

Let's Make a Deal: Developing a Successful Franchise Resale Program

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Many franchisors use sophisticated franchise sales programs to recruit new franchisees. These companies spend tens or hundreds of thousands of dollars generating and qualifying franchisee leads, working candidates through a multistep development process, and closing deals with various relationship-building techniques focused on finding high-performing franchisees to open new system outlets. Why do many of those same franchisors spend considerably less time, effort, and money on franchise transfers, i.e., those instances in which an existing franchisee sells an existing outlet to a franchisee that (more often than not) is new to the franchise system?

In stark contrast to the sophisticated franchise sales program for new franchisees, and despite the potentially golden opportunity to replace an average or below-average franchisee and turn around a struggling location or territory, most franchisors limit their involvement in the transfer process to collecting a transfer fee, conducting a rather limited credit check and financial review, and engaging in an abbreviated training program. Given the dichotomy in treatment between initial franchise sales and transfers, franchisors that do not play a more proactive role with transfers disregard valuable growth opportunities.

If presented the opportunity to design a process that could enhance the likelihood of success for transferee candidates, most franchisors undoubtedly would undertake that effort. One such opportunity is a franchisor-sponsored resale assistance program, where the franchisor provides lead generation resources, general assistance, and overall guidance to the franchisee throughout the resale process, many times for a fee beyond the standard transfer fee. The key benefit of a resale program is that franchisors are more involved in the process, thereby increasing the odds that the transferee candidate truly is a good fit, both financially and personally. Through a resale program, a franchisor can extend the tremendous resources spent on lead



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generation and prospective franchisee qualification to existing franchisees that likely do not have the resources or time to do the same. And although the selling franchisee might be focused solely on finding a transferee candidate that is eager to take the business off the franchisee's hands, franchisors know that more than a willing buyer is required for a successful franchised business. In short, by providing franchisees with insight and assistance in the resale process, a franchisor increases the odds of finding a candidate with precisely the right balance of financial wherewithal, character, resources, and expectations.

This article explores the various business and legal issues that franchisors should consider in developing and administering a successful franchise resale assistance program. In particular, the authors analyze the legal risks associated with state real estate licensing statutes and business broker regulations, two types of laws that easily can be called into play when developing a resale assistance program. The authors then identify potential components of a franchise resale assistance program that every franchisor can use to make a difference in developing or refining its own franchise transfer process. This article is intended to promote discussion between franchisors and their counsel about whether a properly structured resale assistance program might make a difference to all involved in the transfer process: the franchisor, the franchisee selling its franchised business, the prospective transferee, and the franchise system in general.

Business Considerations

Franchise resale programs have grown in popularity in recent years. This trend is due, in part, to the frustration a franchisor experiences when a franchisee, which speaks to prospects during the validation process, convinces the prospect to buy its existing business rather than acquire rights from the franchisor to open a new outlet. The resulting franchise transfer is not necessarily bad, but it likely stymies the franchise sales team's efforts to meet its goal of turning prospects into new franchise sales. Further, the transfer fee received in connection with the sale of an existing unit generally is much less than the initial franchisee fee charged for new franchise sales. Losing new franchise opportunities and generating less fee revenue can impact any franchisor negatively.

A variety of business issues dictate whether a franchisor-sponsored resale program is desirable for a franchise system, including whether the franchisor is part of an emerging or established system and whether a franchisor is willing to commit the resources and efforts necessary to do it right. Simply put, some franchisors provide little or no assistance to franchisees that decide to sell their franchised businesses. Other franchisors understand the business case for a franchise resale program and then design an effective process that results in successful franchise resales.

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At its core, a successful resale program allows a franchisee that is not engaged in the business (for whatever reason) to rely on the expertise and resources of the franchisor to sell the business. A resale program can lead to more focused and efficient sales efforts, thus increasing the likelihood of locating a new franchisee that can invigorate the brand with new capital and commitment. Not surprisingly, this reality has been the catalyst for many successful franchise resale programs over time.

Existing Resources

Successful franchisors have new franchise recruiting systems intended to identify qualified candidates with a good likelihood of becoming high-performing franchisees. These franchisors invest significant resources (money, staff, and other intellectual capital) in generating quality leads, moving the quality leads through a qualification process, and then advancing the quality leads through the final steps of the process to determine if the candidates are a good fit for the franchise system and business model. As the costs of certain components of this process are fixed, why would a franchisor not want to extend the new franchise recruiting system and related development process to a resale assistance program? Each of the elements of the process applies equally to franchise transfers and could increase dramatically the quality of resale candidates when compared to leaving franchisees to find buyers on their own.

As most franchisors acknowledge, many franchisees that find buyers on their own are not completely candid about their businesses or find buyers that are underqualified or ill-prepared to operate the business properly. Using all or part of the new franchise recruiting system in the transfer process enables a franchisor to address some of those issues.

Exit Strategy

Few franchisees view franchise opportunities as the businesses that they own and operate until retirement. They consider (or should consider) carefully their financial objectives, both current and long-term, in owning a franchise. A franchisee's long-term objectives should be tied to a potential exit strategy. Further, the exit strategy should account for circumstances when the franchised business meets the franchisee's financial objectives as well as those circumstances when the business fails. Whether an exit occurs within the initial franchise term, at renewal, or at some later date, a franchisor's resale program is a valuable benefit to a franchisee's exit strategy.

Most franchisees focus their efforts on operating the business and building an asset they can sell at some point. Few know how to sell a business and may prefer to engage the franchisor's assistance rather than that of a business broker, who knows much less than the franchisor about the franchised business. A franchisor can offer tremendous resources and knowledge of the franchised business and franchise system. When compared with the business broker approach to franchise resales, a highly

effective franchise resale assistance program is a better route.

Franchisors also should consider an exit strategy option with struggling or unhappy franchisees. With a franchise resale program, a franchisor may be more effective in dealing with underperforming franchisees that consume too many franchisor resources when, more often than not, they will continue to struggle or be unhappy regardless of what the franchisor does. Further, if such franchisees do decide to sell their businesses, they often do a poor job; and, as a result, their businesses suffer even more. A resale assistance program can be a strategy that more effectively moves the parties to a better business resolution.

Existing Location

Every franchise development representative has worked with candidates that, through their due diligence, realize they are better-suited for acquiring an existing franchise business. Rather than create a culture in which the franchise development representative's individual and team objectives for new franchises are at odds with the candidate that prefers an existing franchise business, the highly successful franchisor creates an approach whereby the resale assistance program meets the objectives of all involved: the franchisor; the candidate; the existing franchisee that sells the business; and even the development representative, who should not be penalized for losing a new franchise sale to a franchise resale.

If executed properly, a proactive franchise resale approach ensures that the buyer purchasing the existing unit understands the economics of the unit, comprehends the existing competition of the business, and makes an educated investment decision. The buyer also will not have to operate the business through its start-up stage and, with proper training from the franchisor, can step in immediately and operate the business. With this approach, most franchisors will see the operations of the existing business improve under new ownership.

Value Proposition

Many franchisors promote vigorously the benefit of "being in business for yourself, not by yourself." The value of owning a business as part of a franchise network typically exceeds the value of owning an independent business without the benefit of a larger and better-known brand. These principles apply squarely to a franchise resale assistance program. Smart franchisors include the resale program as part of their value proposition in their franchise development process. Smart franchisee candidates weigh an effective franchise resale program when making their initial decisions on franchise opportunities.

Assistance

In a properly designed resale assistance program, the selling franchisee retains all decision-making authority over whether to sell its business and on what terms. The franchisor merely provides a service that the franchisee may use when selling its

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business. The assistance also provides the franchisee with an opportunity to understand fully the franchisor's transfer conditions. It should eliminate time that the selling franchisee spends with potential purchasers that do not meet the franchisor's standards, and it also can accelerate the franchisor's decision on whether to exercise any contractual right of first refusal. The end result is that all interested parties understand the rules and procedures of the transfer process—an understanding that, when missing, results in disputes in many franchise transfers.

The service can be extremely valuable and result in benefits to the franchisor and the franchise system overall, but it still is assistance, not control over the franchise resale. It is important to recognize, however, that many legal issues are attendant to a resale assistance program, as discussed in more detail below. Some of those issues are triggered by the degree of control that a franchisor exercises over the sale through its resale program. Control in a legal context often turns on subtle points. Accordingly, a franchisor should design its resale assistance program such that it is clear that the franchisor is doing nothing more than offering assistance.

Legal Implications

As illustrated above, many varied business reasons support the development and administration of a franchisor-driven resale assistance program. Developing a franchise resale program, however, involves much more than understanding the business issues. Indeed, a franchisor must be aware of, and comply with, a patchwork of legal issues that may arise in reselling franchised businesses.

Analysis of these legal issues teaches that a franchisor can develop a resale program that allows for hands-on direct involvement or that adopts a hands-off approach. For example, some franchisors devote an entire department to the administration of a resale program while others assign one or two people to administer transfer paperwork. Either way, and as outlined below, a franchisor must be keenly aware of the intent behind developing the resale program (e.g., whether it wants to act as a business broker or real estate agent or wants to avoid one or both of these classifications) and the responsibilities and risks associated with each option. A franchisor then must act in a way that commands application of the particular statutory scheme or avoids it completely.

FTC Rule and State Disclosure Laws

Federal and state franchise disclosure laws may affect not only how a franchisor develops and administers a resale assistance program but also how it generally approaches franchise transfers on an individualized basis. The Federal Trade Commission (FTC) and fourteen states maintain a statutory scheme devoted to franchise disclosures.¹ These disclosure laws regulate the content and timing of presale disclosures to prospective franchisees.

By their terms, the overlay of federal and state franchise disclosure laws applies where a franchisor, or any person or entity acting on its behalf, makes an offer or sale of a franchise.² The FTC Rule, however, expressly exempts from the scope of its disclosure requirements “existing franchisees who sell only their own outlet and who are otherwise not engaged in franchise sales

on behalf of the franchisor.”³ Four states—Hawaii, Illinois, Indiana, and Michigan—have followed suit and created both disclosure and registration exemptions for franchisee-to-prospect sales of existing units,⁴ while ten other registration states specifically exempt only the registration component of the statutory scheme.⁵ Notwithstanding the differing scope of available exemptions, courts interpreting these laws generally agree that franchise transfers, absent the franchisor's requirement that the transferee execute its current form of franchise agreement, do not implicate applicable disclosure and registration laws.⁶

Nevertheless, federal and state disclosure laws often do apply to the typical franchise transfer process because transferees generally execute new franchise agreements. Accordingly, franchisors that include this requirement as a condition of transfer should prepare themselves for complying with applicable franchise disclosure laws, even if the franchisor otherwise is involved only incidentally in the transfer process (e.g., by ensuring that the transferee satisfies the franchisor's standards for new franchisees generally).

Case law illustrates that a franchisor's obligation to comply with franchise disclosure laws turns on the extent to which a franchisor controls the transfer or assignment process. In *Drake v. Maid-Rite Co.*,⁷ the court analyzed whether a franchisor was liable for its master franchisee's failure to comply with the disclosure requirements under the Indiana Franchise Act. Sweeden, a multiple-unit operator and master franchisee of Maid-Rite restaurants in Indiana, sold one of his restaurants to Drake. Sweeden did not provide a disclosure document to Drake during the sales process. Importantly (and unlike many franchise agreements today), Sweeden's master franchise agreement did not require Maid-Rite's prior approval for transfer. Sweeden and Drake ultimately memorialized their agreement on Maid-Rite letterhead, a fact that Drake later argued was important in holding Maid-Rite liable for Sweeden's alleged wrongdoings. When Drake failed to earn the revenues projected by Sweeden during the sales process,⁸ he sued Maid-Rite for disclosure violations under the Indiana Franchise Act.

The trial court granted summary judgment for Maid-Rite on the basis that Sweeden's sale to Drake was “not effected by or through” the franchisor.⁹ On appeal, Drake argued that summary judgment was inappropriate because “there was a genuine issue of material fact as to whether Sweeden was acting with actual authority or apparent authority as Maid-Rite's agent.”¹⁰

Although Drake argued that Maid-Rite's transfer approval rights amounted to a sale by or through the franchisor, the appellate court disagreed and noted that “[a] sale is not effected by or through a franchisor [merely because] a franchisor is entitled to approve or disapprove a different franchisee.”¹¹ The court continued by noting that Maid-Rite's liability was even more tenuous under this set of facts given that Maid-Rite's agreement with Sweeden did not provide the franchisor with prior approval rights. In short, Sweeden's sale of his existing restaurant to Drake was exempted from disclosure under the Indiana Franchise Act because the sale was made “for his own account” and was “not effected by or through the franchisor.”¹² The court also rejected Drake's argument that Sweeden's use of Maid-Rite letterhead amounted to a grant of implied authority

to act on Maid-Rite's behalf, holding that "Maid-Rite authorizing Sweeden, as a franchisee, to use Maid-Rite's letterhead and logo was not a sufficient act to clothe Sweeden with apparent authority."¹³ In ultimately upholding the trial court's decision, the appellate court concluded that Maid-Rite had no duty to comply with the disclosure requirements of the Franchise Disclosure Act in the transaction between Sweeden and Drake.¹⁴

Conversely, a franchisor was liable for disclosure violations where the transferring franchisee failed to provide a disclosure document to the purchaser and the franchisor was significantly involved in the transfer process. In *Interstate Automatic Transmission Co. v. Harvey*,¹⁵ Interstate, a franchisor of automobile transmission repair facilities, sued Harvey for unpaid royalties incurred after Harvey acquired the rights of an existing franchised location. A former franchisee had sold the location directly to Harvey, but Interstate was involved in various aspects of the sales transaction.

As a defense to the lawsuit, Harvey claimed the sale was illegal because the former franchisee failed to provide him with a prospectus as required by the Michigan Franchise Investment Law (MFIL). Citing provisions of the MFIL that impose "responsibility on Interstate [as a person who directly or indirectly controls a person liable under the investment law] to ensure delivery of the prospectus," the court found Interstate liable for its former franchisee's failure to provide the required disclosures to Harvey.¹⁶ An important factor for the court was the extent of Interstate's control over the franchise transfer process, which included not only approval of the transferee candidate but also Interstate "act[ing] as broker for [its former franchisee] in the selling of the franchise and preparation of all legal documents in connection therewith." As the court explained,

Since Interstate controlled the assignment of the franchise agreement to Harvey and Leidi, it was required under section 16 of the Franchise Investment Law to supply Harvey and Leidi with a franchise prospectus. Since Interstate failed to ensure that Harvey and Leidi were supplied with a prospectus, the trial court erred in determining that Interstate could not be held liable for a violation of this requirement. Moreover, Harvey and Leidi are entitled to damages or rescission of the franchise agreement based on Interstate's failure to supply a prospectus.¹⁷

The single most important lesson from the various statutory schemes and cases interpreting them is that compliance with federal and state franchise disclosure laws is driven by the degree of franchisor control over the transfer process. Compliance with these laws most certainly will be required for franchisors that implement a franchise resale program. At a minimum, most franchisors, whether on an individualized basis or through a formal resale program, reserve the right to approve the prospective transferee and require the execution of the franchisor's then-current form of franchise agreement. In these instances, the franchisor must ensure that the transferee is provided information of the kind and in the manner specified in the relevant statutory scheme.¹⁸

Particularly with respect to these kinds of situations, it is wise for a franchisor to obtain a signed acknowledgment from

the transferee stating that the transferee received a franchise disclosure document (FDD) within the statutory time frame and that no information or projections different from the FDD were provided during the sales process, except as such related to the individual performance of the transferred location (over which the franchisor exercises no direct control in the typical transfer situation). However, as evidenced by the *Interstate* decision and as outlined below, the franchisor must exercise caution if, through a resale program or otherwise, it acts more like a broker or advocate than a mere resource for lead generation or candidate approval.

Real Estate Broker Laws

A franchise resale assistance program may be regulated by other state law, depending on the scope of the franchisor's involvement in each resale transaction and the particular jurisdiction in which the franchisor operates. Accordingly, careful consideration must be given to real estate broker laws because these licensing requirements may be triggered easily, albeit unintentionally, by franchisor involvement in the franchise resale process.

Historical commentary suggests that real estate licensing requirements can be traced to one of two legislative intents: an exercise of state police power or a revenue-generating mechanism. Some courts have found that the underlying purpose behind the enactment of the statute is a key inquiry when determining whether a party has violated applicable real estate licensing laws.¹⁹ Not surprisingly, statutes that are reflective of police power often carry stricter enforcement and stiffer penalties than statutes whose primary purpose is to generate revenue. In Wisconsin, where the real estate licensing statute traces its enactment to an exercise of police power, a violation of the law carries fines and possible jail time.²⁰ Other statutes carry similar force.²¹

Notably, Minnesota specifically exempts franchise sales from its real estate licensing scheme. For example, the term *real estate broker* under Minnesota Statute § 82.17 et seq. does not include "any person who offers to sell or sells a business opportunity which is a franchise registered pursuant to chapter 80C, when acting solely to sell the franchise."²² As noted below, however, this exemption language is the exception rather than the rule. And, as at least one court has noted with respect to broker licenses, "ordinary and prudent [people] . . . endeavor to determine the [applicable] law, if any, regarding . . . broker [licensing requirements]."²³

In determining whether real estate licensing laws are applicable, courts look to the facts of the sales process itself and, more often than not, whether the transaction at issue involved any transfer of real estate, no matter how incidental. Oftentimes, the inquiry is framed this way for good reason: the applicable statute requires it.

For example, in Kansas, the statute is clear that its licensing provisions apply no matter how incidental the transfer of real estate may be to the overall purpose of the transaction.²⁴ In *Media Services Group, Inc. v. Lesso, Inc.*,²⁵ an unlicensed broker (MSG) was unsuccessful in its attempts to obtain a commission following the sale of a radio station business, which included the station's real estate assets. MSG sued the seller of the radio

station (Lesso), claiming that Lesso owed it a commission on the sale of the business. In analyzing whether MSG was entitled to recover a commission, the court first noted that despite MSG's knowledge that the transaction involved the transfer of real estate, MSG was not licensed under the Kansas Real Estate Brokers' and Salespersons' License Act "at either the time Lesso and MSG entered into the Station Marketing Agreement or at the time MSG performed any of the services which MSG claims entitles it to collect a commission from Lesso."²⁶

The court then cited the plain language of the Kansas act as support that the "legislature intended to include practically all real estate transactions under the restrictions of the Act."²⁷ As the court reasoned, had the legislature's intent been different, it would have carved out exceptions for business brokers or "any type of transaction where the real estate portion of the deal was a minimal or 'inconsequential' aspect of the entire transaction."²⁸

The *Media Services* decision cautions franchisors that when developing a resale program in states like Kansas that broadly regulate real estate brokers, the franchisor should ensure that it does not actively engage in the actual sales transaction. Rather, in these states, the franchisor's involvement should be limited to lead referrals, general advice on the transfer process, and ultimate approval over the transferee candidate.

Similarly, in *Kassatly v. Yazbeck*,²⁹ Kassatly personally negotiated a lease transaction for a hotel and sued Yazbeck to recover a "business chance broker" commission. Yazbeck defended the lawsuit on the theory that Kassatly acted as a real estate broker under then-applicable District of Columbia law and thus, due to Kassatly's lack of licensure, was barred from pursuing a commission. In analyzing the issue, the court noted that real estate broker and business broker roles are indistinct in some circumstances, as contemplated by the very title of the applicable statute: Real Estate and Business Chance Licenses.³⁰ And because the facts of the dispute revealed that Kassatly personally was involved in discussing proposed annual rent, working capital contributions, and plaintiff's right to acquire the parcel in question, the court held that Kassatly acted as more than a mere "finder"; he was a real estate broker who, for lack of licensure, was prevented from obtaining a commission.³¹

Similarly, in *Bottomley v. Coffin*,³² the court looked to the nature of the transaction to determine whether Bottomley, a seller of nursing homes, was entitled to recover a commission from the buyer. In holding that Bottomley did not engage in the unlicensed sale of real estate and, therefore, was entitled to recover his finder's fee, the court explained as follows:

Bottomley acted as a finder rather than a [real estate] broker, and therefore was not required to hold a real estate broker's license. Courts have frequently been called upon to draw a line of demarcation between a finder and a broker. Generally, they state that a finder finds, introduces, and brings the parties to a

transaction together. The parties then proceed to negotiate and consummate the deal themselves. The finder does not negotiate any terms of the agreement. A broker does more; he attempts to bring the parties to agreement on his principal's terms. Typically, a broker is aligned with the interest of one party and against the interests of the other.³³

When applied to franchise resale programs, *Kassatly* and *Bottomley* stress the importance of the facts of the underlying transaction in determining whether an entity or person properly can be classified as a real estate broker. These cases further suggest that franchisors that create resale programs simply to provide lead referrals, general information and insight into the transfer process, and approval or disapproval of transferee candidates likely do not risk crossing the line from mere finder to broker under the various real estate licensing schemes.

Unlike laws that apply even when real estate is incidental to the transaction, other laws apply only when real estate is at the heart of the matter. For example, Connecticut law defines *real estate broker* as "any person . . . or corporation which acts for another person or entity and for a fee . . . lists for sale, sells, exchanges, buys or rents, or offers or attempts to negotiate a sale . . . of an estate or interest in real estate."³⁴ The statute further defines *engaging in the real estate business*

as "acting for another for a fee . . . in the listing for sale [or] selling . . . or offering or attempting to negotiate a sale . . . of an interest in real estate."³⁵

Courts interpreting the reach of this statute scrutinize closely the role of real estate in the overall transaction. For example, the Second Circuit in *Marina Management Corp. v. Brewer*³⁶ held that a broker who did not have a real estate license but who attempted to negotiate the sale of a marina (versus the ongoing business operations at the marina) violated Connecticut law because the broker engaged in the real estate business without first procuring a license. The sale of the marina itself was the dominant feature of the transaction, not the sale of the business operations and goodwill associated with the marina.³⁷

Conversely, in *Capital Consulting Group Ltd. v. Rochman*,³⁸ a business broker did not violate the real estate licensing laws (and thus was entitled to collect a commission) where the real estate was not a dominant feature of the transaction. There, the business broker had been retained to sell the ongoing business of the company, including specifically "all furniture, fixtures, machinery, equipment of the business, trade name and goodwill."³⁹ Although the broker's sales brochure detailed the "operations, locations, leases and equipment" of the business, the broker was instructed not to discuss or negotiate (nor did he discuss or negotiate) leases with any prospective purchaser.⁴⁰ Eventually, the business owner refused to pay the broker's sales commission, arguing that because the sale contemplated the continuation of the business's leases, the business broker acted as a real estate broker without a license in violation of Connecticut law.⁴¹

**In states that broadly regulate
real estate brokers, the franchisor's
role should be limited.**

The *Capital Consulting* court rejected the business owner's argument and held that the broker was entitled to his commission because "no element of real estate" was involved in the transaction. The court reached this conclusion because the resulting sales contract referred to the sale of the business rather than specific locations and assets, the value of the business was to be measured with reference to gross annual sales instead of specific assets (which included an incidental interest in real estate), and the broker did not discuss or negotiate any aspect of the leasehold interest with prospective purchasers. Citing these facts, the court deemed it clear that the services for which the broker sought a commission did not involve a real estate transaction.

When developing franchise resale assistance programs, prudent franchisors wishing to avoid application of real estate licensing laws structure their programs to provide for less control over the actual nuts and bolts of the franchisee-to-prospect sales transaction. For example, these franchisors specify in their written resale program documentation that they do not negotiate on behalf of either party to the transaction or otherwise act as an intermediary for the parties' negotiations, such as by presenting offers or counteroffers; do not facilitate or participate in discussions related to the purchase agreement and related transaction documents; and do not provide advice on or dictate specific transaction terms. Instead, and as noted earlier, prudent franchisors limit their role in any resale program to providing lead referrals, general information and insight into the transfer process, and approval or disapproval of transferee candidates.

Business Broker Laws

Business broker laws also may affect how a franchisor administers a resale assistance program. These laws typically establish certain minimum licensure and disclosure requirements in connection with the sales process. A number of states, such as Washington, regulate business brokers under the general real estate licensing statute by expressly including both the sale of real property and businesses or business opportunities within their scope.⁴² Other real estate licensing statutes, although drafted quite broadly to include, arguably, the sale of businesses or business opportunities, are less precise as to the intended scope.⁴³ Still other states, like Illinois, regulate business brokers under entirely separate statutory authority.⁴⁴ For example, the Illinois Business Brokers Act of 1995 expressly applies to transactions where the "sale or exchange of real estate is not the dominant element of the transaction."⁴⁵ Moreover, the Illinois act is unique in that it expressly exempts franchisors from its scope as long as the franchisor maintains an active franchise registration on file with the state of Illinois. Specifically, the act provides as follows with respect to the franchisor exemption:

Persons registered under the Illinois Franchise Disclosure Act of 1987 (and their employees) are exempt from the requirements of this Act as to: offers and sales in connection with franchising activities; or assisting any of their franchisees in the offer and sale of a franchise by any such franchisee for the franchisee's own account regardless of whether the sale is effected by or through registered persons.⁴⁶

Notably, this exemption applies only to franchisors and their employees. It does not apply to independent brokers or affiliates of the franchisor that might be tasked with administering a resale program. Thus, despite the existence of the franchise exemption, it is important to keep this distinction in mind when developing a resale assistance program because the act carries stiff penalties for violations, including criminal liability.⁴⁷

As with real estate licensing laws, the application of business broker statutes seems to turn on the language and intended scope of the statute and the alleged broker's extent of control over (or involvement in) the transaction. For example, in *Ashton General Partnership, Inc. v. Federal Data Corp.*,⁴⁸ an investment banker who mediated the sale of a corporation's assets sued to recover a broker commission.⁴⁹ Defendant Federal Data defended on the basis that Ashton lacked a broker license under then-applicable District of Columbia law and, as a result, was precluded from recovering a commission. Except for its title, Real Estate and Business Chance Brokers, the District of Columbia statute lacked any reference to business brokers.⁵⁰ Nevertheless, citing the *Kassatly*⁵¹ decision and legislative history, the *Ashton* court held that both business brokers and real estate brokers were included within the statutory scope.⁵² Perhaps more importantly, however, the court noted that it is the responsibility of "ordinary and prudent" businesspeople to determine the scope of potentially applicable law wherever they do business.⁵³

As applicable statutory authority and case law make plain, there are no free passes for franchisors whose conduct satisfies the definitional elements of a business broker under applicable laws; indeed, the penalties are impressive and many. Any franchisor that wishes to avoid application of business broker statutory schemes must develop its resale program to allow for distance between itself and the workings of the franchisee-prospect sales transaction. Much like the recommended approach to avoid application of real estate licensing schemes, business broker laws may be avoided if franchisors specify that their role in the resale program is limited to providing lead referrals, general information and insight into the transfer process, and approval or disapproval of transferee candidates. The franchisor then must avoid any conduct that could be deemed to extend beyond these parameters, including negotiating on behalf of either the franchisee or transferee, facilitating or participating in any discussions between the parties regarding the purchase agreement and related documents, or dictating/providing advice on specific transaction terms.

Developing a Franchise Resale Assistance Program

The first step in developing a franchise resale assistance program is knowing when the franchisor and its franchisees are ready. Keep in mind not only that resale assistance programs are a great way for the franchisor to increase the likelihood of high-quality transferee candidates joining the franchise system but also that most franchisees appreciate knowing that the franchisor will assist with an exit strategy if necessary. For example, as franchisees become more sophisticated and investigate potential opportunities, they consider the franchisor's support of a smooth exit strategy as a benefit in choosing one system

over another. Thus, even emerging franchisors whose primary focus rests with initial franchise sales should recognize that an effective resale program oftentimes is weighed by prospects in their search for a franchise system. Consulting with a few well-respected franchisees or, if applicable, the members of the franchise advisory board also can yield valuable information regarding how best to develop and implement a franchise resale program that is well received by the franchisee base in general.

The second step is deciding how much (or how little) control the franchisor wants to have in the resale process. Does the franchisor want to handle all aspects of the resale from lead generation to providing sample forms to closing on the sale of the unit? Or is the franchisor more inclined simply to refer franchisees to a number of lead generation sources for more information? Perhaps the intended role is something in-between, such as a listing agent who refers potential candidates to existing franchisees. Whatever the role, a franchisor must be aware of and prepared to investigate and adhere to its various resulting obligations under the law. This is particularly important for franchisors that exert a significant amount of control over the resale process, such as by engaging in direct negotiations on behalf of either party to the transaction or preparing the actual purchase agreement and related sales documents to be executed by the parties.

The third step is to document how the resale program will work. Carefully delineate the expectations and roles of each party to the resale process: franchisor, franchisee, and proposed transferee. Consult with experienced professionals to ensure that the franchisor does not cross any real estate or business broker lines unless it expressly intends to do so. The franchisor should then share a working draft of the resale program with key franchisees, listen to their thoughts, and address any issues as it deems necessary or desirable. For example, a franchisor might consider the following to be key components of a resale program, depending on how active the franchisor's role will be in the program:

- **System communication describing the program, including the franchisor's objectives for the program and any resale fee associated with the program.** In particular, the franchisor should clarify its role so that it has documented support for its position on the various legal issues. For example, if the franchisor is simply going to forward potential leads to the selling franchisee, the communication should explain that limited role.
- **Additional communication regarding transfer policy and steps, together with any transfer conditions that the franchisor will consider as part of its process.** Regardless of whether the franchisor has a resale program in place, it should articulate clearly its transfer policy to its franchise system. What steps must the franchisee/seller take to initiate and complete a franchise transfer? What should the transferee/buyer do? How will the franchisor consider any right of first refusal? What transfer conditions will the buyer require? For example, the communication should identify some of the more common transfer conditions, including that the seller be current on all fees and other obligations owed (e.g., the transfer fee and modernization

requirements, if any), the buyer's satisfactory attendance at training, a release from the seller, execution of the franchisor's current form of franchise agreement, and so on. In short, a highly effective franchisor clearly articulates its transfer policies to all franchisees and potential buyers.

- **Identification of tools or methods to assist the franchisee in valuing its business.** Many franchisees do not know how to value their business. If a franchisor has an industry standard or even something more common in its system, it should consider sharing that information with the franchisee base. The franchisor also might find it helpful to describe generally how valuations occur, e.g., by describing multiples of gross sales or cash flows and how other formulas can be used. This approach encourages the franchisee to be realistic about the price it can expect when selling its business.
- **Identification of ways that the franchisee may market its business.** This step is particularly helpful if the franchisor is not planning to list the sale or otherwise take on those types of responsibilities. Let the franchisee know generally what to expect if it hires a broker. Also, provide the franchisee with tips for effectively promoting the sale of the business if the franchisee decides to market the business on its own.
- **Sample documents for the franchisee to reference.** Some franchisors provide the selling franchisee with a sample form of a letter of intent, asset purchase agreement, or bill of sale. Clearly, any franchisor that provides these types of documents must state unequivocally that the documents are sample forms, a starting point, and the franchisee should consult its own lawyer in developing forms specific to its own transaction. Additionally, one document that the franchisor should provide to its franchisees regardless of whether a formal resale program exists is the assignment and consent agreement, which all parties—franchisor, selling franchisee, and transferee—execute as part of the transaction. The assignment and consent agreement identifies all franchise transfer conditions that must be satisfied prior to any closing.
- **Provision of leads to the selling franchisee.** If a franchisor chooses to provide leads to the franchisee, the franchisor should clarify for the selling franchisee whether those leads will be generated through the franchisor's normal lead generation techniques or whether the franchisor will use other aspects of its franchise development process. This is an important step because franchisees likely will want to know what kind of value they can expect to receive from the resale program fee.
- **Acknowledgment of the franchisor's role in any resale assistance program.** If the franchisor does not represent the seller or the buyer in any resale transaction, each party to the transaction should be required to acknowledge the franchisor's limited role. The key is for all parties to understand the rules of the game at the beginning of the process.
- **Internal procedures.** A franchisor should understand that franchisees may perceive potential conflicts of interest

with the various roles that a franchisor may take in a resale program, particularly if the franchisor assumes an active role. For example, does the franchisor have the same salespeople sell new franchises as well as resales? How are leads shared between new sales and resales? What impact does the franchisor's right of first refusal have on resale prospects? The franchisor must analyze how it will address those issues internally and then communicate the relevant pressure points to franchisees to minimize potential conflicts and related concerns.

Finally, when ready to launch the resale program, the franchisor should do so at a time when it can generate excitement about the new initiative, such as at an annual convention or in connection with other key system developments. After all, a franchise resale program, when well planned and diligently pursued, serves to protect the investment of time and money expended on the part of franchisors and franchisee alike.

Conclusion

Franchisors that develop franchise resale programs play more active roles in the resale process by design. They intend to be involved in the resale process not only by establishing transfer protocols but also by assuming an active role in effecting the transfer of individual franchised businesses in the system. When contemplating the development of a formal resale program or refining an existing program, franchisors are wise to follow two simple rules: define the franchisor's role in the transaction and be mindful of the consequences. With a more active role in the transfer process comes increased responsibility on the part of the franchisor to ensure that applicable laws and regulations—including the FTC Rule, its state counterparts, and various real estate licensing and business broker statutes—are honored. By following this approach, franchisors will succeed in developing a franchise resale assistance program that makes a difference to the entire franchise system by allowing an exiting franchisee to sell its business to a more qualified and prepared candidate.

Endnotes

1. See Federal Trade Commission Trade Regulation Rule: Disclosure Requirements and Prohibitions Concerning Franchising, 16 C.F.R. §§ 436.1–.11 (2007) [hereinafter FTC Rule]; California Franchise Investment Law, CAL. CORP. CODE §§ 31000–31516 (2007); Hawaii Franchise Investment Law, HAW. REV. STAT. §§ 482E-1 to -12 (2007); Illinois Franchise Disclosure Act of 1987, 815 ILL. COMP. STAT. §§ 705/1 to /44 (2007); Indiana Franchise Act, IND. CODE ANN. §§ 23-2-2.5-1–23-2-2.5-51 (West 2007); Maryland Franchise Registration and Disclosure Law, MD. CODE ANN., BUS. REG. §§ 14-201–14-233 (West 2007); Michigan Franchise Investment Law, MICH. COMP. LAWS ANN. §§ 445.1501–.1546 (West 2007); Minnesota Franchise Act, MINN. STAT. ANN. §§ 80C.01–.30 (West 2007); New York Franchise Sales Act, N.Y. GEN. BUS. LAW §§ 680–695 (McKinney 2007); North Dakota Franchise Investment Law, N.D. CENT. CODE §§ 51-19-01 to -17 (2007); Rhode Island Franchise Investment Act, R.I. GEN. LAWS §§ 19-28.1-1 to -34 (2007); South Dakota Franchises for Brand Name Goods and Services, S.D. CODIFIED LAWS §§ 37-5A-1 to -87 (2007); Virginia Retail Franchising Act, VA. CODE ANN. §§ 13.1-557 to -574 (West 2007); Washington Franchise Investment Protection Act, WASH. REV. CODE ANN. §§

19.100.010–.940 (West 2007); Wisconsin Franchise Investment Law, WIS. STAT. ANN. §§ 553.01–.78 (West 2007).

2. The FTC Rule defines *franchisor* as “any person who grants a franchise and participates in the franchise relationship.” 16 C.F.R. § 436.1(k).

3. 16 C.F.R. § 436.1(j).

4. See HAW. REV. STAT. § 482E-4; 815 ILL. COMP. STAT. § 705/7; IND. CODE ANN. § 23-2-2.5-4; MICH. COMP. LAWS ANN. § 445.1506(f).

5. See CAL. CORP. CODE § 31108; MD. CODE ANN., BUS. REG. § 14-214(c)(1)–(2); MINN. STAT. § 80C.03; N.Y. GEN. BUS. LAW § 684.5; N.D. CENT. CODE § 59-19-04 (2); R.I. GEN. LAWS § 19.28.1-6; S.D. CODIFIED LAWS § 37-5A-13; VA. REGS. § 5-110-75 (2007); WASH. REV. CODE ANN. § 19.100.030; WIS. STAT. ANN. § 553.23.

6. See *Kinnard v. Shoney's, Inc.*, 100 F. Supp. 2d 781 (M.D. Tenn. 2000) (finding no disclosure violation under Indiana law where the franchisee itself transferred an interest in its existing franchised business to its wife and a business partner, absent any involvement from the franchisor). *But see* *Godfrey v. Schroeckenthaler*, 501 N.W.2d 812 (Wis. Ct. App. 1993) (Dairy Queen franchisee that entered into a purchase agreement with third party for existing location not liable for disclosure violations under Wisconsin law; court held that franchisee acted “in its own name” in offering the franchise for sale and was entitled to the registration exemption under Wisconsin law (notably, court did not address the precise scope of the statutory exemption, which, by its terms, applies only to the registration component and not disclosure)); see also *Rich Food Servs., Inc. v. Rich Plan Corp.*, No. 03-1198, 2004 WL 937260 (4th Cir. 2004) (holding franchisor not required to provide disclosure prior to franchise renewal under either federal or New York law where the franchisee continuously operated the business and there were no material changes between original franchise agreement and renewal franchise agreement).

7. 681 N.E.2d 734 (Ind. Ct. App. 1997).

8. The record reflects that Sweeden provided verbal performance indicators of the restaurant's past operation but did not provide any supporting books or records. *Id.* at 736.

9. *Id.* at 739.

10. *Id.* at 737.

11. *Id.*

12. *Id.* (citing IND. CODE § 23-2-2.5-4 (West 2007)).

13. *Id.* at 738.

14. *Id.* at 739.

15. 350 N.W.2d 907 (Mich. Ct. App. 1984).

16. *Id.* at 909.

17. *Id.* at 910.

18. See *id.*

19. *Media Servs. Group, Inc. v. Lesso, Inc.*, 45 F. Supp. 2d 1237, 1245 (D. Kan. 1999) (citing the intent of the Kansas Real Estate Brokers' and Salespersons' License Act “to protect the public from the fraud, misrepresentation, and imposition of dishonest and incompetent persons in the context of real estate business practices,” and holding that business broker's failure to obtain real estate license in connection with sale of a business violated statutory licensing requirements). *But see* *Weingast v. Rialto Pastry Shop, Inc.*, 152 N.E. 693, 694 (N.Y. 1926) (business broker did not violate real estate licensing laws where realty was incidental aspect of transaction because “[a]s failure to procure a [real estate] license is made a crime, the statute must not be extended by implication”).

20. WIS. STAT. § 452.17 (2007).

21. See e.g., CAL. BUS. & PROF. CODE § 10138 (West 2007) (violation constitutes misdemeanor and fines equal to \$100 per violation); DEL. CODE ANN. tit. 24, § 2914 (2007) (penalties for violation include public reprimand and imposition of civil fines, among others); FLA. STAT. ANN. § 475.42 (West 2007) (violation constitutes Class 3 felony punishable by up to five years in prison and \$5,000 in fines); R.I. GEN. LAWS § 5-20.5-17 (2007) (violations can result in fines and minimum of one year jail time for first offense); S.D. CODIFIED LAWS § 36-21A-28 (2007) (violation constitutes Class 1 misdemeanor); TENN. CODE ANN. § 62-13-110(a)-(b) (2007) (violation constitutes Class B misdemeanor and possible payment of treble damages).

22. MINN. STAT. § 82.23(k) (2007).

23. Ashton Gen. P'ship, Inc. v. Fed. Data Corp., 682 A.2d 629 (D.C. 1996) (analyzing both real estate and business broker licensing requirements under then-applicable District of Columbia law).

24. The Kansas Real Estate Brokers' and Salespersons' License Act prohibits an unlicensed party from engaging in the sale of real estate, regardless of whether the sale of realty is merely "a part of a transaction or [the] entire transaction." KAN. STAT. ANN. 58-3036(c) (2007).

25. Media Servs. Group, Inc. v. Lesso, Inc., 45 F. Supp. 2d 1237 (D. Kan. 1999).

26. *Id.* at 1243.

27. *Id.* at 1248.

28. *Id.* at 1249.

29. Kassatly v. Yazbeck, 734 F. Supp. 13 (D.D.C. 1990).

30. *Id.* at 15. (Notably, the Real Estate and Business Chance Licensing law, D.C. CODE § 45-1926 (1981), was repealed in 1999 following the adoption of the Real Estate Brokers' Duties law, D.C. CODE § 42-1701 (1999). By its terms, the Real Estate Brokers' Duties law lacks any reference to business brokers or the sale of businesses generally.)

31. *Id.* at 16.

32. 399 A.2d 485 (R.I. 1979).

33. *Id.* at 488.

34. CONN. GEN. STAT. § 20-311(1) (2007).

35. CONN. GEN. STAT. § 20-311(3).

36. See Marina Mgmt. Corp. v. Brewer, 572 F.2d 43 (2d Cir. 1978).

37. See *id.*; see also Fieger v. Pitney Bowes Credit Corp., 251 F.3d 386 (2d Cir. 2001) (financial advisor, who was not licensed as a real estate broker under Connecticut law, could not collect a commission where he facilitated the sale and leaseback of certain corporate headquarters because the real estate was the dominant feature of the transaction).

38. Capital Consulting Group Ltd. v. Rochman, 589 A.2d 877 (Conn. 1991).

39. *Id.* at 877.

40. *Id.* at 878.

41. *Id.*

42. WASH. REV. CODE § 18.85.010(1) (2007). Under Washington law, business opportunities, which are expressly referenced in the real estate licensing statute, are defined as "the business, business opportunity, and good will of an existing business or any one or a combination thereof." WASH. REV. CODE § 18.85.010(5); see also CAL. BUS. & PROF. CODE § 10131 (year) ("A real estate broker . . . negotiates the purchase, sale or exchange of real estate or a business opportunity."); COLO. REV. STAT. § 12-61-101(2)(h)(i) (2007) (defining *real estate broker* to include people that "negotiate the listing, sale, purchase exchange or lease of a business . . . or the goodwill thereof . . . when such act

or transaction involves [real estate] directly or indirectly"); FLA. STAT. ANN. § 475.01 (2007) ("Broker means a person who . . . negotiate[s] the sale, exchange, purchase, or rental of business enterprises or business opportunities or any real property or any interest in or concerning the same"); HAW. REV. STAT. § 467-7 (2007) (noting that "[i]t shall be immaterial that a transaction also involves property other than real estate, as for example a transaction for the sale of an ongoing business. . . . [T]o the extent real estate is involved, it shall be considered a real estate transaction."); IDAHO CODE § 54-2004(32)(a) (2007) (defining *real estate broker* as "[a]ny person . . . who, directly or indirectly, while acting for another . . . sells, lists, buys, or negotiates, or offers to sell, list, buy or negotiate the purchase, sale, option or exchange of real estate or any interest therein or business opportunity or interest therein for others"); IOWA CODE §§ 543B.1, 543B.4 (2007) (*real estate* includes "business opportunities which involve any interest in real property" and prohibits any person from acting as a real estate broker "whether as part of a transaction or an entire transaction"); LA. REV. STAT. ANN. § 37:1431(3) (West 2007) (defining *real estate activity* as involving a person who "[l]ists or offers . . . for sale any business whose assets include real estate or leases of real estate"); MICH. COMP. LAWS § 339.2501(d) (2007) (*real estate broker* includes a person who "negotiates the purchase or sale or exchange of a business, business opportunity, or the goodwill of an existing business for others"); NEV. REV. STAT. §§ 645.0075, 645.030 (2007) (*real estate broker* includes people who "engage in or offer to engage in the business of business brokerage"); N.H. REV. STAT. § 331-A:2(IX) (2007) ("real estate means and includes leaseholds or any other interest or estate in land and business opportunities which involve any interest in real estate"); S.D. CODIFIED LAWS § 36-21A-6(3) (Michie 2007) (*real estate broker* includes one who engages in the sale or exchange of "any business opportunity, business, or its goodwill"); TENN. CODE ANN. § 62-13-102(16) (2007) (real estate transaction includes "business opportunity"); TEX. PROP. CODE ANN. § 1101.004 (Vernon 2007) (regulating the "direct or indirect" sale of real estate in any transaction); UTAH CODE ANN. § 61-2-2 (2007) ("real estate includes leaseholds and business opportunities involving real property"); WASH. REV. CODE § 18.85.010(1)(6) (*real estate broker* includes people who negotiate the "purchase, sale, lease or rental of . . . business opportunities"); WIS. STAT. § 452.01(2)(a) (West 2007) (*real estate broker* includes anyone who negotiates the sale or exchange of "a business or its goodwill . . . whether or not the business includes real property").

43. See KAN. STAT. ANN. § 58-3036(c) (license required prior to any sale of real estate, whether sale is "part of a transaction or [the] entire transaction"); MD. CODE ANN. § 17-301(b)(5) (2007) (real estate statute may apply if "sale, lease or other transfer of a business enterprise" includes more than "any interest in real property other than a lease under which the business enterprise operates"); MASS. GEN. LAWS ch. 112 § 87PP (2007) (defining *real estate broker* to include any person who "assists or directs in the . . . negotiation or completion of any agreement or transaction which results in . . . the sale, exchange, purchase, leasing or renting of any real estate"); MO. REV. STAT. § 339.010, 1(8) (2007) (same); MONT. CODE ANN. § 37-51-102(18) (2007) (defining *real estate* to include "leaseholds as well as any other interest in real estate or land"); NEB. REV. STAT. § 81-885.01(1) (2007) ("real estate means and includes . . . any interest or estate in land"); N.J. STAT. ANN. § 45:15-3 (West 2007) (*real estate broker* includes people who "assist or direct in the . . . negotiation or closing of any transaction which does . . . result

in the sale, exchange, leasing, renting or auctioning of any real estate”); N.Y. GEN. LAWS § 440(1) (McKinney 2007) (*real estate broker* includes person who lists for sale, sells, exchanges or attempts to negotiate the sale “of an estate or interest in real estate”); N.D. CENT. CODE § 43-23-06.1-7 (2007) (same); OHIO REV. CODE ANN. § 4735.01(A)(7) (Anderson 2007) (*real estate broker* is a person who “directs or assists in . . . the negotiation of any transaction . . . which does or is calculated to result in the sale, exchange, leasing or renting of any real estate”); OKLA. STAT. tit. 59, § 858-102(1) (2007) (*real estate* includes “any interest or estate in real property”); S.C. CODE ANN. § 40-57-30(14) (Law Co-op. 2007) (“real estate transaction means an activity involving the sale, purchase, exchange or lease of real estate”); WYO. STAT. ANN. § 33-28-102(a)(iii)(M) (Michie 2007) (*real estate broker* is a person who “assists or directs in the negotiation of any transaction calculated or intended to result in the sale, exchange, lease or rental of real estate”).

44. In addition to Illinois, states that separately regulate business brokers include, for example, Massachusetts (MASS. GEN. LAWS ch. 259 § 7 (2007)); New Jersey (N.J. STAT. ANN. § 25:1-16 (West 2007)); and Rhode Island (R.I. GEN. LAWS § 42-14-12 (2007)).

45. 815 ILL. COMP. STAT. § 307/10-5.15 (2007).

46. *Id.* § 307/10-80(b-1).

47. *Id.* § 307/10-65 (violation of the Illinois Business Brokers Act of 1995 is a Class 4 felony).

48. Ashton Gen. P’ship, Inc. v. Fed. Data Corp., 682 A.2d 629 (D.C. 1996).

49. *Id.* at 630. The record does not detail the facts of Ashton’s involvement in the negotiations but instead merely states that Ashton “arrang[ed] for the sale of one of Federal Data’s contracts.” *Id.*

50. See *supra* text accompanying note 30.

51. Kassatly v. Yazbeck, 734 F. Supp. 13 (D.D.C. 1990).

52. Ashton, 682 A.2d 637–38 (noting that in the index to the then-current District of Columbia Code, the topic “business chance brokers” is cross-referenced to the “real estate and business chance brokers” statute).

53. *Id.* The court also observed that Ashton should have known the specific business broker licensing requirements under District of Columbia law given that its counsel of record represented Kassatly in Kassatly, 734 F. Supp. at 13.