The franchise application: Danger lurks in an improperly completed document

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The issues surrounding franchise approval have been extensively addressed in the buy-sell world. An ancillary, albeit significant, component of this aspect is the application process itself. This is not a perfunctory exercise. Many problems can arise in a buy-sell as a result of application issues. Let's address some of the most significant concerns.

Getting Started.

Until recently, getting the application process started was relatively quick and uneventful. The seller would initiate the process by forwarding the buy-sell agreement to the manufacturer and, within a few days, the application forms were sent either to the seller or directly to the buyer. Unfortunately, for many franchises, this simple process has changed, for one reason or other, to a more arduous task.

In recent years, buyers have experienced significant delays in either receiving the application and related materials or gaining access to the factory's online application site. The cause for this delay is unclear. Is it a matter of an ill-equipped system to deal with a large volume of buy-sells, or is it something more tactical or even nefarious? Clearly, certain manufacturers simply cannot handle the volume in the current market's high-pace activity and in the era of "platform" deals where several buy-sell's of franchises involving the same manufacturer (e.g., GM in the case of Buick-GM, Cadillac and Chevrolet) are submitted simultaneously.

However, one must question whether there is something more at play with these delays than mere under-staffing. The latter is obviously correctable in a short period of time. When the delays persist after an extended period of time, one suspects that the particular manufacturer is administering the application process in a strategic fashion.

One possibility is that the delay is consciously designed to extend the time periods for a decision on approvability or the exercise of the factory's right of first refusal ("ROFR"), as established under both the franchise agreement and the applicable state franchise statute. For example, sixty (60) days for approval becomes seventy-five (75) or ninety (90) or forty-five (45) days for a ROFR decision becomes sixty (60) or seventy (70). The manufacturer may be building these delays into the system in order to afford it more time to vet the potential buy-sell internally.

There is no question that the franchisors each have a designed program to tightly regulate those who would enter the ranks as their new franchisees. This regulation can be accomplished by carefully scrutinizing the qualifications of the buyer or by invoking the ROFR. Either decision takes time or the typical corporate bureaucracy does not lend itself to a quick decision. As such, it appears that the application process is manipulated to rectify this perceived time problem, all to the dismay (not to mention cost) of the buy-sell parties.

It is incumbent upon the parties and their counsel to press the manufacturer for the application almost immediately upon submission of the buy-sell agreement. It is advisable that the pressure come primarily from the seller since it is the seller that has the legal standing to enforce its franchise rights to sell its franchise. Buyers and their lawyers are cautioned against asserting pressure on the franchisor in this instance, especially at the very start of the new franchise relationship.

Processing the Application.

Fortunately, there is relief for manufacturer abuse of the application process in many state franchise laws and in the case law. For example, most state franchise laws establish a time period (e.g., 60 days) within which a manufacturer must act upon an application. If not, the buyer is "deemed approved". However, the real problem revolves around when the approvability period is considered to have commenced. The manufacturers customarily maintain that the period does not start until a completed application is submitted. This becomes the proverbial moving target since, in my experience, no franchisor ever voluntarily concedes that the application is "complete" and it is virtually impossible to obtain a written confirmation of completeness.

Unfortunately, barring special statutory protection, there is legal precedence for the proposition that the approvability clock does not start until everything required by the manufacturer is submitted. There is also precedence that stated that the clock does not start if there is anything inaccurate in the application.

Vigilance is the key combatant to this problem. Both the buyer (applicant) and the seller must be proactive in addressing any application deficiencies throughout the process. As both seller and buyer counsel, I have routinely insisted upon status reports from the manufacturer about the application. A helpful approach is to send a letter to the manufacturer confirming that everything required in the application process has been submitted, and that the application will be deemed completed unless the manufacturer responds and specifies any open items. This places the onus on the franchisor to identify any open items. In too many deals, the parties simply assume that all is going well with the application, only to find out after several weeks that the application remains stalled because of alleged open items or deficiencies.

The state franchise statutes have begun to address this problem. For example, in New Jersey, the burden is placed upon the franchisor to issue a written request for additional information within fifteen (15) days of receiving the original application. As long as the applicant submits the additional item(s) within thirty (30) days after receiving the request, the approvability period initiated by the submission of the original application is not extended. Needless to say, this process cuts down on the typical manufacturer abuse of the application process. You are well-advised to check your specific state statute at the commencement of a buy-sell transaction to determine the requisite protocol for your deal.

The Application.

The completion of a franchise application is no mean task. It has many components, and the completion of each has its challenges. Needless to say, the proper completion of these is critical for approval. These primarily include the following:

- The basic application. This requires extensive information, both business and personal, about the applicant and usually includes (or requires) a personal financial statement of each applicant.
- A source of funds statement. In my experience, this is one of the most important components of the application. This is the manufacturer's process for determining whether the applicant has sufficient financial wherewithal and liquidity for the acquisition and ultimate operations. It will also highlight where the applicant's funds are encumbered. Most manufacturers place restrictions on the amount of encumbered funds utilized for capitalization and acquisition.
- A pro forma balance sheet of the new dealership entity. This is another important component. Of critical importance here is a demonstration to the manufacturer that the debt to equity ratio of the new dealership company is in line with the manufacturer's requirements.
- A profit forecast. In many instances, this form will require assistance from the manufacturer itself. To a large extent it is a function of the manufacturer's planning volume for the subject dealership and other information that the manufacturer has readily available, but the seller may not. The manufacturer's representative is usually cooperative in assisting in this regard.

Conclusion.

A deal without franchise approval is not a deal at all. A deal that encounters significant delays because of a protracted application process can also result in failure. As such, great care must be given to this aspect of the deal. Proactive parties who carefully follow the requisite protocol and know and enforce their rights afforded under their franchise statutes are the most likely to succeed.

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