



*Guiding You Through the Legal Maze.<sup>SM</sup>*

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**BUYING OR SELLING  
AN EXISTING  
FRANCHISE UNIT**

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## **BUYING OR SELLING AN EXISTING FRANCHISE UNIT**

### **I. OVERVIEW**

A. The relationship between a franchisor and a franchisee is a long-term one. The typical franchise agreement may have an initial term of 10 to 20 years plus renewal terms of 5 to 10 years or more. The franchise agreement may, in fact, have unlimited renewal rights ("evergreen"). During such a long time, many things can occur, including:

1. **Sale of Ongoing Business.** The franchisee may desire to sell his or her franchised business to a third party as a going concern.
2. **Estate Planning Transfer.** The franchisee may desire to transfer all or a portion of the franchised business to his or her spouse or children for estate planning or other reasons.
3. **Disability.** The franchisee, or the principal individual in a corporate franchisee, may become disabled or incompetent.
4. **Death.** The franchisee, or the principal individual in a corporate franchisee, may die.
5. **Divorce.** Many franchises are owned by husband and wife. What if they divorce?
6. **Dissolution.** Many franchises are owned by 2 or more partners, shareholders or members. What if there is a falling out among them?

B. In addition to the traditional corporate, conveyancing, tax and other issues associated with the transfer of any business, there are additional concerns due to certain rights which the franchisor may have that are typically set forth in the franchise agreement. These rights may include: (i) the franchisor's option to purchase the franchised business; (ii) the franchisor's right of first refusal to purchase the franchised business; and/or (iii) the franchisor's conditions precedent to its consent to a transfer. In addition, a person exiting a franchise due to divorce or dissolution will want to be released from all future obligations under the franchise agreement.

C. This Outline will generally address certain issues relating to the sale or transfer of a business and those issues that are unique to franchising.<sup>1</sup>

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<sup>1</sup>*This Outline is not intended to be a comprehensive review of all of the legal and business considerations in selling or buying a business.*

## II. THE SALE OF A FRANCHISED BUSINESS

In addition to the myriad of reasons why a franchisee may want eventually to sell his or her franchised business, there are a number of reasons why a prospective franchisee may want to buy an existing franchised business rather than buy a new start-up franchise from a franchisor. These reasons include: (i) locating a Unit in a more desirable and established location; (ii) purchasing a Unit with an existing operating history; and (iii) possibly assuming an old, more advantageous franchise agreement.

A. **Asset vs. Stock Sale.** Since most franchised businesses are owned and operated by a corporation or limited liability company (for limitation of liability and other reasons, notwithstanding that the franchise agreement may have been signed individually), this article will discuss the sale of a franchised business through the sale of assets or through the sale of stock in the corporation or membership interests in a limited liability company.

### 1. **Sale of Assets**

#### (a) **Advantages**

- (i) Purchasing assets, not liabilities.
- (ii) Stepped-up basis for depreciation and allocation of purchase price to assets.
- (iii) Pick and choose assets purchased.

#### (b) **Disadvantages**

- (i) More complex closing documents including conveyance documents.
- (ii) Sales tax issues under Section 212.10 of the Florida Statutes (possible buyer's liability).
- (iii) Usually there is a requirement for the consent of the franchisor, landlord, if any, and other parties having a contractual relationship with the franchisee.
- (iv) Depreciation recapture by seller.

### 2. **Sale of Stock or Membership Interests.**

#### a. **Advantages**

- (i) Simplicity and speed.
- (ii) May not require the franchisor's, landlord's or other party's consent except where recent or sophisticated agreement.

(iii) Avoid possible double taxation by the seller.

b. **Disadvantages**

(i) Buying assets and liabilities of the corporation, including contingent and undisclosed liabilities.

ii) Assume existing depreciation schedule of assets and tax status of the corporation.

The sale of a franchise by an existing franchisee without significant involvement of the franchisor does not require the use of a current Franchise Disclosure Document or state registration. The prior consent of the franchisor is not considered substantial involvement.

B. **Dealing with the Franchisor.** Most newer or sophisticated franchise agreements have provisions giving the franchisor certain rights in the case of the franchisee's proposed transfer of the franchised business regardless of whether the franchisee sells his or her assets or sells his or her stock or membership interests. However, the franchise agreement should always be thoroughly reviewed because the sale of stock or membership interests may not be addressed. A thorough review of the franchise agreement should always be undertaken before an offer of sale is made.

1. **No Encumbrancing.**

Many franchise agreements provide that neither the franchisee nor any ownership interest in the franchise may be pledged, mortgaged, hypothecated, granted as a security interest for an obligation, or in any manner encumbered.

2. **"For Sale" Restrictions.**

(a) The franchise agreement usually provides that, in connection with the offer for sale of an existing franchised business, the franchisee is prohibited from putting up a "For Sale" sign at the premises.

(b) In addition, the franchise agreement usually prohibits the use of the franchisor's trade name and other proprietary marks in connection with the sale and only allow generic advertising (for example, "Restaurant Business For Sale," not "McDonald's For Sale").

3. **The Franchisor's Right of First Refusal.**

(a) Many franchise agreements provide that the franchisor has the right of first refusal to purchase the franchisee's franchised business on the same terms and conditions as offered by a bona fide unrelated third party purchaser. The reason why the franchisor usually retains this right is to control who may purchase the franchise and also to repurchase franchises and convert them to company-owned Units.

(b) If the right of first refusal exists in the franchise agreement, the following must be done:

- (i) There should be a contingency in the sale agreement making the obligations of the seller to sell and the buyer to purchase contingent upon obtaining the franchisor's waiver of its right of first refusal.
- (ii) A notice should be given to the franchisor in accordance with the terms of the right of first refusal provision. The notice should include a request for a waiver.
- (iii) There is usually a time period in which the franchisor can exercise the right of first refusal, hopefully it will be no more than 30 days.
- (iv) The parties should obtain the waiver of right of first refusal in writing.

4. **Conditions Precedent to the Franchisor's Consent to Transfer.**

(a) Most franchise agreements provide that the grant of the franchise to the franchisee is personal and that the franchisee is prohibited from selling the franchised business without the prior written consent of the franchisor. Usually, the franchise agreement details the conditions in which the franchisor will consent to a transfer, including:

- (i) Waiver of right of first refusal.
- (ii) Absence of both monetary and non-monetary defaults by the franchisee.
- (iii) General release of all claims from the franchisee to the franchisor.
- (iv) Payment of a transfer fee (from nominal to a significant percentage of the initial franchise fee) which may or may not include a training fee. This expense should be addressed in the sale agreement.
- (v) Signing by the buyer of the then-current form of franchise agreement, rather than assumption of the existing franchise agreement.
- (vi) The buyer must meet the requirements of the franchisor including reputation, business skills and financial capacity.
- (vii) The buyer must successfully complete the franchisor's initial training program.
- (viii) Renovation and upgrading of the franchised business which can be substantial dollars.

- (ix) Continued occupancy of the business premises.
  - (x) No excessive purchase price, otherwise the franchisor can veto the sale.
  - (xi) No release of the original franchisee after the sale.
- (b) If the franchise agreement is silent on its assignability, assignment by the franchisee will be presumed.

5. **Estoppel Letter from the Franchisor.**

(a) Regardless of whether the assets or shares of membership interests are being purchased, it is advisable to obtain a written estoppel letter from the franchisor (similar to an estoppel letter from a landlord) confirming the following:

- (i) Consent to the transfer (if required).
- (ii) Waiver of the right of first refusal (if required).
- (iii) Acknowledgement that there are no defaults by the franchisor or the franchisee under the franchise agreement and related documents.
- (iv) Acknowledgment that there are no addenda, riders or modification of the franchise agreement, or oral or "side" agreements.

(b) This would also be an appropriate time to try to "renegotiate" the franchise agreement on behalf of the buyer, but usually the franchisor will insist on the signing of its then-current franchise agreement without negotiation.

### III. **INTRA-FAMILY TRANSFERS**

For a variety of reasons, such as health, estate planning, retirement, etc., the franchisee may want to transfer all or a portion of the franchised business to his or her spouse and/or children. The franchise agreement must be reviewed to determine what restrictions and rights of the franchisor exist. These may include:

A. **Absolute prohibition.** In this event, this issue will have to be negotiated with the franchisor.

B. **Percentage limitation.** Sometimes a minority interest in the corporation (5% to 49%) may be transferred by the franchisee to his or her spouse and/or children without the consent of the franchisor. In all other cases, the consent of the franchisor is usually required.

C. **Transfer Fee.** With respect to an intra-family transfer, the transfer fee may be nominal or waived.

#### **IV. SALE OR TRANSFER UPON DISABILITY OR INCOMPETENCY**

Most franchise agreements require the franchisee - owner/operator to be active in the day-to-day management of the franchised business. What happens when the franchisee becomes disabled or incompetent? In this event, counsel to the franchisee should review the franchise agreement. The franchise agreement may provide that if the franchisee becomes disabled or incompetent for more than a short period of time (for example, 3 consecutive months), a replacement manager is required to be hired. The franchisee may also be obligated to sell his or her interest in the franchise within a period of time (for example, 6 months) subject to the franchisor's right of first refusal and/or compliance with the franchisor's conditions to transfer. Make sure your client is not considered to have been deemed to have abandoned or ceased to operate the franchised business. This could be considered an event of default.

#### **V. DEATH OF THE TRANSFEROR**

A. **Required Sale.** A typical franchise agreement provides that, upon the death of the franchisee, or, in the case of a corporate franchisee, the death of the principal, the franchise may have to be sold by the personal representative of the franchisee's estate within a period of time (for example, 6 months) to an approved transferee subject to the franchisor's right of first refusal and/or compliance with the franchisor's conditions to transfer. The failure to sell timely may constitute an event of default under the franchise agreement.

B. **Life Insurance.** In certain franchise systems, usually where the franchisee is a licensed professional where the spouse, children or other third person cannot easily take over the business, such as a medical-related franchise, pharmacy, legal, accounting, nursing, etc., a form of key man life insurance program may have been implemented which is structured as follows:

1. The life insurance policy is owned by the franchisor on the life of the franchisee.
2. The insurance premiums are split between the franchisor and the franchisee on some basis.
3. Upon death of the franchisee, the franchisor uses the insurance proceeds to repurchase the franchise.
4. The franchisee's heirs have cash instead of a business they may not have been able to operate themselves.

This can be a good financial planning tool regardless of the type of franchised business.

#### **VI. REPRESENTING THE PURCHASER OF AN EXISTING FRANCHISED BUSINESS**

In addition to what a seller has to do with respect to his or her franchisor, a buyer has certain additional responsibilities to ensure that he or she makes an intelligent investment decision.

A. Obtain and review a current Franchise Disclosure Statement from the franchisor. The purchaser and his or her advisors should review it carefully. Understand all of its provisions, including:

1. Whether an exclusive or protected territory exists.
2. What items are you required to purchase from the franchisor.
3. Duties of the franchisor.
4. Services and support of the franchisor.
5. Performance standards.
6. Insurance requirements.

B. Most franchise agreements require the purchaser to sign a new then-current form of franchise agreement rather than assume the seller's existing franchise agreement. Get a copy and attempt to negotiate, if possible.

C. Talk and visit other franchisees to better understand the business and how well the Unit you are purchasing is doing.

D. Visit the franchisor's headquarters.

E. Obtain certain documents from the franchisor:

1. Waiver of right of first refusal;
2. Consent; and
3. Estoppel letter.

F. Address in the sale agreement certain provisions, including:

1. The amount of transfer fee and/or training fee and who pays;
2. The extent of any required renovation or upgrading;
3. Personal guarantee by the purchaser of the franchise agreement;
4. Make closing after, and contingent upon, the purchaser's completion of the franchisor's training program; and
5. Representation and warranties of the seller with respect to the franchise agreement and ancillary documents.

G. Obtain a covenant not to compete from the seller. Don't just rely on the covenant in the franchise agreement since it runs only to the franchisor and not to the purchaser.

It is important that you retain an attorney who is experienced in the purchase and sale of businesses and franchised business in particular and also retain an accountant before you sign any letter of intent or sale agreement. This will definitely save you time and aggravation in the long run.

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