

Resales – The Legal Issues



Resales: Why so Important?

- A Resale is an important rite of passage in the life cycle of a franchise system
- A resale, if not handled carefully, can be complex and costly
 - Passions are often inflamed
 - Demands for money are triggered
 - Uncertainty may arise
 - Prospects of litigation increase

Definition of a “Resale”

- The grant of a franchise of a previously franchised unit

- Two types of resale scenarios:
 - 1. Sale of a franchise by an existing franchisee to a new or existing franchisee

 - 2. Sale of a franchise by a franchisor to a new or existing franchisee (after the franchise is taken back by the franchisor)

Resale by Franchisee

□ Disclosure Document (DD) Issues

- Is a franchisor obliged to provide a DD to the transferee or is it exempt from disclosure as a non-participant in the resale process?
- S.5 imposes the disclosure obligation
- Exemption
 - S. 5.(7)(a)(iv): “this section does not apply to the grant of a franchise by a franchisee if the grant of the franchise is **not effected by or through the franchisor**”

Resale by Franchisee cont.

- **DD Issues cont.**
- Section 5(8): "...a grant is not effected by or through a franchisor merely because,
 - (a) the franchisor has a right, exercisable on reasonable grounds, to approve or disapprove the grant; or
 - (b) a transfer fee must be paid to the franchisor in an amount set out in the franchise agreement or in an amount that does not exceed the reasonable actual costs incurred by the franchisor to process the grant.

Resale by Franchisee cont.

- **Tutor Time (2006)(Ont S.C.J.):**
 - The grant of the franchise was held to be “effected by or through the franchisor”.
 - ZOR imposed a condition not expressly provided for in the existing franchise agreement (i.e., that the spouse of the new franchisee’s principal shareholder sign a personal guaranty).

Resale by Franchisee cont.

□ **MAA Diners Inc./341 Pizza (2003)(Ont. S.C.J.):**

- The grant of the franchise was held to be “effected by or through the franchisor”.
- ZOR’s *operations manager* “took an active role in the franchise arrangements”.
- Meetings took place at ZOR’s office
- Documents prepared by ZOR.

Resale by Franchisee cont.

Lessons Learned

To avoid the necessity of disclosure, it is critical that all:

- ❑ Pre-conditions for approval which must be satisfied as part of the resale be specifically set out in the FA
- ❑ Contractual rights between ZOR and ZEE must be clearly laid out
- ❑ No new obligations should be imposed
- ❑ ZOR and its personnel should not take a leading role in facilitating the transfer

Resale by Franchisee cont.

Lessons Learned...

- Do NOT rely on exemption. WHEN IN DOUBT, DISCLOSE

- Failure to disclose?
 - Rescission remedy
 - Right of action for damages

Resale by Franchisee cont.

□ Essential Conditions for Resale

- Approval of proposed transferee
 - Intentional interference with contractual relations
- Approval of Agreement of Purchase and Sale:
 - Purchase Price – affordable to transferee?
 - Transferor taking security in transferee's assets
 - Bulk Sales Act compliance
 - Termination of employees, hiring others
 - PST and other Clearance Certificates
 - Transfer of licenses
 - Closing contingent on ZOR's final approval

Resale by Franchisee cont.

□ Essential Conditions for Resale cont.

- No existing default or financial obligations under the FA
- Execution by transferee of then-current FA and other Ks
- Satisfactory completion of training
- Renovation of Premises and repair of equipment, to ZOR's then current standards
- Release by transferor
- Payment of a transfer fee and other costs by transferor or transferee

Right of First Refusal (ROFR)

- Can a ZOR, “in good faith”, refuse the transfer?
- Does a ZOR have a ROFR?
- Pros: Allows ZOR to:
 - Buy back successful operating unit
 - Reject undesirable ZEE
- Cons: Availability of ROFR may discourage third party offers

Documents Required on Resale

- What documents are required to evidence the transfer to the new transferee?

- From New or Existing Franchisee
 - Assumption of Franchise Agreement or New Franchise Agreement
 - Personal Guarantees from new shareholders/partners
 - Undertaking to renovate/upgrade
 - Payment of training fee and other fees

Documents Required on Resale

□ From Departing Franchisee

- General Release of Claims against ZOR etc.
- Settlement of outstanding accounts with ZOR, Landlord and Suppliers
- Acknowledgement of survival of non-competition, confidentiality and indemnity obligations, and undertaking to de-identify
- Payment of transfer fee and/or reimbursement of ZOR's administrative and legal costs
- Undertaking to readjust post-closing

Resale by Franchisor (Buy-Backs)

- When sold by a ZOR, the franchised unit to be sold is acquired by a ZOR following:
 - The ZOR's exercise of an option to purchase upon termination
 - The voluntary surrender of the franchise to a ZOR
 - The ZOR's exercise of a right of first refusal on a proposed transfer by a ZEE
 - The death or disability of a Zee
 - The non-renewal of the franchise

Resale by Franchisor

- DD must be provided

- **Special Considerations**
 - Disclosure of all “material facts” pertaining to unit being transferred
 - DD to be modified from the ZOR’s “standard form” of DD to reflect nuances peculiar to the resold franchised unit
 - Other special DD considerations

Resale by Franchisor

□ Special Considerations

- Disclosure of unit financials?
- Avoid Projections
- Substantiated historical claims
- Franchise agreement considerations

Conclusion

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