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Refranchising: An Overview of Franchise Re- Sales and Transfers

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1. **Introduction**

Today's presentation will focus on the refranchising process through franchise resales. The purpose of the discussion is to set out the theory and benefits of an established franchise resale program and how a well developed program can add significant value to a franchise system and provide an effective pressure valve and exit strategy for both successful and less than successful franchisees. In addition to providing a cursory overview of a typical franchise resale program, the discussion will also review the legal implications of resale and the typical contractual issues that franchisors and franchisees need to be aware of when engaging in the transfer or sale of an existing unit.

2. **The Value of a Resale Program in your System**

Most franchise agreements provide an exit opportunity to franchisees in the form of transfer or resale rights upon satisfaction of certain conditions. Beyond the formal conditions to the franchisor's consent to the transfer, there is little guidance to franchisees as to the manner of reaching out to prospective purchasers, the marketing and sales process or the manner of transitioning the franchise from the transferor to the transferee. A well designed resale program can, in addition to establishing an internal procedure for assisting in marketing a franchised unit, increase the perceived value of a franchise by creating a mechanism which assists in "making the market" for franchised units and greases the entire transfer procedure for the benefit of all parties.

The franchise resale program can enhance the value of the franchise system. Disgruntled or poorly performing franchisees who may have been motivated to act unilaterally and sell their unit without notice would be more likely to seek the assistance of an established resale system to more easily identify a buyer and obtain the best price for their unit. A proactive franchisor can employ a structured resale program as leverage and a more palatable alternative to the termination of troubled franchisees. Generally, a resale program can increase the market efficiency of the purchase and sale of existing franchised units, thereby ensuring that franchises are sold for the best prices to purchasers who are properly qualified for the franchisor's system.

Franchise resale programs can provide the following:

- added value to an existing franchise and a recruitment feature
- added predictability to existing franchisees who want to evaluate their exit options
- better match between franchisor and new franchisees
- an overall increase in the goodwill and value of the system.

3. **Legal Issues**

(a) **Contractual.** As alluded to above, the resale process is at its core a contractual matter between the franchisor and the franchisee. Most franchise agreements contain a prohibition on assignment of the franchise rights, sale of the assets constituting the franchised business or any change of control of the corporate franchisee without the franchisor's consent. Consent is typically granted upon satisfaction of conditions similar to the following:

- (A) notice is given to the franchisor with enough time to permit it to evaluate the financial, business and reputational qualifications of the candidate;
- (B) payment of a transfer fee;
- (C) execution of the "then-current" form of franchise agreement;
- (D) payment of all outstanding obligations to the franchisor;
- (E) upgrading of the franchised location;
- (F) release of the franchisor by the existing franchisee;
- (G) existing franchisee's confirmation of agreement not to compete;
- (H) waiver of franchisor's right of first refusal;
- (I) execution of franchisor's form of assignment and consent;
- (J) execution of landlord's assignment and consent;

- (K) execution of any additional or ancillary documentation (including any additional indemnities, spousal guarantees or other support) required to provide the franchisor with the necessary comfort that the transferee can perform its obligations under the franchise agreement.

The principal rationale for imposing conditions to consent include the franchisor's need to pre-qualify the candidate for the franchise system and the cost of undertaking this analysis. Implicit in the resale process is the desire of most franchisors to retain some control and ideally discretion over the ultimate choice of candidate, even if the franchisee has ultimately complied with the letter of all contractual conditions.

Contractual language providing that the franchisor may "unreasonably withhold its consent" to a transfer may provide sufficient contractual certainty to permit a franchisor to exercise such discretion without fear of judicial reprimand. But such language will clearly lower the transferability of a franchise and therefore its value to a prospective franchisee. And the courts may find that the exercise of such discretion would be contrary to a franchisor's obligation to act in good faith as required in Ontario under the *Arthur Wishart Act*. One interpretation is that the courts will honour the principle of freedom to contract and will not find that the obligation to act in good faith and in a commercially reasonable manner does not mean that a franchisor must in all cases provide a right to transfer and that it cannot exercise discretion unreasonably if that discretion is granted by the express terms of a contract. Conversely, if a franchise agreement stipulates an obligation to exercise discretion "reasonably", then a franchisor will likely be prohibited for withholding consent to a transfer without just cause.

- (b) **Statutory Disclosure.** Ontario's *Arthur Wishart Act* provides that a grant of a franchise includes a "sale or disposition of the franchise or of an interest in the franchise". Section 5(7)(a)(iv) of the statute permits a franchisor to avoid the obligation to deliver a disclosure document to a new franchisee no less than 14 days prior to the execution of any agreement relating to the franchise or payment

of any consideration relating to the franchise if the grant of the franchise is not “effected by or through the franchisor”. Section 5(8) of the Act further qualifies that a grant is not effected by or through a franchisor merely because the franchisor has the right on reasonable grounds to approve or disapprove the grant or a transfer fee must be paid in an amount that does not exceed the franchisor’s reasonable costs to process the grant.

The intended effect of the foregoing has been to allow a franchisor to avoid making fresh disclosure to a prospective franchisee where it is merely a passive spectator (but for its reasonable right to assess qualifications) to a franchise resale occurring between two consenting and relatively equally endowed parties. In practice, this has not been as simple as the statute suggests and several cases have considered at which point a sale is effected “by or through a franchisor”. Recently in the case of *1518628 Ontario Inc. v. Tutor Time Learning Centres LLC* (2006), 2006 CarswellOnt 4593; 2006 CanLii 25276 (S.C.J.), the court found that the fact of a unilateral imposition by the franchisor of a new spousal indemnity as a condition to its consent was tantamount to the franchisor not merely engaging in the relatively passive act of approval of the transfer, and constituted the grant of the franchise as being effected “by or through the franchisor”.

It is generally accepted that the franchisor’s requirement that the new franchisee sign the then current franchise agreement elevates the franchisor’s involvement beyond that of a merely passive party interested only in the franchisee’s qualifications. As such, franchise counsel often advise their clients to issue fresh disclosure when this practice is adopted. Many counsel advise their clients to provide fresh disclosure to a proposed transferee no less than 14 days in advance of any transfer, irrespective of the franchisor’s degree of involvement, if for nothing less than inexpensive insurance against a later claim that some element of the franchisor’s involvement meant that the transfer was effected “by or through” them.

(c) **Statutory Good Faith.** Ontario's *Arthur Wishart Act* imposes on franchisees and franchisors a duty to act in good faith in accordance with reasonable commercial standards. There is significant debate as to the scope of this obligation, which is most frequently construed in favour of the franchisee to the detriment of the franchisor. In the context of franchise resales, the franchisor must ensure that its actions are consistent with this duty. Generally, the obligation to act in good faith includes the duty to act honestly, without an improper motive, in a manner which is consistent with current commercial practices and is not capricious or exercised arbitrarily with adverse consequences to the franchisee's business interests. Specifically, a franchisor must consider:

- (i) whether its refusal to consent without good cause may be "commercially unreasonable" and found not to be consistent with the duty of good faith and fair dealing;
- (ii) whether it has a duty to a transferee, and whether it may or should intervene in a sale where it believes that the franchisee is misrepresenting or failing to disclose material facts which could result in too high a price being paid for the transferred unit;
- (iii) whether any intervention in (ii) above could be construed as *prima facie* evidence of bad faith against a franchisor.

Generally, a franchisor has no specific duty to a future franchisee unless the sale is effected by or through the franchisor. In this case the franchisor has the obligation to disclose all material facts related to the franchise system and the grant of the franchise. In this case, the franchisor would arguably be required to disclose its knowledge of any breaches by the franchisee of its franchise agreement and of any undisclosed information or inconsistencies discovered by the franchisor in the resale process. This may result in a failed transaction and possibly the franchisor's exposure to breach of contract and a tort claim by the existing franchisee for intentional interference with contractual relations. The franchisor will need to consult with legal counsel to assess the risk of allowing a potentially improvident transaction to proceed versus the potential problems

arising from blocking the sale. A franchisor may also consider including a condition to transfer in its standard franchise agreement which requires the franchisee to substantiate its valuation of the franchise and permitting the franchisor with the right to require an independent business valuation if in its opinion acting reasonably the franchisee has overstated the value of the franchise.

- (d) **Purchase and Sale Process.** The franchisor has an interest in overseeing the sales process to ensure that the assets and obligations purchased and assumed by the transferee are consistent with the franchise agreement and are those necessary to permit the transferee to operate the business. Specifically, the franchisor will need to review the process and documents to ensure the following:
- (i) the purchase and sale agreement does not purport to “sell” or grant title to any trade-marks, franchise rights, licence rights, the manual, system software, or any proprietary aspect of the franchise system;
 - (ii) the agreement does not ascribe any value to goodwill which value is retained by the franchisor;
 - (iii) the transferee assumes all liabilities and the transferor agrees to be bound by any existing liabilities not expressly discharged on closing;
 - (iv) the existing franchisee agrees to pay all outstanding royalties, fees, advertising fees and other charges on closing;
 - (v) the existing franchisee confirms its confidentiality and non-competition covenants;
 - (vi) the franchisor delivers its form of assignment and consent and the appropriate transfer fee is paid;
 - (vii) the franchisee delivers the landlord’s form of assignment and consent and the appropriate transfer fee is paid;
 - (viii) the existing franchisee delivers a release to the franchisor and its directors, officers, agents and employees;

- (ix) the transferor and the transferee make appropriate arrangements with respect to any outstanding accounts receivable, customer credits and gift cards liabilities.

- (e) **Post-Closing.** Following closing, the new franchisee will be required to undertake the franchisor's training and orientation program and to integrate into the franchisor's system. The franchisor will have an interest in monitoring the departing transferee to ensure that it complies with its non competition covenants and the terms of the franchisor's assignment and consent.

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Introduction

The franchise resale process is a process which if properly executed can significantly franchise systems by providing a predictable exit option for underperforming franchisees and franchisees looking to exit the system. While not all franchisors have in place documented resale programs, it is our view that well documented programs which set out the expectations of the seller, the buyer and the franchisor can increase the value of a system by creating a more efficient resale market, by reducing conflicts between franchisor and franchisees and by ultimately ensuring that the franchisee receives the most value for his or her contribution to the franchise system. We propose to discuss some of the principal issues relating to resales using the following case example.

- exit options for Zee and Zor
- succession planning
- smooth predictable process – “rules for handling the divorce”
- source of revenue and improvement for Zor (fresh investment in system)
- better communication with Zee – ensure you are on top of who wants out and why before problems develop

Case Discussion:

Wally’s Waffles is a medium sized-franchise chain operating throughout Ontario. Willy operates a franchise in Wawa and is in the 3rd year of a 5 year initial term. After promising initial sales and a downturn in the usually vibrant Wawa economy, Willy’s Wally’s Waffles franchise is waning. His store sales are down 25% over the same period a year earlier. He is becoming a discipline problem and has recently received repeated warnings about compliance with system standards including royalty reporting issues. His attitude is increasingly defensive and combative. You have heard from other franchisees that he believes that the franchisor “has it in for him” and favours others. He is not reinvesting in his store and you are not very optimistic about the franchisee’s chances of rehabilitation. You believe it would be in everyone’s best interests to have him out of the system.

Scenario 1

You want Willy out of the system before he inflicts further damage to the brand. You don’t have the energy or desire to build a case for termination for cause, nor do you wish to wait until he decides to leave or abandons his franchise. What do you do?

Talking Points:

1. Procedures

- do you have a resale program/ written procedures on how to approach the franchisee? is this communicated to Zee – annual meetings, training, conventions etc.
- how do you communicate with Zee? Notice periods? etc.
- how do you market the franchise? within the system? outside? advertising?
- do internal sales people have less/more/equal incentive for resales compared with

new franchisees?

-do you have one “point person” for resales?

2. Valuation

-how is the store valued?

-how do you deal with unreasonable price expectations? esp if Zee believes its debt should be the purchase price?

-what if franchisee is making misrepresentations/material non disclosures?

-if purchase price is too high in your view, will you intervene by speaking to the Zee?

-(breach of good faith obligations to Zee? add consent in contract to speak to prospect)

3. What is your degree of involvement in the resale process?

-do you introduce candidates and step away?

-is your role more proactive?

-Legal issue: Section 5(7)(a) Zee to Zee sales are exempt from disclosure under the Wishart Act unless effected “by or through the franchisor”. Section 5(8) stipulates that a sale is not “by or through” if the franchisor has a right exercisable on reasonable grounds to approve or disapprove the grant, and a reasonable transfer fee is payable.

-Disclosure: Typically, it is good practice to provide the prospective franchisee with fresh disclosure in all instances, and particularly where franchisor requires new Zee to sign the most current franchise agreement, and where the franchisor is heavily involved in the sale process

-MAA Diners v. 3for 1 Pizza and Wings – Zor was asked to “facilitate or manage the transaction” = effected by or through

-Tutor Time – additional indemnity requested by Zor = “effected by or through” since “right exercisable on reasonable grounds” did not exist in Franchise Agreement

-Contractual review: As franchisor, you will want to review the agreement of purchase and sale b/w the parties to ensure that it is not inconsistent with the franchise agreement and does not purport to sell assets or rights which the Zee has no ownership of, such as a franchise licence rights (which are assigned), IP rights, goodwill arising from use of franchisor’s trade-marks, and contains no other franchise terms that may be inconsistent with those in the Franchise Agreement.

4. How do you identify and screen prospects?

-is resale screening “abridged” or are different metrics applied due to time sensitivity?

-are transfers mandatory or discretionary in your system? ie. does your franchise agreement stipulate that you “must” transfer upon satisfaction of objective conditions, or do you have “wiggle room” in your transfer conditions?

-Agreement issues:

- fees
- notice of intent to sell
- purchase agreement approvals
- right of first refusal
- candidate approval – Zor’s degree of discretion? Good faith?
- store upgrades, training etc.

5. What options exist to use of the resale process?

- offer to purchase franchise – valuation issues
- allow franchisee to find his own vendor – what are the risks?
- monitor franchisee until default then terminate
- franchisee abandons store = litigation?
- franchisee jumps the gun and sells without consent = default and termination

6. What to do with the lease?

-assuming you are not the landlord/sublandlord and have an option to lease/sublease or a conditional assignment of lease/sublease, do you take over the property or let it go?

-if a transfer, has the appropriate consent and assignment been obtained from the landlord?

Scenario 2

Willy jumps the gun and presents you with a signed agreement of purchase and sale between him and his fishing buddy Warren. How do you respond?

- default process and possible termination;
- keep options open...offer termination agreement with conditions and release of Zor