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Federal Court Rules Against Yum! Brands in Third-Party Franchise Sale Case – What Franchisors Need to Know

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A federal court in Kentucky recently denied a franchisor's request to dismiss its franchisee's claim for intentional interference with prospective economic advantage. Based on this ruling, franchisors should proceed with caution when evaluating a franchisee's proposed third-party franchise sale. *Raheel Foods, LLC v. Yum! Brands, Inc.*, 2017 WL 217751 (W.D. Ky. Jan. 18, 2017) involved a franchisee's proposed sale of a number of Yum! Brands stores and underlying properties (the "Franchises") to a third party. Franchisee Syed Raheel, via several approved business entities, found a qualified buyer to purchase all of the Franchises in a package deal.

Under the applicable franchise agreements and Yum! Brands' standard operating procedures, Raheel was required to obtain Yum!'s approval of both the potential purchaser as a franchisee and the proposed deal as a whole. Raheel alleged that Yum! routinely approved franchise sales, especially when proposed purchasers were existing Yum! franchisees, which was partially the case here. Raheel claimed he submitted at least ten prospective buyers to Yum! for approval, at least four of whom had engaged in extensive negotiations with Raheel. According to Raheel, instead of genuinely considering the proposed sales to four would-be buyers, Yum! unreasonably denied Raheel's approval request and later executed its own purchase agreements with Raheel's four prospective buyers. Raheel also alleged that one potential purchaser, J.A., made an offer to purchase all the Franchises. J.A. was already an approved Yum! franchisee and Yum! approved J.A. for the Raheel sale.

However, Yum! subsequently withdrew its approval of J.A.'s purchase of certain stores owned by the franchisee's related entity (which was not a party to the suit) and instructed the related entity to terminate its contract with J.A. Because Raheel's entire proposed sales package was contingent upon Yum!'s approval of J.A.'s purchase of the related entity's stores, this move by Yum! effectively scuttled Raheel's deal. Months later, Yum! offered J.A. 70 of its corporate-owned stores and 11 underlying properties at a substantial discount, and J.A. accepted. Based upon these facts, Raheel sued Yum! for, among other claims, intentional interference with prospective economic advantage. Yum! moved to dismiss all claims. While most claims were dismissed, the *Raheel* court ruled that Raheel could proceed against Yum! on its intentional interference claim.

Intentional Interference with Prospective Economic Advantage

Under Kentucky law, liability for the intentional interference with a prospective economic advantage arises when a party improperly interferes with another's valid business expectancy. The majority of jurisdictions in Baker Donelson's footprint have adopted similar definitions of this tort. Rejecting Yum!'s argument to the contrary, the *Raheel* court held that this claim could be asserted between business competitors and articulated certain factors to determine whether interference is improper. Specifically, plaintiffs must show malice or some significantly wrongful conduct. Interference is not improper unless it is malicious or without justification, or is accomplished by unlawful means, such as fraud, deceit or coercion. However, a party can act with malice without ill will; in fact, malice may be inferred by proof of lack of justification. In other words, malice can be shown through intentional interference without justification. The central question is whether the actor's conduct was fair and reasonable under the circumstances. In determining whether a defendant's conduct was fair and

reasonable, pertinent factors include recognized standards of business ethics and business customs and practice, the concepts of fair play and rules of the game.

Facts Alleged to Support Raheel's Intentional Interference Claim

Raheel alleged that its entities presented their proposed purchasers to Yum! for approval as required by the parties' franchise agreements. As a result, the proposed purchasers' identities and offered terms were disclosed to Yum! Raheel further alleged that Yum! routinely approved franchise sales, especially when proposed purchasers were already approved as franchisees, which was partially the case here. Instead of objectively vetting the proposed sales, Yum! supposedly undercut Raheel by offering the proposed purchasers corporate-owned stores at below-market prices or refusing to approve the proposed purchasers when presented by Raheel, but later approving them for the purchase of corporate-owned stores.

Yum! argued that because it had the right to deny any proposed sale, its denial of the involved sale could not be improper interference and the court acknowledged that the exercise of legitimate contract rights could not give rise to an intentional interference claim. However, Yum! was only entitled to exercise its legitimate approval rights in good faith, and not for an improper purpose (i.e., to take Raheel's buyers for itself). According to Raheel, Yum!'s only motive for its conduct was to increase profits. Yum! argued that said profit motive justified its conduct because the parties were business competitors. The court recognized that legitimate competition necessarily interferes with prospective business relations and that, as between competitors, competition alone is not an improper basis for interference. In this case, however, Raheel pointed out that it could not sell its franchises and underlying properties in a package deal without Yum!'s approval. Because Yum! was privy to the terms of the deal and allegedly used its contractual rights to handcuff Raheel and poach its potential purchasers, the Court distinguished Yum!'s conduct from cases involving ordinary competition. Based on these allegations, the *Raheel* court ruled that Raheel had adequately alleged that Yum!'s conduct ostensibly violated concepts of fair play and the rules of the game and denied the franchisor's motion to dismiss.

Raheel's Potential Implications for Franchisors

Franchisors should pay attention to the *Raheel* decision and its potential implications for several reasons. First, franchisors should not withhold or withdraw approval of franchisees' proposed sales absent objectively reasonable grounds for doing so, especially in situations where the franchisor has previously approved the proposed third-party buyer. Furthermore, because approval processes entail the exchange of significant and sensitive business information, franchisors should be extremely cautious about pursuing a sale with an approved purchaser if a proposed deal with a franchisee fails. At a minimum, franchisors should wait a reasonable period of time after the proposed sale is terminated before approaching the would-be purchaser. Certain franchisors may want to consider amending the approval provisions in their franchise agreements to include a non-exhaustive list of valid business reasons for: (1) disapproving a proposed purchase; (2) withdrawing approval of a proposed purchase; and/or (3) pursuing a sales opportunity with a franchisee's prospective buyer. Ideally, these reasons would guide the franchisor's third-party sales approval process. That said, such guidance, if not carefully adhered to, could simultaneously create additional risks for a franchisor who rejects a franchisee's proposed sale. A disappointed franchisee could point to such provisions and claim that its franchisor's refusal to approve a proposed purchase was arbitrary or based on an improper purpose if the franchisor's reason(s) for the disapproval are not clearly articulated. In sum, franchisors should pay close attention to the *Raheel* case and tread carefully and strategically when evaluating franchisees' third-party sale requests.