When the Franchisee Wants to Get Out of the Business

by Charles Modell

As many mature franchise systems are now learning, it is inevitable in the lifecycle of most franchisees that the franchisee will ultimately want to sell his/her business. With the exception of the handful of publicly held franchisees that may exist in some systems, franchisees are generally individuals who will experience the same lifecycle events as the rest of the population, including life changing events such as divorce, disability, retirement, and ultimately, death. Some of those events tend to cause people to rethink their priorities and life's work, while others force them to do so. More often than not, the best thing that could happen for that type of person is to make a change in their life, and when they own a business, that means selling the business.

As the owner of the franchised business, the responsibility for finding a buyer, and completing a sale, first and foremost falls upon the shoulders of the franchisee. However, closely following the interest of the franchisee is the interest of the franchisor whose revenue and system may be greatly affected by the sale of the business. If the wrong prospective franchisee is found, the franchisor may face the difficult decision of whether to approve the transfer, or face potential legal action for withholding its consent. If the business ultimately falls into the hands of an incompetent or untrained buyer, the franchisor is the one that will live with the problem. If the franchisee is unsuccessful in selling the business, and the business suffers, or is ultimately liquidated, the franchisor will also suffer. Therefore, it is in the interest of the franchisor to help its franchisees sell their businesses when the need arises. This article will discuss a variety of means by which franchisors have offered this assistance.

Training and Counseling

When the time comes for a franchisee to move on, there are a number of obvious places the franchisee should or may be looking. Family succession is an obvious solution, just as it is in many closely held businesses throughout America. However, how many franchisors have a program in place to train family members for succession to the leadership of the business? While it would be in everyone's best interest for family members to be prepared many years prior to taking over the business, all too many franchisors find themselves providing this training at the same time they are reviewing a request for transfer to the family member. By conducting these training programs on a regular basis, the franchisor cannot only assure a smoother transition for family-owned franchisees, but also assure that everyone involved in the business is more attuned to the franchisor's systems and the benefits provided by the system. Such programs could be presented as stand alone weekend workshops or even as break-out sessions at the franchisor's annual conventions.

Employees of the franchisee are also natural successors to the interest of the franchisee. These employees have already been trained in the operation of the business, but they may not have been trained in the leadership skills necessary to operate a business. Once again, the franchisor can provide important educational programs to franchisees and their employees before the day comes when the employee is forced into this leadership position. Training employees in leadership skills can also be of additional benefit to both the franchisor and franchisee. For the franchisee, its employees are taught skills that can be helpful in operating the business during a temporary absence of the franchisee. In an age of low unemployment, the availability of this training, and the potential for upward movement, could help franchisees attract employees. For the franchisor, providing leadership skills to employees of franchisees could ultimately make it easier for the franchisee to open multiple stores. It also might result in the employee becoming a future franchise prospect.

Financial issues are usually of critical importance in the transfer of franchise businesses to franchisee employees. While family members may not be concerned about maximizing the value of the business upon transfer to an heir, valuation and financing of the purchase price will become critical issues in sales to employees. These are issues that are very difficult to deal with at the time of transfer, particularly if the franchisor has helped groom employees to take over the business but then has reluctance to approve an undercapitalized employee. Therefore, a part of the training provided to employees should include providing information as to capitalization needs and perhaps even suggesting the sources of capital.

Neighboring franchisees are also natural purchasers for a franchised business. In this case, the buyer is most familiar with the system and perhaps can leverage his existing unit(s) to secure financing for the purchase. However, particularly in a system of one-store operators, neighboring franchisees may not have the skills to operate multiple units. Franchisors should consider providing leadership training to its more successful franchisees so that they will be better equipped to take advantage of the opportunity to buy struggling franchises near them and turn them into successful units.

When there is nobody within the franchise system who is interested in acquiring the franchise business, the selling franchisee must look outside the system. Once again, the franchisor can be of assistance. Knowing that the day will come when franchisees will want to sell their businesses, and knowing the day will come when the franchisor may want to encourage a particular franchisee to sell his business, some more mature franchisors are conducting workshops and seminars at annual conferences designed to educate franchisees on how to sell their businesses. Outside speakers can provide significant assistance in helping franchisees determine how to engage a business broker (or in the case of a multi-unit regional franchisee, perhaps an investment banker) who is most familiar with this type of business. For the more typical "mom and pop" business that perhaps is best sold by the owner, rather than by a business broker, outside speakers can still teach franchisees how to package their business for sale.

Franchisors can also help franchisees sell their business by consulting with these franchisees and providing significant information to the prospective selling franchisee. All franchisors provide some information to franchisees in terms of the sale process, even if it is only the "checklist" for obtaining transfer approval that appears in the franchise agreement. Many franchisors have taken the provisions of the transfer clause and provided more detail through formal checklists they provide to franchisees describing what will be needed to obtain the franchisor's approval. These checklists can be very helpful to the selling franchisee, and to its broker, in properly qualifying prospective franchisees. They also can help the franchisor avoid having to pull teeth to get all this information, or worse, having to delay a closing that is in everyone's best interest because the information has not been provided.

There is, however, significant additional information franchisors can provide to franchisees to help them through the sale process. For example, franchisors can assist franchisees in pricing their businesses. This can be a delicate area because, like the seller of almost anything, the franchisee may place an unrealistically high value on the business she is selling. However, franchisors could provide resale information on other units in their system that have sold in the last few years. It would not be necessary to identify those businesses, as the franchisor could simply provide information as to the range of revenues for its various franchised businesses that were sold and the range of prices within each revenue range. This information would not necessarily tell franchisees the price they should set on their own businesses, but it would tell franchisees what comparable businesses have sold for in the recent past.

Franchisors considering providing pricing information to franchisees should consider a couple caveats. First, if there has only been an isolated sale or two in the system for the last few years, the franchisor should not provide this information without consent of the prior buyer and seller. Second, franchisors must be careful as to what information is passed on to which persons. For example, while revenues and sale prices with respect to prior sales could be given to subsequent sellers, the same revenue information generally cannot be provided to prospective buyers unless the earnings claim disclosure in Item 19 of the Offering Circular given to prospective franchisees is broad enough to include the revenue information being disclosed. (There are exemptions to Item 19 for the provision of revenue information pertaining to this particular business.)

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Next, franchisors should always provide a caveat to prospective sellers that this information is merely historical, is based upon information provided by others and has not necessarily been verified by the franchisor. Finally, franchisors should caution anyone to whom this historical information is provided that the value of the consideration provided in each transaction may be higher or lower than the actual stated price depending upon a variety of factors, including whether the purchase price was all cash or included low interest notes, whether the buyer also assumed liabilities in the transaction, and whether or not the transaction included consulting or noncompete agreements, the value of which may not have been indicated in the purchase price.

Franchisors could also track other information regarding sales in their systems that would be of interest to selling franchisees. For example, a selling franchisee might be interested in knowing how other franchisees sold their business (whether by themselves or through brokers), how those franchisees advertised for buyers (whether local or national publications), how long the businesses took to sell, and what type of advertisements may have been most beneficial.

All of this may sound like a lot of work for franchisors, and those who have provided this type of information will confirm it does take significant effort to track the information. However, as more mature systems are learning, the alternatives are not better. If a franchisee wants to sell its business and cannot find a buyer, what is the cost to the franchisor when the franchisee loses interest in the business and the business begins to deteriorate? If a franchisee gets overly impatient and comes to the franchisor to buy the business, what is the cost to the franchisor either in terms of having to purchase a business it does not want or perhaps facing litigation from franchisees, who then decide they were misled as to the particulars of the business and never would have bought the franchise if they had understood all the work involved, or that they were locked into the investment? While we do not mean to suggest a franchisor who does not provide any sales assistance to franchisees has any liability for failing to do so, it may not be comforting to a franchisor to hear from its chief financial officer about the drop in royalties that are not the fault of the franchisor, or from the franchisor's attorney about the legal fees involved in defending a spurious action from a franchisee who could have, and should have, been replaced while the business was successful.

Taking an Active Role in the Sale Process

Some franchisors have gone beyond the training and counseling of franchisees in selling their businesses and have taken an active role in the sale process. Rather than providing samples of advertisements used by other franchisees, some franchisors have actually placed advertisements for selling franchisees (with the consent of the franchisee), either at their own cost or at the franchisee's cost. Some franchisors also make leads available from their own new sales efforts. While diverting a lead from a new sale to the purchase of an existing business does not add stores or revenues to the franchisor's balance sheet, the transfer of a unit from a "tired" operator to a new one might have almost as positive an effect as adding one new unit to a system but still having to service a disenchanted long time owner.

Franchisors express mixed feelings as to how much they want to get involved in talking to prospective buyers of the franchise business. Some franchisors will express concern that they do not want to be a participant in the sale and incur liability for the statements of the franchisee. However, it is suggested that franchisors can provide some protection to themselves through written disclaimers, noting that the business is owned by, and being sold by, the franchisee, that neither the franchisor nor the franchisee is acting as the agent of the other, and that the franchisor has not reviewed, and is not responsible for, any information being provided to the prospect by the franchisee.

By talking to prospective franchisees, the franchisor can keep the prospective franchisee from developing false expectations that the franchisor will have to live with for the balance of the term of the franchise. The franchisor can help everyone involved by helping the prospect appreciate the value of the franchise and understanding the franchisor's various programs designed to improve the profitability of the business. If the franchisor does take an active role in the sale process, then the franchisor must also take responsibility for delivering an Offering Circular to the prospective franchisee at its first personal meeting and wait 10 business days before accepting any new agreements from the transferee.

Becoming a Party to the Sale

Some franchisors, particularly more mature ones, have found there are more resales of existing franchises than sales of new ones in their system. These franchisors should not only consider the programs referred to above, but they may also want to consider becoming even more involved in the sale. In preparation of this article, we solicited information from existing franchisors and found several programs whereby the franchisor actually had members of its franchise sales staff dedicated to the resale of franchises.

In one example we found, the franchisor offered to enter into agreements with its franchisees whereby the franchisor was appointed as the exclusive sales agent to solicit potential purchasers for the franchised business. The term of the agreement was for the earlier of one year and the date of closing of the sale of the business. The franchisor and its franchisee negotiated a form Asset Purchase Agreement that was attached to the Exclusive Sales Agent Agreement, detailing the basic terms that would be acceptable to the franchisee. The agreement also detailed specific information pertaining to the business that the franchisee would provide to the franchisor for disclosure to prospects. The franchisor received a commission for brokering the sale, essentially the same as a broker would receive. In fact, the entire agreement contained provisions very similar to provisions contained in an independent broker's agreement, including indemnification of the franchisor, and acknowledgment by the franchisee that the franchisor was not responsible if it could not find a purchaser.

The benefits of entering into a broker arrangement with franchisees should be obvious. The franchisor's sales staff should be better equipped than anyone else to find prospective franchisees for this system and to sell the system to those prospects. Moreover, there should be little problem with the approval process if the franchisor does its homework in soliciting prospective franchisees; no prospect that did not qualify would even be brought to the selling franchisee. The franchisor has better control over the information given to prospects, and the representations (whether legally binding or not) that are made to the prospect as to the franchisor's obligations and commitments. Finally, a franchisor who takes control of the sales process should have little concern that buyer and seller will decide to look for a way to circumvent the approval process, or circumvent the franchise agreement and have the business operate as an independent business, as can sometimes happen when buyers and sellers get together on their own.

There are some drawbacks to the broker arrangement. Despite disclaimers and agreements, the more hats the franchisor wears, the more potential liability the franchisor faces. In most cases, this potential is outweighed by the benefits of replacing tired franchisees with new ones. In addition, if there is real estate involved in the sale, then in most states the franchisor would have to be licensed as a broker in that state in order to obtain a commission for brokering a sale. In some cases, this may also be true where no real estate is involved. There may be ways around this problem if one of the principals of the franchisor holds a broker's license in one state and enlists the help of a broker in another state in each sale. A review of the real estate laws of each state is beyond the scope of this article, but it is recommended that each state's laws be checked before entering into any type of commission arrangement with respect the sale of an existing franchise.

A variation of the broker arrangement is for the franchisor to purchase an option to acquire the business. The franchisor, for example, would purchase an option to acquire the business for $100,000 (assuming for purposes of this example that this is the price the franchisee agreed to accept for its business). The franchisor may pay $1,000 for the option, with the option payment to be applied against the price. The franchisor would then have perhaps up to one year to exercise the option. During the time, the franchisor would look for a buyer for the business. If a buyer was found, then the franchisor would simply sell and assign its option to the buyer, perhaps at a premium in order to cover the franchisor's costs and profit (a variation on the commission theme), and the buyer could close on the purchase. (Keep in mind that in the case of option agreements, broker agreements and the like, there may be disclosure requirements that must be met under federal and state franchise laws.) The option agreement may also be a way to avoid the licensing requirements for brokers, but once again, each state's real estate licensing laws must be considered.

The ultimate participation of the franchisor in the sale of its franchisees' businesses occurs when the franchisor actually purchases the business. Some franchisors have no company-owned operations and are not in a position to pursue this option. However, others represent sources willing and able to serve as purchasers of their franchisees' businesses. Some franchisors have even established formal guidelines and formulas under which they will purchase franchised businesses, which are published for all franchisees so that they know what to expect when they are ready to sell their business. If the formulas are reasonable for both parties, this practice gives the franchisor a built-in mechanism for the development of new company-owned stores without the franchisor having to take the initial risk of investment. Whether the business is held indefinitely and operated as a company-owned store or resold to a new franchisee varies with each system and, no doubt, with each location.

For many franchisors, it may not be practical to actually purchase its franchisees' businesses. Franchisors have to understand that if the purchase is a means of ending an acrimonious relationship, it may become a blueprint for others who want to get out of the business; rather than going through the sale process and taking responsibility for the sale, and perhaps they will turn to the same lawyer the prior franchisee used, manufacture a dispute and hope to negotiate the same type of sale. Franchisors, therefore, must understand the business precedent they may be setting when buying a franchisee's business. However, in the right system, and at the right prices, this alternative is still much more preferable to a franchisor than having unhappy franchisees whose businesses are deteriorating.

Pushing the Issue

There may be times when it is clear to the franchisor, if not to the franchisee, that the franchise unit and the franchisee's investment will suffer if the franchisee continues in business. If the franchisee has defaulted in its obligations to the franchisor, the franchisor has the ability to terminate the agreement (subject to cure periods set forth in the franchise agreement or under state law). The threat of termination could convince a franchisee that the better option is to sell the business and recoup a portion of her investment. If a default notice has been sent and the time is running for cure, it would be very difficult for most franchisees to sell their business in the short period of time given for cure. In those instances and in circumstances where a franchisor and franchisee agree that the business should be sold the franchisor might consider implementing a delayed termination in consideration for the franchisee's commitment to sell the business prior to the date termination becomes effective.

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The concept of the delayed termination will only work where (i) the franchisor prefers to keep the unit in the system, and (ii) both franchisor and franchisee agree that the best course of action is for this particular franchisee to leave the business entirely, but to recoup a part of its investment through sale of the business. An outside date, such as six months ahead, could be set for termination of the franchise. During that time, the franchisee would not have any right to cure, as presumably any right to cure would already have lapsed. During this time, the franchisee would try to sell the business, perhaps with the assistance of the franchisor as suggested earlier in this article, knowing that it has a reasonable time to find a buyer, to have the buyer become qualified as a successor franchisee, and to complete the sale, before termination takes effect. The franchisee thereby recovers a portion of her investment, and the franchisor keeps the unit as a viable unit in the system.

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