

Selling the Franchise System: Laying the Legal Groundwork to Optimize Value

Pro-active steps can improve the purchase price of a franchisor.

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AN INCREASING NUMBER of buyers, especially private-equity firms, have discovered that purchasing a well-run franchisor company offers significant opportunities. These buyers view franchisors that generate long-term royalty streams as the golden egg. Last year, the franchisor of the Massage Envy Spa system found itself with coveted “buyer envy” when a frenzy of buyers vied for ownership and drove up its purchase price.

The heightened interest in this sector has sparked interest in selling, especially with owners approaching retirement age and looking for a liquidity event. Here are highlighted key legal issues for the seller to consider in the sale of a franchisor and the pro-active steps that can improve the purchase price of a franchisor.

1. Assess the Franchise Agreements. The seller’s franchise agreements are contract rights that often serve, along with its trademarks, as the franchise company’s most valuable assets. Savvy buyers will review the franchise agreements in-depth to determine the quality and reliability of the royalty stream they are purchasing. To prepare for this review, a seller should track the versions of the franchise agreements in use in the system and make note of any significant variations among them. The seller should also create a log of each version, noting key changes, especially in royalty and other fees and rights granted or reserved.

In addition, legal counsel should review whether the franchise agreements give the franchisor flexibility in responding to dynamic changes in the marketplace. Can the franchisor update the system, add new product lines, change suppliers, create value programs and add products or services that could not have been anticipated when the franchise was first sold? If not, the franchisor will need to change its franchise agreement

going forward. Are there franchise agreements where the territory granted is too large, creating an impediment to future expansion? If so, the franchisor may want to negotiate with the franchisee to reduce or split up the territory.

As franchises come up for renewal, the franchisor should consider steps to bring older agreements more in line with the franchisor’s most current franchise agreement. Such steps may include incentive programs to encourage franchisees to enter into the newest version.

2. Secure Intellectual Property Rights. Imagine taking the franchise name off retail units and trying to promote the business. Picture a competitor setting up shop with the same trade dress and a confusingly similar name across the street. Understandably, buyers will closely examine the strength of the seller’s trademark and other intellectual property rights because they often form the foundation of the franchise system. If the franchisor has failed adequately to protect and police its trademarks, or if there are other legal concerns regarding the ownership or validity of its intellectual property rights, the franchisor’s value will be seriously affected.

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Consequently, the seller should conduct an audit of its intellectual property. The seller should create a list of all intellectual property it uses or licenses, check on the status of its registrations and renewals, determine if there are any concerns and establish a game plan to address those concerns.

Whether the franchisor follows up with cease and desist letters to infringers or takes a more conciliatory approach with a third party who may hold conflicting rights to the trademark, the franchisor should attempt to resolve as many of these conflicts as possible before going to market.

3. Resolve Litigation and Reduce Potential Claims. Significant ongoing or threatened litigation can cast a cloud over the value of a company. Because a buyer often will evaluate such litigation on a worst-case basis, ongoing litigation, proceedings or threats can disproportionately reduce the valuation given to the franchisor. Moreover, a buyer may insist on being indemnified against the litigation in the purchase agreement. When this occurs, the seller will be put in the undesirable position of having significant post-closing exposure, often without the ability to fully control what occurs in the litigation. Because of

this, a seller who is party to significant litigation against it should renew efforts to get the litigation settled before embarking on the sale of the business.

Sellers should take steps to reduce the risk of future lawsuits from franchisees and other third parties. As a defense against claims, the seller should establish a pro-active, comprehensive release program. A release frees the franchisor from most franchisee claims for damages resulting from a breach of the franchisor's duties and from other claims the franchisee may pursue against the franchisor. Eliminating potential claims at every opportunity will reduce buyer concerns about exposure to franchisee liability and limit the seller's exposure if the seller provides indemnification against such claims in the purchase agreement.

4. Shore up the Franchise Sales Process. Each seller should conduct a comprehensive franchise sales

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compliance audit before bringing the franchisor to market. This sales audit will determine whether the sales force has followed disclosure and registration laws consistently. Do all receipts document that the franchisor has followed proper compliance procedures? Have franchisees complained about promises made outside the contract? Upon finding non-compliance issues, the seller should implement compliance training and other tools — e.g. checking for receipts, adopting closing acknowledgements and seeking releases — to minimize future issues and to cleanse past missteps.

5. Enhance the Legal Underpinnings for Growth. One of the most significant factors that boosts a franchisor's valuation is a buyer's belief that it can significantly expand the franchisor's business after the purchase. The seller should do as much as it can to establish the legal underpinnings for this growth. Franchisors should consider provisions in franchise agreements that would unduly limit expansion geographically, by product or service, or through alternative distribution channels. Modifications or changes to such provisions should also consider the impact on existing franchisees, unit economics and royalty streams.

More recently, franchisors have viewed international growth as a significant opportunity. Where this is the case, the seller

should establish plans for initial development and consider legal actions such as pre-emptive trademark filings in appropriate countries coupled with searches to ensure that no conflicting marks already exist. Where buyers look toward international opportunity, typically they will conduct due diligence to confirm the opportunity. No seller wants to be in the position where the buyer is the first to discover that there is a blocking trademark in a significant foreign country. ■



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