other. As noted above, courts have ‘near-universally rejected’ that concept, as explained above in the quote from the U.S. Court of Appeals’ **Broussard** decision.

In sum, we respectfully submit that these statutes and cases more than amply illustrate several propositions, which, in sum, are that:
(1) Franchisors do not "control" franchisees. In an employment relationship, for example, the employer controls his or her employees by issuing instructions and, failing adherence, dismissing the non-compliant employee. Franchisors and franchisees are independent businesses that may agree to meet certain rules of conduct, but failing adherence to those terms, franchisors must resort to the courts (or arbitration) to compel performance.

(2) Franchisors – as trademark owners – are required under federal law (the Lanham Act) to impose certain controls in order to maintain their trademark rights.

(3) Requirements for advance review and pre-approval of proposed franchise transfers are not only upheld by state and federal courts, but are also buttressed by state statutes that require franchisees to obtain the franchisor’s consent prior to a proposed transfer.

(4) Courts have long recognized that franchisors may impose controls over their franchisees for reasons that are legitimate and consistent with the unique nature of the franchise relationship. Courts will not allow franchisors to run roughshod over franchisees – courts typically apply standards of good faith, reasonableness, and other similar principles before deciding whether to enforce a contract even as written. The judicial decisions discussed above reinforce this point: franchisors sometimes win, and sometimes they do not. Courts have concluded that whatever degree of influence franchisors may have, they do not have a “fiduciary” relationship to their franchisees. Moreover, the very fact that these matters must be litigated at all underscores the first point – that franchisors do not exercise "control" over franchisees.

We appreciate the opportunity to explain our views and the views of our members on these matters, and would be pleased to meet with the FASB Staff or Board members to answer questions or provide additional information. Please feel free to contact me directly at (202) 662-0767 or by email at matthew@franchise.org if we can be of further assistance.

Sincerely,

Matthew R. Shay
Executive Vice President