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PERSPECTIVE

Best Practices for Business Franchises During the Pandemic

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Many franchise systems are in “survival” mode. They must assess far-reaching consequences of the coronavirus, and plan for the financial impact of customers and employees staying at home, mandated closings of dining areas, “shelter-in-place” and similar government orders that are certain to drive down average unit volumes. Franchise systems in all industries would be well served to proactively adapt their systems to allow franchisees to provide some level of service, while navigating legal issues prompted by COVID-19. Here are a few critical legal issues to consider during these uncertain times.

Reviewing Franchise and Multi-Unit Development Agreements

The franchise agreement governs substantially all the obligations and responsibilities of the franchise relationship, and most of the issues franchisors and franchisees will need to work out in responding to the pandemic, handling requests for unit closures, waivers of brand standards, fee relief, and may require analysis of contractual provisions and potential negotiation of amendments, waivers, and/or forbearance agreements.

New Standards and Brand Protection

Franchisors should understand the need to grant franchisees flexibility to adjust their operations to the daily realities of the pandemic. At the same time, franchisors must protect the value of the brand and maintaining consistency in system standards to the extent possible. Franchisors have latitude under the Lanham Act to act swiftly to protect their brands, goodwill and trademarks. The Lanham Act requires franchisors to guarantee the quality of the services and products sold under their trademarks. This may require extraordinary measures during the coming weeks, and may entail temporary waivers of operational requirements that are monitored on a regular basis as circumstances change, extensions of due dates for upgrading equipment or renovating facilities, and permission to use alternative suppliers.

Payment Deferrals

In ordinary circumstances, franchisees make monthly or bi-monthly payments of royalties, marketing fund contributions, technology fees and other fees to the franchisor. Many brands that have shifted to take-out or drive-in only are deferring percentage royalty fees at varying periods, to keep franchised outlets financially viable. If the business has been

ordered closed, those payments might be fully abated. Full or partial waivers at the outset are atypical, but may occur depending on the duration of the economic standstill. Systems with minimum royalty fees grant waivers for a specific time, to be reevaluated later for potential extension.

Force Majeure Clauses

Most practitioners are familiar with these pattern clauses allowing for contract performance to be suspended or cancelled in the case of war and other forces outside of the parties’ control. Present in franchise agreements, leases and vendor contracts, franchisees should be mindful of their scope, as well as causation and notice requirements. Whether COVID-19 may be considered a force majeure and excuse a franchisee from contractual obligations depends almost entirely on the language of the provision and conditions it anticipates. Courts tend to interpret such clauses narrowly. Broader verbiage such as “act of God” or “impossible circumstances” may depend on the law governing the agreement or applicable jurisdiction, but terms such as “pandemic” and “disease” are more likely to cover COVID-19 a force majeure.

Some force majeure clauses state that the event must

prevent total or partial performance. Others require significant interference, a hinderance or otherwise making the party’s performance substantially more onerous than anticipated. In either case, a causal link between the force majeure event and the failure to perform is usually required. For example, if a local government order shuts down bars and nightclubs that do not serve food, the ensuing elimination of foot traffic may not alone prevent the quick service restaurant adjacent to these establishments from staying open, even if the franchisee generated most of its revenues from customers drawn by those neighboring businesses. Such franchises may have to rely on statutes such as the Uniform Commercial Code, or equitable doctrines of impossibility, impracticality or frustration of purpose. Force majeure provisions can also vary widely in terms of notice requirements and may be deemed waived if they are not properly invoked.

Insurance

It would behoove franchisors and franchisees to check with their insurance brokers for business interruption insurance coverage if franchised units must close due to COVID-19, as well as any operational changes. One example is making or distributing items like personal protective equipment

and hand sanitizer that otherwise would not be a product of their operations, to meet increased demand for suddenly scarce medical equipment. Current insurance coverage may not extend to newly added products. Many bars and restaurants have adapted to public health orders against dine-in services by selling pantry staples in addition to regular menu offerings. Restaurants are now adding or expanding their existing delivery services to meet social distancing demands. Such businesses should notify their insurance of these changes to assure liability coverage is extended to these new services. In addition, temporary shutdown of businesses can impact both liability and property coverage. Many policies will extend coverage of a vacant or unoccupied building for a 30-day grace period. If a business is closed and the building deemed to be unoccupied, without notification to the broker and/or carrier, losses or claims due to property damage from storms, vandalism and accidents in addition to theft and other events could be denied.

Renewals and Transfers

Franchisors have little incentive to resist a loyal franchisee who is up for renewal in 2020. This may be the time to ask the franchisor to extend the current franchise agreement another 90 to 180 days, if the franchisee is able to remain financially viable through the crisis. Transfers are more likely to be put on hold, if the deals have not already fallen through. A franchisor is unlikely to take on operators who are new to the system because training may be physically impossible or not feasible with social distancing

and travel restrictions. It would not be unreasonable for a franchisor to withhold consent to a transfer during the current emergency, unless the selling franchisee remains operationally responsible for the business for some period after the pandemic ends.

Regulatory Compliance

Franchise companies with a fiscal year end of December 31 were already updating their Franchise Disclosure Documents when COVID-19 arrived in the U.S. A customarily busy time of year for franchisors is now clouded by uncertainty as to whether they can meet April filing deadlines, and if they can, whether they will be able to offer and sell franchises in 2020. The California Department of Business Oversight has not extended the April 20 deadline, and consistent with social distancing restrictions, examiners are allowing applications to be electronically signed in lieu of notarized signatures, waiving late fees and encouraging online filing. Although some registration states like California have made accommodations, there is hardly uniformity.

Despite these variances, the best practice is not to allow franchise registrations to lapse, because the state franchise agency may treat a late filing as an initial application and subject the disclosure documents to stricter scrutiny, lower priority compared to timely renewals, and higher filing fees. Even if the franchisor does not plan to sell franchises, the documents should still be updated and filed to preserve the registration. For franchisors faced with prospect of negotiating their franchise offering to boost sales, be prepared to track and

disclose to the final terms of the sale.

When we emerge from the pandemic, the Financial Disclosure Documents will need to reflect any material changes in the franchisor's financial condition, outlet count and other potential disclosures attributable to this crisis. Examples of material changes due to COVID-19 include the timeframe for franchisees to select a site, build-out, and begin operations of the franchise, the initial investment costs and working capital needed to operate the franchise for the first 90 days, and adverse changes to the franchisor's outlook or financial statements. One area certain to create unique COVID-19 difficulty is the use of a financial performance representation in the Franchise Disclosure Document. Franchisors may consider removing the financial performance representation and adding it back to the FDD after the pandemic turns a corner. Even if the rep-

resentations accurately reflect pre-pandemic operating data, it may no longer meet the "reasonable basis" legal standard. State examiners have already shown they will expect a renewing franchisor to articulate why its financial performance representation is reasonable and not misleading in the context of the pandemic.

Conclusion

Franchising as we know it has changed, both in the short and long term. To best address these challenges, franchisors, franchisees, suppliers and other vendors need to communicate, work together and be creative and adaptable, with the goal of coming out of this crisis as strong as they entered it. Franchise companies grow through passion and compassion for their brands, customer needs and franchisees. This is needed more now than ever if operations are to emerge on the other side and ultimately flourish. ■

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