FRANCHISE
Succession Planning and Transfers

A Best Practices Handbook

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Selling and transferring ownership of a franchised business is something that many franchisees do not think about until they are at the point where they are retiring or ready to sell their businesses. Many people mistakenly assume this is a simple process, but there are myriad decisions to make before a franchised business can be sold and ownership transferred.

Perhaps the best way to prepare is to create a succession plan – an advance strategy that maps out how a franchisee plans to remove himself from the business in the future and transfer it to a new franchisee owner, who could be a family member or a third party buyer.

This handbook provides a blueprint for establishing a succession plan along with a list of decisions to be made in the planning process.

Selling and transferring ownership of the business not only affects the franchisee, but also the franchisor. One section discusses how franchisors can work with their franchisees to find a suitable buyer for their franchise. Having a plan in advance will make this sometimes emotionally difficult process easier to execute.
The International Franchise Association, the world’s oldest and largest organization representing franchising, is the preeminent voice and acknowledged leader for the industry worldwide. Currently celebrating a half-century of service with a growing membership of more than 1,100 franchise systems, 10,000-plus franchisees and more than 500 firms that supply goods and services to the industry, IFA protects, enhances and promotes franchising by advancing the values of integrity, respect, trust, commitment to excellence, honesty and diversity.

**IFA Mission**

Protect, enhance and promote franchising

**IFA Vision**

The preeminent voice and acknowledged leader for franchising worldwide

**IFA Strategic Priorities**

- Government relations
- Public relations
- Education and professional development

**IFA Values**

Integrity
- Infusing high ethical standards into all efforts

Respect
- Showing thoughtful consideration for all members, staff and others with whom we work

Trust
- Faithfully fulfilling our responsibilities to members

Excellence
- Delivering high quality content and programs that propel franchising forward

Diversity
- Embracing the diversity of individuals, ideas and perspectives

For more information, visit the IFA Web site at www.franchise.org.
The IFA’s Franchise Relations Committee is dedicated to developing information and programs that promote positive relations and encourage dialogue and cooperation between franchisees and franchisors. For additional content produced by the Franchise Relations Committee, please visit www.franchise.org/franchiserelations.aspx.

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A. INTRODUCTION

America’s business community is built upon family-owned businesses which includes franchises. More than 90% of all businesses in the United States are family-owned and employ 62% of the private sector workforce. Two-thirds of the nation’s Gross Domestic Product is produced by family-owned businesses. Further, over the last 20 years, more than 80% of the net new jobs created in the United States were created by family-owned businesses. A large number of family-owned businesses are franchise businesses of which over 900,000 exist today.

Unfortunately, statistics are not very good as pertains to the continuation of family-owned and franchise businesses. Almost 70% of all businesses fail to survive to the second generation. Of those that do survive, only 12% make it to the third generation. A considerable number of franchised business owners would like to maintain ownership of their franchises after retirement. However, for several reasons this does not happen in 70% of businesses. One of the primary causes of a family business not staying in the family is the failure to create and execute a management succession plan. Other major reasons include inadequate estate planning, and the subsequent lack of funds to pay estate taxes.

Most business owners want their businesses to survive them and the vast majority, exceeding 80%, want to pass their business, or franchises, on to their children or other family members. However, the number one reason this does not occur is due to the lack of a viable succession plan. Therefore, in order to ensure the continuity of ownership by the family of a franchise, a succession plan must be developed and implemented.
B. WHY A SUCCESSION PLAN IS NEEDED

Approximately 70% of family-owned franchises will not survive the retirement of the original owner without a succession plan in place. There are many reasons why the owner may not be able to continue to operate the franchise and needs to have a replacement waiting to take over. For example, one never knows when he may die or become physically incapacitated due to an illness. Also, there are legal and financial problems that can arise in which the owner needs to be immediately replaced by a successor. There have even been cases where the owner has, without notice, walked away because he had had enough and wanted to go into immediate retirement. However, at some point in time a successor will take over for the original owner of the franchise. And the point is, one never knows when that successor will need to take over. As we have always been taught, an ounce of prevention is worth a pound of cure and therefore it is of extreme importance to have a succession plan in place if the owner of the franchise wants to maintain ownership as opposed to transferring it to another.

There are several competing interests when the owner does need to retire. If members of his family are also employees they might feel like they should be the successor. Also, if the owner has several children each of them may feel that they should be put in charge of the franchise. Additionally, there are non-family employees that, because of their length of service or importance to the franchise, want to become the successor to the owner, or at least obtain a stake in the franchise. Even when there are no family members of the owner actively involved in the franchise, there can still be pressure applied because these family members want to ensure that they will end up owning the business if something should happen to the owner. For these reasons and others, an effective and complete succession plan needs to be implemented by each franchise owner to ensure the continued success of the franchise in the event the original franchise owner is no longer able to or willing to lead and operate the franchise.
C. THE SUCCESSION PLAN

(i) DEVELOP TEAM OF ADVISORS

The franchise owner needs to control the succession plan from beginning to end. After all, it is his company and therefore needs to control the management continuity strategy. The owner can select to do this in one of two ways. First, the owner might decide just to work with selected members of his or her family and allow immediate family members to actively participate in helping the owner decide upon a successor. Second, the owner might decide it is advisable to bring in professional advisors such as an attorney or business experts in his industry that know what qualities are imperative for a successor to have to be a successful replacement of the owner. Regardless of what approach is taken, it is advisable to contact the franchisor and determine what help the franchisor offers with regard to transfers. Often times the owner will find it beneficial to combine both strategies and select a successor based upon input from both his immediate family members and professional advisors.

(ii) IDENTIFY QUALITIES SUCCESSOR MUST POSSESS

Once the franchisee has his team of advisors in place he must identify those qualities that his successor must possess in order to successfully run and operate the franchise. Many franchisors require certain qualifications of a successor to the existing franchisee. Depending upon the type of franchise, there could be some very specific and highly technical qualities that must be possessed by a potential successor. Such qualities would be ascertained by the franchisee, his advisors, and the franchisor as part of his succession plan. However, there are many qualities that the successor must possess that are common to all franchises. For example, the successor must qualify as a franchisee and have a complete knowledge of the business he or she is to run and operate, or at least the ability to acquire this knowledge within an acceptable time frame. Further, the successor must possess the traits of enthusiasm, persistence, determination, willingness to learn, and basic intellectual capacity. Other qualities would include the ability to plan and organize, able to solve problems, an eye for detail, along with good health, plenty of energy, and a gung-ho attitude.

(iii) IDENTIFY THE SUCCESSOR

Once the first and second steps of the succession plan have been completed, it is now time to identify potential successors. Oftentimes, the franchisee will assume that his children will want to take over the business and be the successor. However, the owner of the franchise must identify the right successor for his business whether or not it is one of his children or another family member.

The franchisee should make it clear to each of his children and other family members whether or not he or she is required to join the business on a full time basis. Also, it might be appropriate to give the potential family member successor the opportunity to work outside the business first to gain valuable skills in other business settings. This is done by Chick-fil-A with the grandchildren of the founder. The franchisee must realize that the successor may or may not come from within his or her family. Further, it is possible that, if there are two strong contenders for successors, the franchisee may work with both of them to be his successor and both may be responsible for the effective operation of the business upon his retirement.
The two main reasons franchisees do not put a succession plan into place or give it much thought is because one, they feel like they have plenty of time to do so and two, that they might offend family members if they pick one over another. However, it is interesting to note that the average life span of a family-owned business is 24 years and that is also the average time the original owner is at the helm of the franchise. However, never knowing what will happen tomorrow, it is always important early on in the life of a franchise business to have a succession plan in place so that successors can be groomed because they may be needed sooner than later.

**(iv) TRAIN THE SUCCESSOR**

Now that the successor has been picked, and assuming any legal matters are taken care of, the franchisee must train the successor by transferring his knowledge to him gradually over time. Depending upon the franchise, the owner will need a transition period of one to three years to adequately train his successor. The successor must follow a succession plan that includes education about the business. This may include attending the required franchisor training course(s) and working with the current owner to learn everything there is about the business. The successor must get to know the franchise’s most important customers along with its key suppliers, vendors, and other people in businesses that have contributed to the success of the franchise. The franchisee must convey the key factors that he feels has led to his success and those key factors that he feels will lead to success in the future. As much as possible, the franchisee must document all of his knowledge and processes so that the successor will know how things are done and why. Much of this knowledge is already contained in the operations manual provided by the franchisor. However, the owner will still contribute much knowledge in the successful operation of the franchise that is not contained in the operations manual and other materials provided by the franchisor.

Gradually the franchisee must show his trust in his successor by delegating more and more responsibilities to him. The owner must realize that the successor may make mistakes from time to time and needs to be there to assist in correcting the mistakes and turn them into learning experiences. Further, the owner needs to provide his or her successor with the appropriate documents that are required to efficiently operate the franchise. These documents include such items as financial statements, insurance policies, key contracts, corporate and/or other business documents that dictate how the business is to be run, along with sharing all franchisor materials with the successor.

Initially the successor will shadow the franchisee and just watch the franchisee. Gradually the owner will delegate more and more responsibilities to his successor so that he can effectively train him. Also, this transition period allows for not only the other employees of the franchise but also for the franchisee’s customers, suppliers, and vendors to develop confidence in the successor as well. The end result is that all parties come to identify the franchise with the successor as opposed to the original owner.
Finally, the succession plan, as part of the franchisee’s estate planning, must be structured in such a way as to minimize the impact of estate, gift, and inheritance taxes on family members and the business. Franchise owners who fail to consider the potential impact of estate and inheritance taxes could easily force, upon their passing, their remaining family members to sell the business in order to pay the estate’s tax bill. At this point it is critical to have a tax attorney and a CPA who specializes in taxes to determine which vehicles are best in order to minimize these taxes. Several items that can be utilized in order to do this are items such as family limited partnerships, an estate freeze, various types of trusts, lifetime gifting, and buy-sell agreements. The franchisee must cover these issues with competent legal and tax counsel and any further discussion of these types of legal options is beyond the scope of this handbook. However, before the owner of franchise can determine which options to utilize from a legal and tax perspective, he must first check with his franchisor in order to determine if written permission is needed from the franchisor in order for the owner to participate in one of these legal strategies. After all, the franchisor will want to know what is going on and will want to review whatever is done before it is done concerning these items.

D. CONCLUSION

A franchise owner, upon purchase of a franchise, should already be implementing a succession plan. One never knows when a successor will have to take over long before expected. Therefore, it is always better to be proactive than reactive. However, not all franchise owners are looking to develop a succession plan because for whatever reason they have already decided they will sell the franchise to a third party, which could include a family member. Therefore, for those situations, the second part of this handbook covers the sale of a business, which under franchising is referred to as transfers.
A. INTRODUCTION

Entrepreneurs rarely take the time to consider how they are going to handle ‘the end’ at the start-up or during the life of a business. Little thought is given to the implications of a transfer or succession of a franchised business with a thorough review of the applicable franchise documents.

For many entrepreneurs, it is difficult to consider the dissolution of the franchise at the onset. Many choose to optimistically focus on the benefits and potential. Even if a clear understanding exists initially about the process and procedures for a transfer or succession of the franchise, it is rarely revisited or reconsidered during the life of the business.

Only on the occasion of a significant event like an illness or retirement does the issue get the attention it deserves. And the result is all too often less satisfying than it might have been if a process to exit the system had been clearly documented and agreed upon at the beginning of the franchise relationship.

B. EXIT STRATEGY

An important part of any succession plan is the exit strategy for the franchise owner. Disability, retirement, death – these are all issues that must be planned for and addressed. The timing of a transition depends on a number of factors, such as the franchisee’s age, health, retirement goals, and the readiness of a buyer/successor. The franchisee must consider whether to maintain some involvement with the business or make a clean break.

The following are potential non-family successors in the sale of your business:
   a. an outsider
   b. an existing employee and possibly retaining partial ownership
   c. a select group or to all of your employees
Of course, all three of these are subject to the franchise agreement terms and provisions concerning renewal, termination, repurchase, modification and assignment of the franchise. There are contract restrictions on the franchisee’s right to freely transfer the franchise. These contract limitations are sometimes also subject to separate state legislation.

These standard franchise agreement provisions enable franchise systems to enforce high quality standards and ensure uniformity. Failure to comply with these restrictions generally becomes cause for default and termination of the agreement and exposes the franchisee to the risk of ending up with no franchise at all. So it is of utmost importance to make all plans within the scope of the appropriate provisions of the franchise agreement.

(i) SELLING TO AN OUTSIDER

The outsider challenge is identifying someone interested in and familiar with your business, then qualifying them both operationally and financially, and matching their personality and skill set to the franchise concept.

One example is a vendor or supplier prepared to move into business ownership. A key supplier of ice machines with a long working relationship with a regional distributor enjoyed the end-user customer contact so much that he purchased the business when the distributor/seller left to begin his next career. However, the first place to look is to the franchisor. Many franchise systems assist franchisees with locating a successor and handling the resultant transfer.

Another source of interested parties may be a client that is subject to downsizing and/or consolidation of a large corporation who is prepared to secure their future by purchasing a business. A third party referral, such as a business broker or a broker’s referral network may speed the process of qualifying and matching possible prospects.

(ii) MARKETABILITY OF THE FRANCHISE BUSINESS

Buy low and sell high is always a great idea, whether it is a stock or a business. Sell the store when sales are climbing, placing the buyer in a positive state of mind and psychologically prepared to make the purchase. The following are important to the buyer.

- A fully trained staff is an attractive asset
- All key management positions are filled
- The lower the debt load of a business the higher the liquidity and cash flow
- Severability of real estate from the business
- Complete and detailed corporate books and records
- A positive EBITDA (Earnings Before Interest, Taxes, Depreciation, & Amortization) trend line
- A franchise that is not overly dependent on the owner for its operational success and profitability
- The age and condition of the equipment and facilities
(iii) VALUATION OF THE BUSINESS

There are valuation issues in the event of death for franchisees with a substantial net worth. The estate tax – even as modified by the Economic Growth and Tax Relief Reconciliation Act of 2001 – is a principal consideration in developing the succession plan. The Internal Revenue Code requires the estate tax to be imposed upon the fair market value of the estate of the deceased at the time of death. Franchises can present unique problems in the area of valuation. A major reason for preparing a succession plan is to avoid the prospect of a forced sale that would diminish the value of the franchise business.

(iv) VALUATION METHODS

There are three basic methods of valuation accepted by the courts and the IRS: book value or net worth, capitalization of earnings, and comparable sales of similar franchise businesses. The most persuasive, when available, is comparable sales. As a rule, the information on comparable sales of franchise businesses is in the possession of the franchisor. Ideally, the franchise system should provide its franchisees with all the information it can about comparable sales without divulging confidential information.

A business is worth what another party will pay for it. A franchisee may have invested 24 hours a day, 7 days a week for years in a business, which may be worth millions to them. But the buyer has no emotional investment and will only purchase if the business offers a better return than another business offered in the marketplace.

To set a marketable price, one source of information is the resale list of the franchisor. Ask how many transactions were resales. What percent of their asking price did they sell for? What multiple of gross sales, net sales or profitability is commonly used to set the selling price? The market sets the price and if the price is too high, the prospect has the option of investing in a new start-up location if territory is available. The advantage of buying an existing store is generations of cash flows and an established client base, as long as the asking price for these is reasonable. Finally, any transfer and franchise fees that may apply to this transaction must be discussed with the franchisor. This should be considered in determining any transfer price offered to a prospective successor.

There are a number of ways of valuing a business. Go to www.smallbusinessnotes.com for a comprehensive list of the different ways a business can be valued in determining the price at which to sell the business.

(v) SELLING TO AN EMPLOYEE

Employee Stock Ownership Plans, which involve transferring ownership of the company both to family members and to employees, cannot be used on their own to transfer ownership wholly to family members, but they can be used in combination with other methods of transfer – such as gifting or recapitalization – to keep majority ownership in a family.

One scenario of a key employee purchasing the business might be, “If I die or am disabled, the contracts that I have with my two trusted executives require them to run the company for at
least two years. They have an option to buy the company at any time for $7 million or, if they decline, they will be paid a substantial performance bonus if the company is ultimately sold for more than $8 million.”

One method for keeping good employees interested in growing the business is ‘key man’ insurance. This is a policy in the name of the employee, where the company pays the premium and the employee accrues the cash value of the policy.

With so many decisions and choices, every succession plan should be reviewed and approved by the selling business owners, their accountant, attorney and franchisor. One must plan ahead for a successful and smooth exit strategy.

C. THE TRANSFER PROCESS

Most franchisors have determined how they are going to handle the transfer process. This is reflected in the FDD and more specifically detailed in the franchise agreement. A typical process would be as follows:

1. Notification: The franchisee must give notice to the franchisor of his intent to transfer the business, whether to another franchise operator or family member. The period for notification, if not regulated by State law, is generally 30 to 90 days before the proposed transfer.

The franchisor most likely will require the payment of a transfer fee at the time the request for transfer is received or later, when documents are signed giving the franchisor’s approval. Most franchise agreements require the franchisee to notify the franchisor in the event of the death or disability of the franchisee. There are generally specified timeframes for a qualified successor to be named and meet the franchisor’s approval criteria.

It would be prudent for every franchisee to have a prospective successor identified should they be needed. However, very few franchisees have considered identifying a prospect in advance.

2. Approval: The franchisor will have the right to approve the transferee the franchisee designates, whether it is another businessperson, a relative, or another franchisee. The prospective franchisee will have to meet the franchisor’s current requirements for a new prospective franchisee, including financial qualifications, experience, business acumen and commitment to operate the franchise.

For the franchisee’s family members, sometimes the approval requirements are less stringent. Care should be taken to understand the nature of the transferors liability after the transfer, as many franchisors do NOT release the original franchisee from all or part of their liability under the franchise agreement, when it is assigned to a successor.
3. **Right of First Refusal:** Many franchisors have a right of first refusal to purchase the franchised business at the point of a proposed transfer if certain factors exist. These may include instances when the prospective successor is a businessperson from outside the system, a family member that is deemed not qualified to operate the franchised business, or other similar situations.

Some franchisors will negotiate this provision out of the franchise agreement, especially in a new franchise system. However, as the franchisor and their system grows, a franchisor will be increasingly reluctant to remove or dilute this provision.

4. **Training:** If the franchisor approves the transfer, there will be required training to further qualify the transferee to operate the franchised business. This training may require the transferee to attain some level of competency to satisfy the qualification process. There may be training fees to be paid by the transferee, along with travel and living expenses incurred during the training period.

5. **Effective Dates for Transfer of the Franchise:** Depending on the type of business, there will be a point in time when the transfer officially occurs. If the business has tangible assets, it will generally be on the day and date when those assets have been officially conveyed to the transferee. If it is a service business, it is generally when the accounts have been presented and the revenue generated after that date accrues to the transferee.

(i) **LOCATING PROSPECTIVE BUYERS**

One of the benefits of owning a franchised business is the available pool of prospective buyers. The pool of candidates may include:

- Existing franchisees in the same system.
- If allowed, franchisees of other concepts in the same vicinity who are looking for expansion opportunities, but are limited within their present concept.
  - For example, a Baskin-Robbins franchisee with no access to another 31 Flavors franchise in their area may seek another franchise brand, such as a coffee shop or sandwich shop, in the same area.
- Franchise prospects that are interested in buying a ‘going concern’ with immediate cash flow versus a start-up situation, which could take 6 to 12 months to open.

One of the keys to success in locating a buyer for a franchised business is to understand the role the franchisee and the franchisor can play in the transfer process. However, almost always the prospective franchisee must meet the qualifications as set forth by the franchisor and be approved by the franchisor. **Franchisor’s role:** The franchisor will generally take a ‘hands off’ approach in the preparation of the legal sale documents, but experience indicates that many are eager to support a franchisee in the transfer process. The franchisor wants to ensure a qualified operator ends up with the business and many franchisors will actively market the opportunity within their organization and to new franchise prospects. **Franchisee’s role:** The bottom line is that a franchisee is responsible for making the decision they want to affect a transfer and locating an appropriate transferee. There are numerous avenues and resources for reaching that decision that a transfer is appropriate and for locating potential transferees.
• Franchisee’s network – One place to look is within the franchisee’s own sphere of influence, such as business contacts, vendors, other franchisees in the area, friends and relatives. Many transfers result from interest shown in a franchised business by someone with personal involvement in the business and/or the franchisee.
• Franchisor’s network – If the franchisor is willing to provide access to, or stimulate interest from, their network of franchisees, prospects and vendors, it is the franchisee’s responsibility to independently investigate each lead and determine if it represents a true prospect. Because the prospect referral came through the franchisor doesn’t necessarily mean they will meet the franchisor’s criteria for approval to acquire the franchised business.
• Business Brokers – There is an active business broker network in the U.S. and abroad that represent buyers and sellers of businesses, both franchised and independent. One must be certain that the broker works with franchised businesses and understands that the buyer must ultimately be qualified and approved by the franchisor prior to the buyer acquiring the franchise. Many prospects initially seeking a non-franchised business through a business broker become interested in a franchised business during the process.
• The basis for using a business broker, whether to represent the sale of your business or to provide prospective buyers for your business, is the contract you sign with them. It will identify the services the broker will provide and fees that will be incurred should a sale result. These fees can vary substantially between brokers. Before employing a broker, the seller should request a client list from the broker, with contact information, to get recommendations regarding the broker’s past services to his clients.

(ii) APPROVAL/DISAPPROVAL PROCESS

Once the decision has been made by a franchisee to sell a franchise business, the transferee has been identified and the price and terms have been agreed upon, the franchisor will have the right to grant or deny the request for approval of the transferee within a specified timeframe. The franchisor may also require franchise and/or background check documents be completed before it will consider an application for approval.

• Approval – The franchisor’s approval of the buyer should be in writing to ensure no misunderstandings. The approval will generally state whether it is contingent on any other factors, such as obtaining financing, successfully completing training and approval of documents such as an Asset Sale Agreement or Purchase Agreement.
• Disapproval – One of the most challenging aspects of the franchise relationship can be the disapproval of a request to transfer a franchised business, whether to another franchisee, a third party buyer or to a family member. There are sometimes rights provided in the franchise agreement to appeal the disapproval of a transfer request. However, at best, this results in a delay in the transfer timetable.

(iii) THE IMPORTANCE OF ESTABLISHING A TRANSFER POLICY

There are several reasons why a franchisee may choose to exit the franchise system and transfer his business and franchise to another party. A franchisee may choose to transfer because he is retiring, not experiencing the level of success or satisfaction he was expecting, or because the business was very successful and now the franchisee wants to sell at a favorable price and
pursue other opportunities. Regardless of the reason for transfer, every franchisor should have established a transfer policy/process so that all franchisees can understand it and transfers can move forward as smoothly as possible.

The transfer policy should take into consideration the interests of all the parties involved. The three parties always involved in transfers are: the franchisor, the franchisee (transferor) and the transferee (prospective new franchisee).

The franchisor’s interest in transfers is wanting to make sure the transferee meets its current criteria for qualifying as a franchisee, that the transferee will be a good fit within the system and that the business is being sold/purchased for a reasonable price to afford the transferee a good chance for financial success. The franchisee’s interest in transfers boils down to wanting to exit the franchise system in a timely manner, while getting the highest price for their franchised business.

The transferee’s interest is different. The transferee needs to be sure the system they are entering is one they want to be active in for the life of the franchise agreement. The transferee needs to make sure they are paying a fair price for the business and need to be aware of the challenges that may occur from assuming ownership of an existing business, regardless of whether the business is successful or not.

(iv) A PERFECT WORLD TRANSFER SCENARIO

In a perfect world, all transfers would be cookie-cutter cases and the process the franchisor has established would be followed quickly and smoothly every time. Unfortunately this is not a perfect world. But that doesn’t mean franchisors shouldn’t establish transfer policies as if it were. Here is a sample “perfect world” transfer scenario:

1). The franchisee communicates his desire to sell his business and exit the system to his Field Representative or his contact at the franchise headquarters.
2). Once the initial communication has been made, the franchisor representative and the franchisee discuss whether the franchisor may have a qualified prospect for the unit. However, in most cases, the franchisee must look for his own buyer.
3). Once a candidate is located, the franchisor will interview and qualify the candidate in a similar fashion as a new prospect. One of the most frequent complaints from franchisees regarding transfers is that the franchisor is much more stringent in establishing its qualifications for a transferee than they seem to be for a new franchisee coming into the system. This seems unfair to the franchisee because such practices make exiting the system for them more difficult. If the same approval criteria are used for transfers as for new sales, there would be less room for dispute.
4). While a qualified transferee is being sought, a price for the business should be established. Regardless of when the sale price is arrived at by the transferor, they should be aware that under most franchise agreements, the franchisor has the right to know the asking price and other terms of the transfer of the business, for possible exercise of its right of first refusal or compliance with the franchise agreement, and to approve the terms.
It is the franchisor’s responsibility to protect the transferee and the system. If the transferee’s debt/equity ratio is too high based on the purchase price and the amount of debt owed to the transferor or the lender, the transferee may not successfully grow the business and may jeopardize its success.

5). Once a qualified candidate is found and approved and a fair price is agreed upon by all parties, a closing and transition timeline should be set. This timeline should outline such things as: training for the transferee with the franchisor, on-site training for the transferee either by the transferor or the franchisor, a closing date, signing of legal documents involved and payment of the purchase price and transfer fee.

6). When all of the items on the transition timeline have been completed, the transferee will take over the business. From this point forward, the involvement of the transferor (original franchisee) will vary from system to system. In some franchise systems, it is likely the original franchisee will have no further contact with the transferee or the franchisor, after the transfer is complete.

It is usually easier for the transferee and franchisor to have a better working relationship if the transferor isn’t continually “in the middle” of the new relationship offering their opinions. In some cases, some franchisors may encourage the transferor to stay involved for a few months after the transfer occurs, because the original franchisee’s continued involvement may help the transferee more quickly get on their feet.

(v) WHAT NORMALLY HAPPENS IN THE TRANSFER SCENARIO

Most franchisors will tell you that most transfers do not go exactly like their transfer policy provides. There are circumstances that affect every transfer, making it difficult to follow the rules at times.

Sometimes the franchisor is the last to know when a transfer is about to occur or has already taken place. The franchisor gets contacted after the franchisee has found someone locally who is interested in purchasing the business and then they report the closing is already scheduled.

As a franchisor in this scenario, first start sorting through the pieces of the puzzle, because a franchisor cannot stick its head in the sand and refuse to work with the franchisee to correct the situation. Once you determine how far into the transfer process the franchisee already is, a franchisor needs to do its best to proceed from there.

(vi) LOCATING BUYERS

Locating buyers for transfer units is the primary task. Franchisees often look first to interested parties within their region.

Perhaps a local multi-unit operator is interested in growth by acquisition or maybe an acquaintance has always been interested in getting involved with the system and this is a convenient location to avoid relocating. However potential buyers are located for the purchase of this transfer unit, a franchisee should follow the system’s transfer policy to avoid confusion and delays.
(vii) UNQUALIFIED CANDIDATES IN TRANSFERS

One of the most challenging circumstances in transfer situations is when the franchisee presents a potential buyer and the buyer does not meet franchisor’s qualifications to be a franchisee. This situation can become more complicated if the franchisee and prospective transferee have already agreed upon a price, scheduled the closing and are moving forward with the transfer before contacting the franchisor.

It is worthwhile to mention that while most franchisors will not unreasonably withhold its approval of a transfer, there is still a qualification process which must be followed. The franchisee (who probably went through a similar franchisee criteria and qualification process when they entered the system) should be aware they need to help the transferee get approved if they want to exit the system in a timely, cost-effective manner.

When a situation arises where the franchisee has brought a truly unqualified candidate to the franchisor for approval, the franchisor should be concise and straightforward with the franchisee in their assessment. Clearly outline why the candidate does not qualify, but do not leave the conversation open for further discussion. If the franchisor can clearly identify to the franchisee why a particular candidate did not qualify, then the franchisee should be willing to go out and search for a candidate who does meet the criteria.

If the franchisee brings multiple candidates to the franchisor for review, but is repeatedly told the prospects do not qualify, the franchisor should be prepared for strong resistance from a franchisee. If the franchisor is continually rejecting the franchisee’s candidates, perhaps the franchisor should step back and consider whether they are fairly evaluating the candidates or if there is some other reason why the prospects are not meeting the franchisor’s current standards.

(viii) TRANSFER FEES

Some franchisors have fees associated with the request to have a buyer approved while others have fees associated with the subsequent transfer of a franchised business. The franchisor does not want franchisees to capriciously submit prospects for review without remuneration for the time and resources it will take to adequately review and approve each prospect. Sometimes, the fees are connected to various elements of the process, with separate fees for reviewing the request, qualifying prospects, approving the request and finally documenting the request.

In some circumstances, the franchisor may set the fee as a percentage of the sale price, which can result in significant fees. Generally, the fees charged by franchisors for approving the sale of a business and the transfer of an existing franchise agreement are spelled out in the franchise agreement. The fees can be significant, which is why it is important to address them clearly in the franchise agreement and for a franchisee to thoroughly review and understand the transfer process.

Most franchisors contend the transfer fee, payable at the time of closing by either the transferor (franchisee) or transferee, is needed to cover the franchisor’s expenses of being involved in the transfer process, which often can be lengthy and time-consuming for the franchisor to approve the buyer. The transferor may feel they shouldn’t have to pay the transfer fee because they paid the franchise fee when they joined the system.
It is important to both the franchisor and franchisee that a requirement to pay the amount of such fee be clearly specified in the franchise agreement, including payment of the transfer fee as a condition of the closing and transfer of the franchise.

D. TRANSFER DOCUMENTATION

There are primarily two ways to transfer a franchised business, with accompanying documentation. The first method is for the franchisor and transferee to sign a new franchise agreement under which the transferee will be awarded a full new term of 5, 10, 15 or 20 years. The second method is for the transferor, transferee and franchisor to execute an “Assignment of Franchise Agreement”.

The assignment method is often used when there are multiple years left on the original franchise agreement or when the transferor negotiated favorable terms initially for himself, which would continue to be a benefit to the transferee. A franchisor may sometimes prefer this method if it does not have a current franchise disclosure document or is not registered to sell franchises in the state where the transfer is taking place.

If the selling franchisee has an old or outdated franchise agreement, the franchisor may want to have the transferee execute a current form of agreement to be consistent with new franchise sales. It is important to the franchisor to have the transferor sign a general release stating that no claims or disputes exist for the period the franchise agreement was in effect. This brings closure to the business relationship for both parties. Once a buyer is identified and the business terms (e.g., personal and real property to be transferred, purchase price, financing) are fully negotiated, the legal process – as briefly described below – can begin.

(i) DOCUMENTATION

A buy-sell agreement will need to be drafted by legal counsel, whether the transfer is of the assets of the business (including the franchise rights) or the stock or partnership interest in the franchisee. If assets will be sold, it may be called an “Asset Purchase Agreement.” If stock will be sold, it might be described as a “Stock Purchase Agreement.” In either case, to make the drafting process more efficient, a “letter of intent” or a “term sheet” initially will be prepared and executed, outlining the main provisions of the parties’ agreement. In either case, the documents must be in compliance with the franchise agreement. The transferor needs to confirm what is owned by the franchisee and what is owned by the franchisor and only include assets that are truly transferable.

The buy-sell agreement will describe the parties to the sale; the specific assets, stock, or partnership interests to be sold; the timing of the sale; the purchase price and how and when it will be paid; any financing; indications of who is responsible for debts and liabilities; and other such terms particular to the sale. This is a negotiated document and legal counsel is usually involved in its preparation.

Franchise transfers also take place when there is a transfer of assets from the estate of a deceased or incapacitated franchisee. Transfers may also occur when an individual franchisee personally transfers to another legal entity (e.g., corporation or limited liability company) which the franchisee has formed for convenience of ownership or tax purposes. Typically simpler documentation is required in instances where a third party is not involved.
(ii) CONSENT TO TRANSFER

The franchise agreement will address transfers by both the franchisor and the franchisee. For franchisor transfers, the agreement typically will state that the franchisor is free to transfer the franchise agreement and that it need not obtain any consent or approval to do so from franchisees. However, franchisees are permitted to transfer only if they obtain prior written approval from the franchisor.

Typically, the franchise agreement will state that approval “will not be unreasonably withheld”. It would be considered reasonable for the franchisor to withhold consent under circumstances, such as:

- the selling franchisee has not paid all outstanding monetary obligations to the franchisor and, in some cases, outside suppliers;
- the selling franchisee is in default under the franchise agreement;
- the selling franchisee has not signed a general release of claims;
- the selling franchisee has not paid a transfer fee to cover the franchisor’s costs of the transfer;
- the selling franchisee refuses to acknowledge its post-termination obligations regarding confidentiality and non-competition and to remain liable for all pre-transfer obligations;
- the terms of the buy-sell agreement would create an undue financial strain on the franchised business and place the business in jeopardy;
- the buyer does not meet the franchisor’s financial, educational, managerial or other qualifications;
- the buyer fails to complete the franchisor’s initial training program;
- if required by the franchise agreement, the buyer refuses to upgrade/renovate the premises to meet standards;
- if required by the franchise agreement, the buyer refuses to sign the current franchise agreement or to have its principal’s guarantee performance personally.

(iii) APPLICABLE STATE LAWS

There are some state laws that apply to the process of obtaining approval from a franchisor to transfer. These laws may restrict franchisors from withholding approval of a franchisee’s transfer request, except for “good cause.” The definition of “good cause” varies from state to state, but generally requires franchisors to accept transferees that meet “reasonable” qualifications. Permissible grounds for disapproval of a transfer under such a state law may include situations where the transferee: (1) is a competitor to the franchisor; (2) refuses to agree to the terms of the franchise agreement; (3) fails to cure a default by the current franchisee under the existing franchise agreement; (4) would have an overly-large territory as a result of the transfer; or (5) would pay a purchase price so high the franchisor reasonably believes it would impair the transferee’s ability to generate sufficient cash flow to operate the franchised business successfully.

A few state laws also require a franchisee to provide the franchisor with written notice, as well as information concerning the proposed transferee, before making a transfer.

A franchisors’ refusal to consent to a transfer can be challenged by a franchisee based upon common law, as decided in court cases by judges in the jurisdiction provided for in the franchise agreement. The provision most typically referred to is known as the “covenant of good faith and fair dealing.”
Application of a covenant of good faith and fair dealing requires a court to determine whether the franchisor’s withholding of consent to transfer under the circumstances presented would have been reasonably expected by the parties at the time they entered into the franchise agreement, regardless of whether the issue is directly addressed in the franchise agreement. This follows the assumption that a franchisor may not perform acts that negatively affect their franchisee’s interest. However, most courts have not implied a covenant of good faith and fair dealing on issues not specifically referred to in the franchise agreement.

**(iv) DISCLOSURE**

While franchise sales laws require franchisors to provide franchise disclosure documents (FDDs) to prospective buyers, in the case of transfers this obligation continues to be the responsibility of the franchisor and not the selling franchisee. Franchisors are often legally obligated to provide such disclosure documents to the buyer, especially to buyers who sign a new franchise agreement and do not assume by assignment the seller’s existing franchise agreement. To be able to provide such disclosure, the franchisor needs to have a current FDD in effect, and also in some states must be currently registered to offer and sell its franchises.

**(v) TRANSFER PROCEDURES**

Many franchisors distribute to selling franchisees “transfer packages,” which contain instructions on the procedures to follow in selling their franchise business. These packages provide step-by-step instructions and may include forms and standard documents to be executed, such as an umbrella document called a “Consent to Transfer and Release Agreement”. This addresses all of the present and future obligations of the parties in connection with the transfer and is to be signed by the franchisor, the transferor, and the buying franchisees.

Even the most detailed transfer packages, however, will not cover every type of transfer. Transfers can include a complete sale, a sale of a partial interest in the franchise, a transfer on death, a transfer to their own corporation or LLC for convenience, a public offering, or otherwise. Each will present unique features to be addressed in the process and documentation.

The descriptions above provide a general sense of what will be required for many transfers. There is no “one-size-fits-all,” and each transaction is different, so that – from both the business and legal perspectives – careful planning and a customized approach will often be necessary. For legal issues, the advice of an attorney who has experience with franchise transfers will be valuable.
E. TRAINING AND OPERATIONAL SUPPORT FOR TRANSFEREES

(i) DIFFERENCES COMPARED TO A NEW FRANCHISEE

In some respects, the franchisor’s job is significantly easier with a transferee. Much of the start-up support that would be provided to a new franchisee may be unnecessary, as the transferee will be taking over a fully staffed and operational business. In site-specific businesses, for example, the franchisor is relieved of providing training and support in the areas of site selection, lease negotiation, architectural planning, interior design, and construction. Typically, transferees are entering an established business operation, which will often have existing management and staff in place, the hiring process will have been completed and the employees trained.

The franchisor does face some unique opportunities and challenges when providing training and operational support to transferees who are becoming franchisees.

If the transferred franchise was well run prior to the transfer, the goal of a successful transfer may be to provide a seamless transition between franchisee and transferee, maintaining the high standards set by the original franchisee. This may have implications relative to the new franchisee adjusting to an established culture among the employees at the unit level. There may be a need to help the employees adapt to changes in ownership and a different culture and environment.

Conversely, when the previous franchisee was a less-than-stellar or unsuccessful operator, the challenge becomes one of instituting incremental improvement to the existing operation. In some cases, improvement can be attained gradually until an operation is operating at or above system standards. In other cases, more radical changes may be necessary.

(ii) COMPLIANCE REVIEW AT TRANSFER

At the same time, many franchisors look at a transition with a new franchisee as an opportunity to improve a unit to meet current system standards. A change of franchisee ownership may invoke provisions in the Franchise Agreement for remodeling and upgrades in décor, equipment, signage, new POS systems, or instituting changes in operating procedures to the current system standards.

In this case, the franchisor and the transferee can look at a transfer as an opportunity to improve both their location and the system as a whole.

(iii) INITIAL TRAINING PROGRAMS

When an established unit is up and operating with experienced personnel, there may be a temptation on the part of some franchisors and franchisees to skip or to minimize the transferee’s need for initial training. And while shortening or eliminating training might be possible, there are a number of reasons why the transferee should be required to and want to complete the same training program as a new start-up franchisee.
The first reason is improved quality control to meet current operating standards. The transfer process allows the franchisor the opportunity to identify and break bad habits and to correct non-standard activities that unit-level personnel may have developed under the previous franchisee. This training will help strengthen the system for both the franchisor and franchisee. There is also the possibility that the new franchisee will not pass training – and it will be better to determine this in advance before the new franchisee is in the unit operating it.

A second reason relates to legal issues. One advantage to the franchise relationship is that the franchisor can reduce the risk of liability for the acts of their franchisees. If a franchisor fails to provide adequate training on an issue relative to safety or other operating policies, a franchisee’s actions may create this type of liability for a franchisor.

For example, a franchisee that is not trained in the area of sexual harassment might unwittingly create liability both for itself and for the franchisor by stepping over the line with an employee to create a harassment charge. If properly trained and tested by the franchisor concerning sexual harassment issues, that franchisee in the same situation might avoid creating a problem with significant liability potential.

One final reason for full and complete training of a transfer franchisee is that this process provides an opportunity for the franchisor and its staff to develop a relationship with the new franchisee. Aside from the ability to make a determination as to the franchisee’s competence in operations, the training experience is a “once-in-a-relationship” opportunity for bonding with the franchisor and is an opportunity for the franchisor to explain “why we do it like that.”

(iv) ON-SITE VISITATIONS

In many franchise systems, the frequency of on-site visitations by franchise service consultants in the field decreases over time, as the franchisee grows more and more competent and experienced in the operation of the franchise. When a new franchise transferee takes over an established operation, the franchisor may continue with the previously established field visit frequency appropriate for an experienced franchisee, instead of the visit frequency of a new franchisee.

It is more appropriate in the first weeks following a transfer to visit a transferee at least as frequently as the franchisor would visit a new start-up operator. In some cases, the visits should be more frequent. While the transferee may have a number of advantages over the start-up operator from the standpoint of existing trained staff and an established customer base, in the first weeks of operation the inexperienced transferee with little or no training can permanently damage years of goodwill built up by the previous franchisee through their errors and operating mistakes. The initial visits by franchisor field representatives often focus on personnel and morale issues, as well as on operational issues.

(v) HOW TO GET NEW TRANSFEEREES UP-TO-SPEED OPERATIONALLY

Many franchise systems require the transferee’s initial training to be completed before the transfer is finalized as it is the critical element in bringing transferees up-to-speed in their new business. As indicated above, it is strongly advised that transferees attend the full training program offered to new start-up operators.
If the transferee is bringing in a new manager to oversee day-to-day operations, that individual should also complete the franchisor’s entire pre-opening initial training program. If the prior franchisee’s management staff is going to remain in the business and report to the new franchisee, it is often useful to have these key managers also attend refresher training conducted by the franchisor.

This is particularly important if the operations of the original owner were not maintained according to the franchisor’s system standards. Such training will not only ensure the managers are familiar with current procedures in use throughout the system, but it will also help to create new enthusiasm for their role in the business. An added benefit of the new franchisee and the former franchisee’s managers attending training together is that they will begin developing their own personal networking relationship in a positive environment away from the business location.

Another strategy to help improve the transferee’s operational performance and results, when appropriate, is to conduct on-site training at their location immediately following their successful completion of headquarters training. Although most franchise systems provide on-site training to new start-up operators, many do not provide similar (or as extensive) training to transferees at their location. A thorough on-site training component for transferees will enable the franchisor to:

- Observe the performance of the transferee in their new business and identify any issues which need further attention;
- Assist the transferee and their staff to implement current operations standards, introduced at the time of the transfer;
- Identify and correct any operational deficiencies that might exist at the location;
- Provide training as needed for unit co-workers and employees; and
- Following on-site training at the transferee’s location, the franchisor can identify any remaining operations issues that need to be addressed, and develop an action plan with the transferee for resolving them.

(vi) MENTOR PROGRAMS

Many franchise systems have established mentor programs to facilitate the successful transition of an existing franchised location to a new operator. Additionally, a mentorship program is available through the Franchise Relations Committee of the International Franchise Association. In a typical mentor program, a transferee will be assigned to an existing experienced operator prior to their assuming day-to-day management responsibilities of their new business. The extent of the mentoring process can range from an experienced operator simply being available as needed to answer questions on the telephone, to a more direct role of meeting with the transferee or helping them with operations issues at their franchised location.

Key elements of a successful mentoring program include the following:

- Only franchisees that are operating at or above the franchisor’s standards should be permitted to fulfill a mentoring role;
- Ideally, mentors will be located within the same city or region as the transferee. This local connection will enable the mentor to best understand the needs of the transferee, and be available if needed to meet with the franchisee; and
- Although the franchisor should have some input into the mentoring program (e.g., which franchisees are approved to be mentors), franchisees should be very much involved in developing and managing the mentoring process. A mentoring program must have the full support of franchisees to succeed.
Successful mentor programs will not only benefit the transferee, but will also benefit the existing franchisees that participate as mentors. Through the mentoring process, existing franchisees will develop relationships with new operators in the system more quickly. They begin to develop dialogue within their region on issues such as best practices, cooperative marketing and other topics related to the growth of their respective businesses.

F. CONCLUSION

While transfers are not always going to be cookie-cutter cases or follow the transfer policy perfectly, it is critical to the franchise system for the franchisor to have a detailed transfer policy in effect so that all parties are on an even playing field and fewer disputes will result.

For many successful business persons, from day one their business is “For Sale”. This doesn’t mean that millionaire business owners hang up a “For Sale” sign next to the “Grand Opening” sign. It does mean that many successful business owners have two business plans in their heads, if not on paper.

The first business plan covers how to build a successful business. The second plan shows the business owner how to maximize his return on investment when he wants to sell his successful business. Their second type of business plan is considered an exit strategy.
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