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The SBA Rings in the New Year with New Process

The Small Business Administration (SBA) has announced that, beginning January 1, 2017, it will no longer maintain the SBA Registry and will no longer review each franchisor's FDD and Franchise Agreements to ensure that franchisees are, from the SBA's perspective, independent small businesses. Replacing those processes will be a short standard (non-negotiable) franchise agreement addendum developed by the SBA that participating lenders will have to include in the packages they submit to the SBA if they want the SBA to guarantee the loan. If the lender's package includes the addendum signed by the franchisor and borrower franchisee, the SBA will assume that the franchisee is sufficiently independent of the franchisor.

The SBA's new standard addendum addresses four key areas that franchisors who have been listed on the Registry will be used to seeing:

1. Transfers of Ownership of the Franchisee: The franchisor cannot own an interest in the franchisee, so it will agree not to exercise its right of first refusal in connection with a transfer of partial ownership interests. Also, the franchisor will agree not to unreasonably withhold its consent to such a transfer.

2. Franchisor's Option to Purchase: If the franchisor exercises an option to purchase the franchisee's assets but there is disagreement on the purchase price, the value must be determined by an appraiser chosen by the franchisor and franchisee.
3. Real Estate: The franchisor's purchase option cannot include real estate if the franchisee owns the premises, but the franchisor can require the franchisee to lease the real estate to the franchisor for the remainder of the franchise term for a fair market value rent. The franchisor cannot record against the real estate any restrictions on the use of the property, such as restrictive covenants, branding covenants, or environmental-use covenants.
4. Employment Matters: The franchisor cannot directly control the franchisee's employees, by, for instance, hiring, firing, or scheduling the employees.

In addition to requiring this signed addendum, the SBA recommends – but does not require – that participating lenders also consider seeking an agreement from franchisors that: (a) allows the lender and the SBA to access the franchisor's books and records relating to the franchisee's billing, collections, and receivables; (b) provides that upon default of the loan, the franchisor will agree to defer the franchisee's payment of fees, royalties, marketing fund contributions, and other amounts owed to the franchisor; (c) provides the lender with 30 days' notice of the franchisor's intent to terminate the franchisee's franchise agreement; and (d) provides the lender with the opportunity to cure any defaults under the franchise agreement. We recommend that our clients speak with us before signing any such agreement.

These new procedures will greatly streamline the SBA process and hopefully relieve franchisors' frustrations with what have been extremely long and costly reviews associated with listings on the Registry and annual renewals. But, as with any significant change like this, there may be hiccups on the initial roll-out, and there will be questions. We will issue further client alerts as appropriate and will have one-on-one conversations with our clients during the upcoming renewal season, but we would be happy to address any questions or concerns before then.

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<u>Contacts</u>	<u>Contact Information</u>
Amy Cheng	312-243-1716 or amy.cheng@chengcohen.com
Fredric A. Cohen	312-243-1717 or fredric.cohen@chengcohen.com
Michael R. Daigle	312-957-8366 or michael.daigle@chengcohen.com

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Cheng Cohen LLC · 311 N. Aberdeen, Suite 400 · Chicago, IL 60607 · USA

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