

## POST-COVID OPPORTUNITIES AND LEGAL CONSIDERATIONS TO FRANCHISE RESALE

by Jennifer Stallings Dewey and Rebecca Papi

It would be difficult to find any person or business that has not been affected by COVID-19. Over the last few months, most states have issued “stay at home,” “shelter-in-place,” and other similar orders. Businesses all over the country have ceased operating. Many others that have remained opened have experienced a substantial decrease in their business volume. Americans have filed for unemployment in record numbers. Franchise systems are no exception and have faced closures, layoffs, and myriad other issues. While this ongoing crisis is causing hardship all around, franchise systems will eventually recover. This will undoubtedly present opportunities for existing and prospective franchisees interested in buying or selling franchise units amidst recovery from this difficult period.

These mandated closures (or decreased business) and an uncertain economic climate will uniquely, and perhaps disproportionately, affect franchise businesses. Although a number of franchisors have made concessions to their franchisees (i.e. waiving or deferring royalty payments or making concessions relating to defaults), not all franchisors are able or willing to make such accommodations. This means that many franchisees are not only losing revenue, and subject to the normal expenses of a business (rent, utilities, labor costs, and the cost of supplies and/or inventory), but they may also still be liable for royalty fees and/or required purchases.

These forced closures may make it impossible or undesirable for some franchise units to return to business as usual. Some businesses will suffer financial hardship such that reopening will be impossible. Other franchise owners may have used this mandatory time off to consider what might be next for them. Regardless of the reason, it may be time for many franchisees to consider selling their businesses.

The good news is that there will probably be continued, and maybe even increased, interest in purchasing a franchise. Over 30 million Americans have filed for unemployment since the beginning of this pandemic.<sup>1</sup> With relief afforded under the CARES Act, this not only includes traditional employees, but also self-employed contractors and business owners. For those in this position looking for a new beginning, it may be a good time to consider investing in a franchise. While there are of course risks with opening a business, franchises offer certain advantages including: 1) a business model (everything from pricing to branding) that has already been established and proven; 2) scale for purchasing supplies and inventory; 3) communal knowledge and experience across the system; and 4) shared operating costs such as marketing. These elements benefit franchisees as they reopen following quarantine and make these businesses attractive to prospective purchasers. Further, according to Franchise Direct, even though the 2008-2010 recession took a toll on the U.S. economy, franchises fared better than most other retail chains and small businesses.<sup>2</sup>

Franchising is a unique and complex business model and the resale of a franchise unit by the franchisee includes a number of considerations.

This article will address pertinent legal concerns relating to this type of sale and discuss some of the steps that can be taken now in preparation of a sale.

### Franchise Agreement and Other Contractual Obligations

When addressing any question or issue relating to a franchise, the first stop should always be the relevant franchise agreement. A franchise agreement outlines all of the terms of the franchise relationship. Most franchise agreements contain provisions relating to the transfer of the franchise. The franchise agreement may contain provisions relating to any or all of the following:

- Franchisor must approve of the sale.
- Purchaser will have to be approved by the franchisor and a franchisee.
- Franchisee must pay a transfer fee.
- Franchisee must comply with the franchise agreement and other related agreements.
- Purchaser must execute franchisee’s current franchise agreement (or a new franchise agreement), and any subsequent addendums, or ancillary agreements.
- Franchisee must execute a general release of the franchisor from obligations under the franchise agreement and related agreements.
- The purchase agreement between franchisee and purchaser relating to the sale of the franchise must be approved by the franchisor.
- Franchisor requires franchisee or purchaser to update the franchise to the most current facility image, which may include design, construction, signage, and equipment specifications required by the franchisor.
- Franchisee must pay all costs of the franchisor in granting approval.

The franchise agreement may also contain provisions relating to a franchisee’s conduct following its termination (which would occur along with a sale). Such provisions may include any or all of the following:

- Non-compete, exclusivity, or territorial requirements – prohibition against franchisee engaging in business that competes with the franchise system, owning competitor franchises, or locating a new franchise in another franchisee’s exclusive territory.
- Non-solicitation – prohibition against the franchisee recruiting customers, suppliers or employees of the business being sold.
- Confidentiality obligations with respect to the franchisor’s trade secrets, financial information, business model, etc.
- Requirement that the franchisee ceases using the franchisor’s trade name, service marks, or trademarks.
- Requirement that the franchisee de-identify or disassociate property with the franchise system (in the event the selling franchisee retains such property)

<sup>1</sup><https://www.nytimes.com/2020/04/30/business/stock-market-today-coronavirus.html>

<sup>2</sup><https://www.franchisedirect.com/information/a-look-at-how-franchises-impact-the-economy>

If a franchisee owns multiple units or has additional arrangements with the franchisor, such as an area development agreement or territory agreement, there may be additional documentation to consider relating to a sale of one or multiple franchise units. Each such document should be carefully reviewed by an attorney experienced in franchise law to determine what contractual obligations exist between the franchisor and franchisee that will affect the sale.

In addition to the franchisor, there may be other parties affected by the sale. If there is any financing associated with the business, it may be necessary to obtain the lender's approval for the sale. Likewise, depending on whether real property is owned or leased, approval from a lender, transfer of the property, or assignment of a lease may need to occur. If the business involves special licenses or permits, those may need to be transferred and may require approval of a government agency or other third party. When updating a facility image, there may be local governmental approvals required in connection with design and construction. Lastly, the sale may trigger contractual rights of other parties such as suppliers or customers that may have a right to notice or consent to the sale.

## Statutory Law

Generally, franchises are governed by both state and federal law. The federal law, the Federal Trade Commission's Franchise Rule, focuses on the disclosure requirements for a franchisor selling franchises and does not contain anything specific to subsequent transfers. A number of states contain statutes specific to franchises. A smaller subset of those states have what is known as franchise relationship laws. Certain relationship laws contain provisions relating to the transfer of franchises. If the business is located in one of the ten states<sup>3</sup> with such laws, it is important that the seller be familiar with the obligations or rights provided in this legislation.

These laws differ in content but generally impose one or both of the following: 1) restrictions on the franchisor's right to approve or disapprove the sale of the franchise and/or 2) notice requirements that provide certain time periods during which the franchisee must provide notice of the proposed sale to the franchisor. These state statutes will overrule the contractual terms contained in the franchise agreement.

## Preparing for Sale

The purchaser of a franchise business from a franchisee (as opposed to purchasing a new unit directly from a franchisor) will need to assume the rights and obligations of the existing franchisee under the franchise agreement (or enter into a new franchise agreement). Further, the purchaser will assume all or some of the assets (including contract rights and obligations) of the seller. The purchaser will learn all about the brand and related franchise system from the franchisor; however, the seller will be responsible for providing detailed information about its specific unit(s). This process, common in the sale of all businesses (not just franchises), is typically referred to as

due diligence.

During the due diligence process, the purchaser will request a considerable amount of information about the business it is purchasing. Requests for information may include some or all of the following documentation:

- Corporate records (formation documents, bylaws, operating agreements, minute books, list of officers, directors, and/or managers, organization chart)
- Member or shareholder information
- Financial statements for the past 3-5 years (as well as internal budgets, projections and other financial reports)
- Financings/encumbrances (debt agreements, financing arrangements, details of any governmental grants, subsidies, or other financial assistance)
- Lists of assets
- Material contracts and commitments (vendor contracts, distributor contracts, sales representative contracts, joint ventures or partnership agreements, franchise agreements, license agreements, advertising, and consultant agreements, equipment or other personal property leases, installment sales agreements, standard form contracts, etc.)
- Tax returns for the past 3-5 years (including any correspondence from the IRS, audits and reports by the IRS, list of any deficiencies, fines, penalties or assessments, etc.)
- Legal/liability issues (including all law suits, claims, administrative proceedings or other governmental investigations, etc.)
- Intellectual property (including registered and unregistered patents, trademarks, copyrights, tradenames, domain names, software licenses, technology sharing, use and disclosure agreements, etc.)
- Insurance policies
- Environmental matters
- Human resources (including a list of all employees, including positions salaries and bonuses paid, employment agreements, non-solicitations or non-competition agreements, employee benefits, retirement plans, company handbook, etc.)

The list above is not exhaustive. The information a prospective purchaser will need to evaluate depends on the type of business involved and the individual circumstances underlying the transaction. Ideally, every business would maintain accurate and complete records. Realistically, this does not always happen. It is not uncommon for records to be disorganized, out of date or incomplete. The recent closures and/or decline in business due to COVID-19 may be a great time to do an internal audit of records and get things in order. This is especially a good idea if a sale is on the horizon.

## Conclusion

The decision to buy or sell a franchise is a difficult one. As outlined in this article, there are a number of considerations to take into account

<sup>3</sup>Arkansas, California, Hawaii, Indiana, Iowa, Michigan, Minnesota, Nebraska, New Jersey and Washington. See ARK. CODE ANN. § 4-72-205(a); CAL. BUS. & PROF. CODE § 20027; HAW. REV. STAT. ANN. § 482E-6(2)(I); IND. CODE ANN. § 23-2-2.7-2(3); IOWA CODE § 523H.5; MICH. COMP. LAWS ANN. § 445.1527(g); MINN. R. 2860.4400; NEB. REV. STAT. § 87-405; N.J. STAT. ANN. § 56:10-6; WASH. REV. CODE ANN. § 19.100.030.

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and the initial decision is just the beginning of the process. The current state of affairs in the world with mass quarantines, business closures, and economic uncertainty is alarming to say the least. While no one is certain when things will return to business as usual, we do know it will happen eventually. This crisis may give rise to an increase in opportunity for the purchase and sale of franchise businesses. Securing experienced and knowledgeable advisors to assist with this process including attorneys, accountants and financial advisors is invaluable preparation for such opportunities.

Whether you are a prospective franchisee, an existing franchisee looking to expand within their current system, or a departing franchisee ready to sell their business; Dickinson Wright PLLC is in a position to assist. Our firm is full service with attorneys experienced in representing all types of businesses in mergers and acquisitions as well as advising clients with respect to the unique and varied issues that come along with the franchise business model. The sale or purchase of a franchise can be a trying process, but we are here to assist at every turn and protect our client's interests so that they can focus on looking toward closing the transaction and planning a new beginning.

## ABOUT THE AUTHORS



**Jennifer Stallings Dewey** is a Member in Dickinson Wright's Detroit office. She can be reached at 313-223-3498 or [JDewey@dickinsonwright.com](mailto:JDewey@dickinsonwright.com).



**Rebecca Papi** is an Associate in Dickinson Wright's Detroit office. She can be reached at 313-223-3518 or [RPapi@dickinsonwright.com](mailto:RPapi@dickinsonwright.com).