

# The New SBA Franchise SOP: Documentation of Found Issues

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This document reflects issues and concerns raised by Franchisors/Attorneys regarding content in the new SBA franchise addendum and communicated to FRANdata.

In **black font** is the actual text found within the addendum, **blue font and in black boxes** are issues or concerns within that category or section as communicated to us by Franchisors and/or their attorneys.

## DEFINITION OF A FRANCHISE

Gas supply agreements are not franchises. PMPA is exempted from the FTC definition.

## FORM

In the second (introductory) paragraph, there should be a reference to brand and location of unit. We often sign agreements with the same franchisee (two brands on the same site, or two separate projects in different markets signed the same day). We need to have some ability to have certainty as to what agreement this addendum amends. Maybe after the definition of Franchise Agreement, SBA can add “with respect to a [BRAND] located or to be located at [LOCATION DESCRIPTION].”

## CHANGE OF OWNERSHIP

If Franchisee is proposing to transfer a partial interest in Franchisee and Franchisor has an option to purchase or a right of first refusal with respect to that partial interest, Franchisor may exercise such option or right only if the proposed transferee is not a current owner or family member of a current owner of Franchisee.

Change of ownership: we do have concerns if the proposed transferee is a family member of a current owner since that person may not be qualified to run a franchise, may not be familiar with our brand, etc. So to limit our rights in that situation is a problem. Same issue with a current owner if that current owner is not the operator – we would have requirements that there be a qualified operator in those instances also.

The “Change of Ownership” paragraph states that the franchisor cannot exercise its right of first refusal if a proposed transferee is a “family member.” I would like the amendment to be a little more specific, e.g., does a third cousin qualify as a “family member”?

We require franchise entity to have a principal operating partner. If a partial transfer goes to a party that doesn’t have any restaurant experience, this would pose a problem in our system.

If the Franchisor's consent is required for any transfer (full or partial), Franchisor will not unreasonably withhold such consent.

I am reluctant to agree not to “unreasonably withhold consent” to any transfer, as this language is undefined and unnecessary.

We modified this provision in our franchise agreement in 2016, which completely eliminated the need for an SBA amendment.

From a legal perspective, we lose some language that is helpful in the event of a franchise termination that is important primarily to demonstrate that the parties have a common understanding of our business concerns that would become the basis for our refusing to give consent to certain matters. Our goal would be to avoid the need to argue over what constitutes a “reasonable” basis. Language in our current addendum was included with the consent of the SBA for this specific purpose, and was acceptable as reasonable.

First, we lose the ability in advance to set some parameters within the addendum regarding what conditions we as franchisor may place on giving a required consent to, and some conditions regarding obligations after, a transfer or termination.

I would think it would not be deemed an “unreasonable” refusal of consent that the franchisor places certain relevant business conditions on approval for a transfer. These would include conditions such as requiring that the transferee (a) meet our then current standards for approval of new franchisees, (b) have the financial ability to undertake and assume both current and ongoing franchisee obligations such as payment of operating expenses and debt and the ability to complete required renovations, and (c) have the required management and/or successfully complete the required training. If we can do that by using a related document, we should be covered. However, if including such language is questioned by a bank as placing its SBA guarantee at risk, then it would be a problem that could prevent our willingness to agree to the SBA Addendum.

SBA should add “if such transfer otherwise meets the conditions for such transfer set forth in the Franchise Agreement” at the end of the sentence. (Otherwise, I'm not sure what is considered unreasonable, and like other franchisors, we have provided conditions to our consent already in our franchise agreements. Is an application fee that is double the new unit app fee (as many companies do) considered unreasonable? Is a full PIP of the property (which most companies require) considered unreasonable? Is payment of franchisor's legal fees considered unreasonable?)

In the event of an approved transfer of the franchise interest or any portion thereof, the transferor will not be liable for the actions of the transferee franchisee.

We are not in agreement with the provision of the amendment that eliminates the transferor guaranty.

We also need the transferor to remain liable – again if the transferee is not in the same financial position as the transferor.

I find problematic the provision that the transferor cannot be held liable for the performance of the transferee. If that provision is non-negotiable, the inevitable result will be franchisors disapproving more proposed transfers based upon this increased risk. Franchisors must now apply a higher standard for creditworthiness to the buyer/transferee. That inflexibility might be better for the SBA and its bank, but it will not be good for the franchisor, the franchisee, the proposed transferee...or franchising, in general.

Third sentence (sixth line), it should refer to a transferor “that, following such transfer, has no remaining interest in Franchisee or the franchise.” This is important as we often have transferors transfer their interests to a newly formed subsidiary of theirs, or may sell off only part of their interest to another investor who comes into the deal and they both may be jointly and severally liable under their guaranty. This language might otherwise override these very commonplace practices.

When a franchise sells, there are always trailing fees that are paid post-closing. Our system is set up to make the incoming franchisee liable for these fees and any indemnity obligations of the selling franchisee. In practice, it results in the incoming franchisee escrowing sufficient fees to ensure that the obligation is paid, and reserving rights against the selling franchisee. This system has worked well. The individual amounts owed by the selling franchisee are generally \$20,000 to \$30,000, making these amounts uneconomical to collect through individual legal action. But the volume of these transactions could result in exorbitant fees that might have to be written off as bad debt. Even if the selling franchisee agrees to pay trailing fees in advance, that would require more individualized negotiation, and more accounting costs. So if this remains a mandatory requirement, that is highly problematic. We are highly likely to drop our Brands from the Franchise Registry, and tell our franchise owners that we won't sign the Addendum required by the SBA.

The language states the transferor will not be liable for the actions of the transferee franchisee. But what if the transferor only transfers a portion of its ownership interest to the transferee. Does this preclude a franchisor from requiring the transferor to be (or remain) a joint and several guarantor with the transferee on the franchise agreement?

## FORCED SALE OF ASSETS

If Franchisor has the option to purchase the business personal assets upon default or termination of the Franchise Agreement and the parties are unable to agree on the value of the assets, the value will be determined by an appraiser chosen by both parties

Appraisal language is not clear. Are the assets being sold at an auction or is the appraisal going to value it as a going concern?

Forced sale of assets: if the franchise agreement already has a mechanism for selecting an appraiser that should control. The way this section is written is very open ended –what if the parties can't agree on an appraiser? How would they actually select one? Sophisticated franchise agreements would have a mechanism that would specify the means for selecting a reputable appraiser.

In the Forced Sale of Assets paragraph, it would be better if the amendment spelled out who is required to pay for the appraisal. Do the parties split the cost? What happens if the franchisee can't (or won't) pay for its share of the appraisal. Is the franchisor allowed to offset its purchase price paid in this amount, or does the franchisor have to eat that cost and still pay the full FMV dictated by the appraisal.

How does this restriction affect a Franchisor's right of first refusal in connection with sales to competitors?

If the Franchisee owns the real estate where the franchise location is operating, Franchisee will not be required to sell the real estate upon default or termination, but Franchisee may be required to lease the real estate for the remainder of the franchise term (excluding additional renewals) for fair market value.

In the event of a termination, the language of the addendum could also impact our ability to assume possession and/or protect proprietary brand image features. If the franchisee owns the land and building, we can't force a sale and can only lease the premises "at fair market value". Fair market value at the time of a termination could be substantially different from such value at the inception of the franchise, and the degree of difference will determine the likelihood of a dispute. There is nothing in the addendum that provides a reasonable mechanism or standard to determine the "reasonable" value. Likewise, I would expect that lenders will be reluctant to agree to a valuation which does not also protect their ability to collect on the loan as originally intended. For instance, if there has been a decline in market valuations for property in the area, the fair market value could produce a rent which would not service the debt. It would be helpful if there were some means for determining value based on the actual business operation.

Similarly, only allowing for a lease for the remainder of the primary term means that any default in the last few years is highly unlikely to result in a franchisor assuming possession because the franchisor would be unable to amortize its investment and would be unwilling undertake the human resource and contract efforts to staff and operate for a short period.

## COVENANTS

If the Franchisee owns the real estate where the franchise location is operating, Franchisor may not record against the real estate any restrictions on the use of the property, including any restrictive covenants, branding covenants or environmental use restrictions.

They agreed to not recording, but they including language that said any damage they face by not recording will be paid by the franchisee.

We are also concerned by the prohibition on “branding covenants”. Although the restriction is only with respect to “recording” covenants, we routinely seek agreements from the franchisee and from landlords allowing us to take actions if the franchisee fails to adequately de-identify the restaurant upon a termination of the franchise agreement. Filing suit against a financially insolvent franchisee would not be meaningful. As a result, because only certain aspects of the building would include registered trademarks we could lose the ability to protect important brand image aspects of the building, such as specific color combinations, awning design, and certain interior design features, all of which are becoming increasingly prominent aspects of our trade dress.

Are deed restrictions that are required not imposed by franchisor – for instance a remediation by court order done by the franchisee. What happens when it is a first time site for our franchise, and there is a deed restriction on the site, but not by us – Not franchisor required.

## EMPLOYMENT

Franchisor will not directly control (hire, fire or schedule) Franchisee’s employees.

Employment: franchisees are independent contractors and we would never be engaged in any of their employment matters. As written, that section implies that perhaps franchisors do get involved in employment matters. That needs to be deleted.

Why on earth is their employment language in the addendum” This is really overstepping their bounds

There is a presumptive link of joint employment

Can we strike “control” and limit to “hire, fire or schedule” if that is what is intended? Otherwise, is requiring employees to wear certain uniforms, or to take certain training, an exercise of “control”?

Yes, we do have a concern with the language of this amendment. In particular, the section that says franchisor will not hire, fire, manage, or schedule the Franchisee’s employees. In many occasions, the Franchisor has been hired by the Franchisee to manage their franchise (subject to a separate written agreement). This amendment completely contracts the purpose of the management agreement. How are franchisors handling step-in right relative to this provision?

## CLOSING PARAGRAPH

Between “This Addendum” and “automatically terminates,” insert “will be effective only upon closing of the Loan and.” Also, an additional section (iii) should be added for when the Franchise Agreement is terminated. We shouldn’t have to make this amendment effective unless the loan actually closes, and it should terminate when the Franchise Agreement terminates. As is recently the case, we are issuing these at franchisees’ request prior to loan closing, and if they end up seeking other financing, this purports to be effective in perpetuity.

## ADMINISTRATIVE BURDEN

They incorporated the fixes SBA issues into their agreements because in the Goddard system they already have so much paperwork to sign. Yet another document is an administrative burden. This is ridiculous.

There is also language in our current addendum that was designed to address lending and security concerns of the bank, including language to protect the bank’s collateral and its priority interest. As such, banks will likely want to include some of these provisions in a separate agreement. A separate agreement should be possible so long as it does not alter the required addendum through conflicting terms, and that may allow us to incorporate the “explanatory” language we need.

There are several exhibits in the franchise world that aren’t addressed. Common in our world is to finance franchisees, and we have subordination agreements

Deed restriction issues



For more than 25 years, FRANdata has been the industry leader in the strategic analysis, forecasting and measuring of franchise performance and operations. Leveraging the largest database of franchise information in the industry, FRANdata helps any business that touches franchising by providing the objective information and analytical expertise they need to make smarter and better business decisions. FRANdata, headquartered in Arlington, Va., is often cited as a franchise expert in such leading media as The New York Times, The Wall Street Journal, Forbes Magazine and The Washington Post.

Powered by the FRANdata database, the Franchise Registry provides every franchisor the opportunity to make financing easier and better for their franchisees. Thousands of SBA and conventional lenders visit the site every month to find and learn about the franchise brands to whom they are considering lending. Besides publicly validating that a franchise is viable and thriving, the site allows franchisors to take advantage of such financing tools as Financing Eligibility Service, Bank Credit Reports, Enhanced SBA Loan Performance Analysis, and understand their franchise credit score with the FUND report