Franchising Update: Setting Up for Success in 2021

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As life begins to normalize and businesses begin to revitalize after COVID-19 restrictions are being modified or eliminated, 2021 could present an opportunity for buyers and sellers of franchises to leverage a turnaround of the franchise market.

During the past year, franchises, like many other businesses, have taken a significant hit with declining sales, burdensome state requirements for closure, and restricted occupancy. These challenges have been further complicated with disruptions to supply chains and non-payment of royalty fees. Whether a struggling franchise or a COVID-19 success story, existing and future franchisors and franchisees have been given an opportunity to examine the franchise model in a new light and to consider risk verses reward tolerance.

For those interested in improving their franchise model or pursuing a new franchise, the past year of the pandemic has demonstrated several areas of consideration:

- Franchising may present opportunities for women-owned businesses. Over the past year, over 2 million women have left the workforce due to the pandemic and may be looking to re-enter the workforce in a different way (such as opening up or investing in a franchise).
- The International Franchise Association estimates over 26,000 franchised locations will be added in 2021 and projects franchise employment to grow by over 10% (approximately 8.3 million workers), partly due to workers re-entering the workforce and considering different employment options.
- The restaurant, fitness, health and beauty industries (those franchises hit the hardest) have an opportunity to expand growth and reinvent their business model as a result of more confident consumers wanting self-care after a year of the pandemic.
- The Cares Act (both phases of the Paycheck Protection Program) enabled existing franchises to weather the storm through over 1.7 million in loans ($126 billion in aid), thus allowing existing franchises to continue operating by providing funds to maintain their employees, pay rent and other operating expenses. Additional government loans are still available to assist small to mid-size businesses.
- Parties may be more eager to negotiate more flexible terms and work with modified business plans. For example, a franchisor who has not had growth or experienced location closures, might be more amenable to negotiating reduced royalty fees, more favorable term limits and longer time frames for build-out.

Regardless of the above factors, the success of any franchise hinges on the business complying with legal requirements and making sure the intent of the parties is accurately memorialized in the franchise documents. Any existing or perspective franchise will benefit from having a discussion on franchise law with their franchise attorney. Topics that should be addressed include:

- Restructuring or amending franchise agreements in order to address force majeure provisions (permitting franchisees to terminate their franchise agreement in the event of a crisis).
- Updating franchise policies and procedures (including maintenance of the franchise in compliance with COVID-19 health and safety measures).

- Updating the Franchise Disclosure Document (FDD) to reflect any material changes for each state in which the business is operating. Examples of material changes include:
  - Updating the Initial Estimate Investment (Item 7 of the FDD) including the additional costs to comply with CDC guidelines, increased costs for cleaning supplies and/or installation of safety measures.
  - Updating the Financial Performance Representations (Item 19 of the FDD) to provide accurate data for 2020.
  - Modifying the service disclosures to be disclosed in the FDD. Examples of modified services include changes to the business model to allow for virtual services, delivery options, or other new service options. .
  - Modifying other key employee provisions. Any modifications to the franchisor or franchisee ownership structure and any change in key employees must be amended in the FDD.
- Modifying operational manuals to address COVID-19 updates, possible changes in suppliers and sources of supplies and changes in operations.
- Negotiating or renegotiating leases with emphasis on reducing rent, extending the term, adding or extending a renewal option and/or modifying force majeure provisions to include COVID-19 related events.
- Reviewing filing and renewal dates and state modification law to determine if a franchisor can extend any time-frames (e.g. New York, California).
- Re-evaluating international franchises regarding possible sale options given on-going travel restrictions. For example, a U.S. franchisee with 5 units in England may want to sell the England units due to limitations on traveling.
- Reviewing any modification to lender requirements if seeking financing or restructuring an existing loan. For example, some lenders may require more extensive financial forecasts, projections and prior budget analysis than in prior years.
- Tracking any forgiveness applications for those franchisees who have received PPP monies.

As with all businesses, franchisors and franchisees must consider these factors and more when evaluating their growth strategy or contemplating changes to their existing business model. For more information on any aspect of franchise law, please visit us at /practices/business-law/ or contact Pamela M. Kapsimalis with specific questions.