Lathrop GPM

American Bar Association
43rd Annual Forum on Franchising

WHO YOU GONNA CALL: THE ROLE OF FRANCHISE LAWYERS IN MERGERS & ACQUISITIONS

Mark A. Kirsch
Lathrop GPM, LLP
Washington, D.C.

and

Charlene York
Worldwide Express, LLC
Dallas, TX

October 27 - 30, 2020

Table of Contents

WHO YOU GONNA CALL:
THE ROLE OF FRANCHISE LAWYERS IN MERGERS & ACQUISITIONS

I. INTRODUCTION

Mergers and acquisitions ("M&A") of franchise systems have been occurring in the franchise industry for decades, but in the last ten to twenty years there has been a significant increase in the volume of transactions, the variety of brands and business models involved, and the valuation of these deals.[1] In addition, franchising has seen an increase in large multiple-unit franchisees that are seeking growth capital and/or exit strategies.[2] These larger franchisees sometimes turn to financial sponsors and investors, which is also fueling the M&A market. As we write this paper, the country is still in a severe economic downturn due to full or partial business closings, stay-at-home orders, and unemployment, due to the COVID-19 pandemic. So, some of the luster and "froth" of the M&A market from 2011 to early 2020 has cooled down. Nonetheless, some business commentators and experts believe that the cool-down in the M&A market will be short-lived.[3]

What does this mean for franchising and franchise lawyers? We believe there will be a return to more transactions involving franchisors and franchisees, private equity firms, family offices, and strategic buyers.

As any follower of the ABA Forum on Franchising's conferences and publications will know, the topic of franchise M&A has been addressed, including a variety of related topics, numerous times in the last decade (and further back), and it has been a topic of the International Franchise Association (IFA) legal symposium for over twenty years. The collections of papers, presentations, and books by many of our colleagues in the franchise bar is quite impressive, and provides an extensive source of advice on this issue. Attached as Appendix A is a list of some of the papers and books on franchise M&A. Throughout this paper, we will refer to many of these sources, particularly for examples of documents utilized in franchise M&A transactions. The goal of this paper, however, is not to plow over the source ground. Rather, our intent is to provide guidance and perspective regarding the franchise counsel's role in these M&A transactions. While no two deals, buyers, sellers, or franchise lawyers are the same, the overarching goal of each deal is the same – how to get a deal to closing, and "get the ball over the goal line." The franchise lawyer's role plays a large part in accomplishing this objective.

We will address the various phases and facets of franchise M&A deals, from the perspectives of in-house counsel and outside counsel, and from both the buyer and seller sides of a transaction. Our focus will lean heavily to the sale of a franchise system, in part because the role of franchise counsel in those transactions is more involved and varied than in multiple-unit franchisee portfolio deals. However, we also will address multiple-unit deals, as well as franchise

---

[1] *See, e.g.*, Ritwik Donde and Darrell Johnson, *PE Buys Into Franchising: From unicorns to warhorses, M&A is on the rise*, Franchising.com (Jan. 16, 2020) https://www.franchising.com/articles/pe_buys_into_franchising_from unicorns_to_warhorses_ma_is_on_the_rise.html.

[2] *See, e.g.*, Ben Warren, *Multi-Unit Moguls: 25 of the Industry's Largest Franchisees: Franchisees in every segment have found success through multi-unit growth*, 1851 (Nov. 17, 2017) https://1851franchise.com/multi-unit-moguls-25-of-the-industrys-largest-franchisees-2704740.

[3] *See, e.g.*, Milana Vinn, *After decline in H1 2020, PE dealmaking is set to rebound: PwC*, PE Hub (July 24, 2020) https://www.pehub.com/after-decline-in-h1-2020-pe-dealmaking-is-set-to-rebound-pwc/.

counsel's role as advisor to the lender of a franchise system buyer and as an advisor to a representations and warranty insurer.

II. TRANSACTION STRUCTURES

As a prelude to an in-depth discussion of the franchise counsel's role in M&A, the following is an abbreviated summary of the principal type of M&A franchise deals; and the types of buyers, sellers, and other interested parties, because the nature of the party effects their strategic goals and therefore impacts counsel's role.

A. Types of Acquisitions

1. Purchase/Sale of Franchise System(s)

The main type of transaction in the franchise M&A space is the purchase or sale of a franchise system or franchisor. The sale of a franchise system includes the sale of the assets of franchisor or the franchise system, or an ownership interest in the franchisor seller, as discussed in more detail below.[4] Generally, the sale of a franchise system includes the sale of the franchisor's intellectual property, which often includes the trademarks, service marks, and other marks licensed to the franchisees, the operations manuals, and proprietary information of the systems, such as recipes, methods of doing business, software used in operation of the franchise businesses, and other confidential information. Most importantly, the sale of a franchise system includes the sale of the material contracts of the seller, including the franchise agreements, vendor contracts, software licenses, management contracts, and other agreements that are the life blood of the franchise system. Additionally, the sale of the system also will include the sale of any company-owned units, or in the alternative, a negotiation where the sellers become franchisees of the existing company-owned units. Each franchise system will have its own assets that will be sold (or retained), and the amount of assets will vary from franchise system to franchise system.

2. Purchase of a Large Multiple-Unit Franchisee Portfolio

One of the growing areas in franchise M&A is the transfer and sale of large portfolios of multiple-unit franchises in a particular brand.[5] These are not three- or five- or ten-unit transfers that have existed in franchise systems for decades. Rather, as multiple-unit owners grow within a brand, they may own many dozens or hundreds of units. As they seek additional capital for expansion, they have turned to private equity ("PE") firms. PE firms will buy a franchisee portfolio, inject capital into the franchisee, and in many cases, provide enhanced management and additional human capital to help expand the portfolio. The PE firm will position the multiple-unit portfolio to be sold to a larger PE firm. Some franchisors may welcome PE investment in their larger franchisees, as it can accelerate growth, add capital to the system, improve unit-level operations and economics, and possibly facilitate the (profitable) exit of underperforming franchisees (resulting in, hopefully, a profitable transaction for the selling franchisee owners). These transactions are different from traditional multiple-unit sales, or changes in ownership, because many of the typical change of control provisions in a franchise agreement may not be

[4] *See infra* Section II.A.3.

[5] The authors are aware that certain franchised industries have more PE ownership than others. For example, fitness brands and casual dining chains have many PE owners of large multiple-unit franchisees. *See, e.g.*, Darrell Johnson, *Shifting Landscape: 5 Trends Changing MU Franchising*, Franchising.com (Jan. 4, 2019) https://www.franchising.com/articles/shifting_landscape_5_trends_changing_mu_franchising.html.

applicable, or may be antithetical to the operating structure of a PE firm. For example, virtually all franchise agreements require the personal guarantee of one or more principal owners of the franchise entity. PE firms, however, and their principal managers or officers, will not provide personal guarantees. Also, many PE firms, whether through the same or a different fund than the one that is investing in the franchisee portfolio in question, will have ownership interests in a similar business, including one that might be deemed a competitive business under the franchise agreements. These two areas, as examples, create the need for franchisors, franchisees, and the PE firms to creatively address these conflicting issues. Many franchise agreements require that a new franchise agreement (and most likely the "then-current" form of franchise agreement) be executed upon a transfer. Therefore, the key assets of the seller – the franchise agreements – will be terminated as part of the transaction. Consequently, to address these and other issues, franchise counsel to a buyer in a multiple-unit franchise portfolio transaction can play a pivotal role.

3. Asset vs Equity

The two most common structures for a sale are an asset acquisition and an equity purchase. Each has its benefits and limitations.

An asset purchase allows the buyer to specifically choose the assets and liabilities it acquires and exclude everything else. This structure is best suited to shield the buyer from liabilities the buyer does not intend to assume.[6] Further, the general rule regarding successor liability is that where one company acquires the assets of another, the buyer is not liable for the debts and liabilities of the seller or transferor.[7] This has been held to apply in franchise transactions.[8] However, if this is done at the franchisor entity level and the purchased assets are placed into a new entity, the franchisor essentially has to start over from a state registration perspective. It creates a "dark" period when franchises cannot be sold while the new franchisor prepares an opening audit and applies for initial registrations. Regardless of the capitalization of the franchisor and number of franchisees in the existing system, the state franchise exemptions that require years of operating history likely will not be available to the new franchisor, even if the system has been in existence for the required amount of time.[9]

On the other hand, an equity purchase permits a buyer to acquire the entire target company and step directly into the shoes of the seller. If done at the franchisor level, the Franchise Disclosure Document ("FDD") of the acquired company would need to be amended to reflect the changes resulting from the acquisition, but the franchise entity remains the same. Because of this, the buyer can continue to rely on the existing audited financials to maintain its registrations and exemptions. The potential downside to an equity purchase is that other than those that are specifically excluded, the buyer acquires all of the seller's liabilities, known and unknown. While the buyer can attempt to minimize its risk by performing more detailed due diligence, negotiating strong indemnification provisions, and including a holdback amount in the purchase agreement[10],

---

[6] AMERICAN BAR ASSOCIATION, MERGERS AND ACQUISITIONS OF FRANCHISE COMPANIES 74–76, 181–83 (Leonard D. Vines & Christina M. Noyes eds., 2nd ed. 2014).

[7] *Id.* at 54, 79.

[8] *See, e.g.*, Schwartz v. Pillsbury Inc., 969 F.2d 840, 845 (9th Cir. 1992); *see also* Stering Vision DKM, Inc. v. Gordon, 976 F. Supp. 1194, 1201 (E.D. Wis. 1997).

[9] See more detailed discussion *infra* Section III.D.4.

[10] See discussion of indemnification *infra* Section III.C.2.c.

it is possible that an issue can arise if the seller lacks enough assets to cover its indemnification obligations if a significant claim is made.

Generally, the decision regarding an asset sale verses an equity sale is determined by non-franchise factors, such as tax considerations, ownership and investment issues, future divestitures, and the creation of equity incentive programs for management and/or employees. Therefore, franchise counsel's role in those decisions is limited. Nonetheless, it is important for franchise counsel to raise the franchise issues so that the buyer or seller recognizes the franchise impact, even if it does not change the course of action.

B. Types of Buyers and Sellers

1. Financial Sponsor Buyer

Over the last several decades, PE firms have found the franchise business model to be a very attractive investment, whether they invest in an entire franchise system or in a large multiple-unit franchisee, particularly where the target is "asset light" with available free cash flow. Some PE firms focus on specific industries, while others spread their investments across a range of industries, or focus on company size or a point in the franchisor's life cycle to make investment decisions. In most cases, the goal of a PE firm is to hold the investment for a limited period of time (five to seven years is not uncommon). During the hold cycle, the PE firm will infuse capital to grow the business, as well as leverage efficiencies and cut costs so that it can maximize profit before selling to someone else (most likely another PE firm). In many cases, some or all of management is generally left in place and there is minimal disruption to the day-to-day operation of the system, at least from the franchisee's perspective. In fact, an infusion of capital by the PE firm may result in additional support and other resources that benefit franchisees in running their businesses.

A related type of financial sponsor is what is referred to as a "family office." A family office is generally a privately held company that manages investments for high net worth or ultra-high net worth individuals or families whose wealth is not dependent upon raising funds from investors. Due to their nature, family offices may have longer investment timelines than PE firms. Nonetheless, if family offices invest in franchisors or multiple-unit franchisees, their strategic goals will be similar to those of the PE firms. Franchise counsel's role is assisting a family office will be similar to that of representing a PE firm.

2. Strategic Buyer

Other potential acquirers of franchise systems include franchisors in the same or complementary industries that may be seeking to develop a multiple-brand portfolio of franchise concepts, or to combine competing brands under one brand. Also, a strategic buyer may include a supplier to the franchise brand's industry, with the goal of creating a more vibrant and efficient vertically integrated distribution system. Finally, a strategic buyer in the multiple-unit franchisee arena may be another multiple-unit franchisee in the system that is seeking to expand through acquisitions, along with organic franchise development.

While day-to-day operations may not change much from the franchisee perspective when a system is purchased by a PE firm, things may be very different if the buyer is either a competing franchisor or another company involved in the target company's industry. When a competitor purchases a franchise system, the goal may be to integrate the two systems and there likely will be very significant changes, both from a franchisor corporate perspective and from the

perspective of the franchisees. The buyer may integrate the acquired corporate operations into its existing structure, which would result in a total or near total management change. There may be additional or different suppliers, as well as new technology that has to be purchased and used by the franchisees. Additionally, if the buyer is a directly competing franchise system, there are likely to be competition, territorial encroachment, and marketing fund issues, as well as concerns regarding the future growth of the acquired system, and the protection of the confidential and proprietary information of each system from the other system's franchisees.[11]

C. Other Interested Parties

1. Lenders

Many buyers of franchise systems and multiple-unit franchises, particularly PE firms and other financial investors, will seek to borrow capital to fund the transaction.[12] The buyer may borrow a percentage of the purchase price from a third-party lender. These lenders are committing significant resources, with the goal of obtaining a significant return. Therefore, just as a bank evaluates the homeowner/borrower and the house before granting a mortgage, the lender evaluates the buyer and the assets—the target franchise system or the multiple-unit franchisee. Consequently, the lender will likely engage franchise counsel to assist in the underwriting process to evaluate the franchise target. While franchise counsel's role as an advisor is less involved than the finance/debt counsel for the buyer or seller, experienced franchise counsel can and should provide value to the lender to assess risk.

2. Representations & Warranty Insurer

The role of franchise counsel for the representations and warranty ("Reps and Warranty") insurer is very similar to that of franchise counsel to a lender.[13] The insurer will be conducting its underwriting of the risk of the deal in a shorter timeframe, sometimes no more than forty-eight hours, than that afforded to the lender. Therefore, the Reps and Warranty insurer often relies on the buyer's franchise counsel's diligence, due diligence review, and calls with franchise counsel.

III. FRANCHISE SYSTEM SALES AND ACQUISITIONS

Each franchise sale or merger transaction has its own unique circumstances and characteristics, and therefore, franchise counsel's advice and specific tasks are likely to vary. Nonetheless, most transactions exhibit many of the same overarching issues, challenges, and processes. In the authors' experience, franchise system transactions tend to have more variations and more franchise issues than multiple-unit franchisee transactions. Subsequently, franchise counsel for the buyer and seller will usually have a larger and more important role in franchise system transactions. Therefore, this Section III will focus on franchise system acquisition and sale transactions, including a summary of the road-map, or the "anatomy" of the transaction, and will be followed by the franchise-heavy aspects of the purchase and sale transaction, from the pre-sale activities of the buyer and seller, through the closing and commencement of franchising

---

[11] Kirk Reilly et al., *Litigation After Acquisition of a Competing Franchise System*, ABA 29TH ANNUAL FORUM ON FRANCHISING W-6 at 8–12 (2006).

[12] The purchase price paid to the seller or the seller's owner in these transactions will generally be in cash (although there may be some future payments based on earn-outs). However, the source of the buyer's money will not always be from its own coffers, and commercial lending is both required and desirable in many cases.

[13] See discussion of rep and warranty insurance *infra* Section III.A.11.

activities with a new owner. While this Section III focuses on the sale of a franchise system, Section IV.A will address the sale of multiple-unit franchisee portfolios.

A. Process

There are many steps on the journey that is a franchise system (or multiple-unit franchisee portfolio sale transaction) – some of these steps are for the seller, some for the buyer, but most involve a combined dance with two (or more) partners. The following is a high-level summary of the significant steps in the transaction, and for many of which, franchisor counsel can play a significant role. This subsection is intended as only an overview, with a more detailed discussion of the franchise counsel's role in many of the steps followed in Sections III.B, III.C, and III.D, below.

1. Preparing the Franchisor or Multiple-Unit Franchisee to Sell

Preparing the company for sale is an ongoing process that starts long before management begins discussions with potential buyers. The same compliance and data management protocols and practices that a wise in-house franchise counsel establishes and follows as part of the day-to-day operation of a well-run legal department are the same protocols and practices that are needed when the time comes to get the company ready for sale. These good practices ensure that key documents and contracts are up-to-date, executed, complete, and saved under a consistent naming protocol so that they can be easily located. Such good practices give in-house franchise counsel a head start to perform a pre-sale review to identify and correct any deficiencies that are discovered. For those deficiencies that can't be easily fixed, in-house franchise counsel has time to alert management to any issues that will need to be addressed, either in the valuation process or during the negotiating process with potential buyers. See Section III.D.2 below for a more robust discussion about developing and managing the timeline of when to stop franchise sales and when to amend the FDD in light of the transaction.

2. Engaging an Advisor

In larger transactions, the seller will engage an investment banker to assist in getting the company ready for sale. The role of the banker will be to assist management in valuing the company, creating a game plan for the sale, and then identifying the most promising potential buyers in the market. In choosing an investment banker, seller's management should consider their experience, including the number of transactions they have completed, and their experience in the sale of other franchise systems. Ideally, the banker would have some experience not only with franchise systems, but also with businesses operating in the franchisor's particular industry. Because of the critical role the investment banker will play, it is very important that management be comfortable with the bankers, not only with their experience and credentials, but also feel confident that the bank team will be able to work with seller's management in a collaborative way.

One role of the investment banker is to prepare the "Confidential Information Memorandum" (referred to as the "CIM"). The CIM is the principal presentation document that the selling franchisor's (or multi-unit franchisee's) investment banker creates for prospective investors and buyers. Franchise counsel is not often deeply involved in the creation of the CIM. In a transaction involving a franchisor, the CIM usually provides basic information about the seller's franchise system, including the number of units and whether some are company-owned, the geographic spread of the existing units, detailed financial information that can shed light on the health of the existing units, and more. However, seller's franchise counsel should review the CIM for accuracy. In multiple-unit franchisee transactions, the CIM contains similar information, such

as the location of the units, existing development rights, and unit economics. Given the level of information in the CIM and the fact the information has been compiled into one document, the buyer's franchise counsel should review the CIM as part of its preliminary due diligence.

3. Valuation Issues

There are a handful of ways for franchisors to value their business and determine an acceptable purchase price. The most common form of valuation is the price-to-earnings ratio, where the company determines its earnings before interest, taxes, depreciation and amortization (or EBITDA) and uses a multiplier to determine the expected sale price. Market reports issue standard price-to-earnings ratios for various industries, which help companies price their business to current market conditions. Determining the value of the company for sale is generally handled by senior management in collaboration with the investment banker. There are, of course, franchise-specific metrics that are critical to these valuation calculations for both the seller and buyer. [14] Franchise counsel are not heavily involved in this process, but there are issues with which franchise counsel may have detailed familiarity, such as the franchise development pipeline, and contract changes regarding royalties, that can bear on valuation.

4. Data Room Creation

As part of the transaction, buyers and bidders will need to review an extensive list of documents – many of which are not franchise-related. Gone are the days when individuals from the prospective buyer (lawyers, accountants, etc.) would visit the seller's offices and manually review files and documents. Rather, documents will be viewed digitally.

Most transactions of even modest size will use an electronic data room to manage the due diligence process. A data room is a virtual repository where the seller's key documents can be gathered and stored securely for review by potential buyers. The data room will be organized according to an agreed-upon schedule of categories of documents that will be produced for due diligence review. Typically, the documents produced will include the company's corporate, operational, human resources, technology, financial, tax, and franchise documents. Having a well-organized data room will not only speed the due diligence process along, but also will show potential buyers that the target company has maintained good recordkeeping practices.

Depending on the size of the deal and the number of parties involved, the data room may be created and managed by the investment banker team, sell-side corporate counsel or in-house franchise counsel. A few examples of software platforms or third-party vendors that enable this or provide this service include: Dropbox, Merrill Data Site, SS&C Intralinks, or SmartRoom. Using these services permits the seller to regulate the review process, grant permissions so that the respective parties involved can only see the documents related to their area of review, and track which bidders are viewing which documents.

5. Non-Disclosure Agreements

Non-disclosure agreements ("NDAs") are used between the parties in the initial stages when sharing competitively sensitive information, including the terms of a potential sale. The seller will be concerned with protecting the confidential and proprietary information that it provides to a potential buyer, particularly if the buyer is a competitor. On the other hand, the buyer will want to

[14] *See* Vines, *supra* note 6, at 155–74; *see also* Alan R. Greenfield et al., *Mergers & Acquisitions: The Basics of Buying and Selling the System*, ABA 40TH ANNUAL FORUM ON FRANCHISING W-18, at 7–11 (2017).

have access to enough information to make an informed choice about whether to enter into a letter of intent or to proceed to the due diligence period and signing of a purchase agreement.

6. Term Sheet or Letter of Intent

Although some smaller transactions may go straight to a binding purchase agreement, most transactions that do not involve multiple bidders involve the creation of either a term sheet or a letter of intent ("LOI"). Both of these documents set out the basic terms of the proposed deal between the parties. Generally, a term sheet is an unsigned and nonbinding list of the basic terms of the proposed transaction. In more complex deals, the parties may use a term sheet as a starting point to negotiate a more detailed LOI or go straight to negotiating the purchase agreement itself. LOIs are signed agreements and tend to describe the deal points in more detail. They may be binding or non-binding, but generally all LOIs have non-binding provisions addressing certain deal terms, and binding provisions regarding confidentiality, non-competition, and non-solicitation, as well as an exclusivity period during which the seller agrees not to seek other buyers while the buyer completes their due diligence and the parties complete their negotiations.

Commonly addressed terms in the LOI include a purchase price, the terms of any holdback, earn out or other purchase price adjustment formula, whether the signing of the purchase documents and closing will be simultaneous or if there will be a deferred closing date, the timing of the due diligence period, the scope of the buyer's due diligence, whether the buyer will be permitted access to any of the corporate employees or franchisees before closing, and in some cases, a breakup fee and the terms under which such a fee must be paid to the seller if the buyer decides not to proceed with the transaction. Some LOIs also may include a list of the types of documents that the seller will make available to the buyer for review during the due diligence period.

7. Bid Process with Multiple Potential Buyers

Many franchise M&A transactions, particularly with larger or more mature systems, involve an auction or bid process. An auction is a process in which the seller, in conjunction with its investment banker and M&A advisor, solicits multiple bids from prospective buyers, with the goal to obtain the highest purchase price and the most favorable terms. Following an expression of interest by the buyer, and the execution of an NDA, the seller permits the various potential buyers to access the data room. The seller will often prepare a "bid" draft of the purchase agreement, which is written in an extremely seller-friendly manner. The seller also may prepare an initial draft of the Disclosure Schedules (as further discussed in Section III.A.10 below). Each bidder or potential buyer, following the conclusion of its due diligence document review and management call (as discussed further in Sections III.A.8.b and III.C.1.b below), will submit a bid with a proposed purchase price and transaction terms, a revised purchase agreement, and other relevant economic, contractual, legal and business terms and conditions.

The seller may select the winning bidder based on the initial bids, and proceed on an exclusive basis for a limited time with further diligence by the bidder, negotiations, and eventual execution of the purchase agreement. However, depending on the size of the transaction, the number of interested bidders, and the submissions, the seller and its investment banker also may proceed with another round of bidding with a select group culled from the first round of potential buyers. During this process, the remaining bidders "sharpen their pencils" and submit revised – usually higher – bids. They will also spend more time evaluating the business and the sellers, and vice versa. Eventually, and sometimes rather quickly, the seller selects a buyer and they proceed with final negotiations that will lead to the purchase agreement.

The nature of the sale process – whether it is an auction process, as well as the size and scope of the auction, the number and type of potential bidders (if known), and other characteristics of the transaction – will impact franchise counsel's advice on issues such as diligence and purchase agreement reps and warranties.

8. Diligence

One of the most critical elements of the M&A process is the prospective buyer's evaluation of the seller's business, including economics, financial statements and financial results, management operations, personnel, contracts, legal compliance and regulatory issues. This is known as the due diligence process which is undertaken by the buyer, its financial advisors, lawyers, accountants, and other specialists (and is discussed in detail in Section III.B below). This is one area where franchise counsel earns their stripes because the franchise agreements and the franchise relationships are the key "assets" of the business, particularly for a system that has few company-owned outlets or other tangible assets.

a. Documents

The due diligence process, and particularly the review of the documents the seller provides in the data room, enables the buyer to review the key agreements that makes the seller's business tick. A buyer should review all of the documents in the data room to understand the workings of the target company, both good and bad. In the franchise context, buyers often review the relevant documents to determine a variety of issues, including whether the target has been compliant with franchise disclosure and relationship laws, whether the franchisor and franchisees are in compliance with the franchise agreements, the target's development pipeline and many other issues (as discussed further in Section III.C below).

b. Calls With Seller's Management

Usually, towards the end of the diligence process, after the buyer has had a chance to review all the documents in the data room, the buyer will request a call with the seller's management. Even with an extremely comprehensive data room, there is information that is difficult to ascertain simply from a review of documents. For example, while it is helpful to review the franchise documents to determine if the franchise disclosure laws have been observed, absent formal demand letters or other less formal correspondence airing grievances, there may be little or no documentation to help the buyer understand the level of satisfaction the franchisees feel toward their own performance and the performance of the franchisor and franchise system generally. Therefore, a discussion between the management team of the franchise system and the buyer is helpful in obtaining information that is critical to the business, but not easily identifiable from the documents in the data room.

9. Purchase Agreement

The purchase agreement is the document the buyer and seller will sign to evidence the sale of the franchise system or franchise units. As referenced above, there are generally two types of purchase agreements – an asset purchase agreement or an equity purchase agreement. The asset purchase agreement will bind the buyer to purchase all or substantially all of the assets of the company, including the franchise agreements and other assets, unless the buyer and seller agree to exclude certain assets. On the other hand, an equity purchase agreement will bind the buyer to purchase an ownership interest in the seller such that the buyer steps into the shoes of the seller. The purchase agreement contains all of the material terms of the sale, including the

purchase price, representations and warranties about the business by the seller for the buyer to rely on, promises the seller and buyer make to each other, both pre- and post-closing, and the timing of when the parties will close the sale. Because of the nature of the purchase agreement and its integral role in the transaction, the purchase agreement is heavily negotiated by the parties.

Many M&A transactions involve a detailed and complicated ownership structure of the buyer, or the surviving entity for a merger. There may be several layers of ownership "above" the surviving entity or franchisor. The layered ownership structure is designed by the corporate attorneys and advisors for tax, investment, and lending purposes, as well as to permit selling shareholders and management team to roll-over a portion of their sales proceeds into the surviving entity, to permit different types of investment by the PE firm and its management, and other reasons. For the purpose of this paper, however, we will not address those details or variations, as they generally are not franchise-specific and franchise counsel is not often involved in negotiating the post-closing ownership structure.[15]

10. Disclosure Schedules

The purchase agreement will make reference to disclosure schedules. This is a document, or group of documents in which the seller provides details required under the purchase agreement or specifically references and/or disclaims certain material information and documentation so the parties understand exactly what they are agreeing to and lets the buyer know exactly what it is purchasing. For example, the disclosure schedules will identify, among other things, the list of critical assets, contracts, required consents, intellectual property, financial statements, litigation, suppliers, and, of course, franchise agreements and franchisees. The disclosure schedules will also provide disclosure of certain information in response to the reps and warranties that affect the assets and/or liabilities involved (as discussed further in Section III.A.11 below), such as when the seller has not complied with laws or regulations, or if certain material assets are being excluded from the purchase agreement. The buyer will use the information it has gathered from the data room during diligence to review the seller's disclosure schedules to ensure it is aware of all of the data contained in the disclosure schedules, and in particular, the exceptions to or exclusions from the reps and warranties.

11. Representations and Warranty Insurance

Representations and warranty insurance (also referred to as Rep and Warranty insurance or "RWI") is an insurance policy that protects a party against any losses that arise due to a breach of some or all of the reps and warranties the parties agreed to in the purchase agreement. Parties will take out an RWI policy for their transaction if they do not want to build into their purchase agreement a different mechanism for compensating the buyer if there is a breach of the seller's reps and warranties (often referred to as a holdback).[16] For example, if an RWI policy will cover any losses the buyer incurs due to a breach of the reps and warranties up to $10 million, and the deductible is only $1 million, the buyer receives $9 million in coverage that it would have otherwise had to take out of the purchase price as a holdback. RWI policies usually provide the buyer with coverage for up to 3% of the purchase price with a deductible of 1% of the purchase price; therefore, RWI is usually reserved for deals of larger size. The use of RWI has increased

[15] *See* John C. Coates IV, *Mergers, Acquisitions and Restructuring: Types, Regulation, and Patterns of Practice*, Harvard John M. Olin Discussion Paper No. 781 (July 2014) https://dash.harvard.edu/handle/1/20213003.

[16] See discussion of indemnification *infra* Section III.C.2.c.

significantly in M&A generally,[17] and the authors have seen it more frequently in franchise M&A transactions for the last several years – before COVID-19 – when the M&A market was very active.

12. Signing

Transactions can be structured where the parties sign the purchase agreement and related documents and concurrently close the deal (a "sign and close"), or the purchase agreement is signed first with the actual closing deferred to some later date when an agreed set of conditions are satisfied (a "sign and then close"). The decision regarding which method to use should be made early in the negotiating process because the provisions required in the documents for each type of structure differ in certain material respects.

a. Simultaneous Sign and Close

A sign and close offers the advantage of a clear delineation of risk. When the parties sign and close simultaneously, the specific moment at which risk shifts from the seller to the buyer is clear. There is no period during which the parties must negotiate who will be responsible for the risk of loss for the many possible events that could occur in the interim. However, a simultaneous sign and close transaction is not always possible. For example, if the transaction is conditioned on the parties obtaining a Hart-Scott-Rodino antitrust clearance, or the buyer must obtaining financing, or the seller and/or buyer must obtain shareholder approval before closing, the parties may have no choice but to use a sign and then close structure.

b. Sign and Then Close in the Future

In a sign and then close structure, the parties must carefully consider and negotiate the pre-closing covenants that describe the activities that are permitted and prohibited by each side during the interim period, as well as allocate the risk for any events that occur in the period between signing and the closing date. Typical pre-closing covenants will include restrictions on the seller that prevent it from incurring additional debt other than in the ordinary course of business and from entering into or cancelling any material contracts. For the buyer, there may be restrictions on how much contact can be had with the franchisees or a franchisee association.

In allocating risk in a sign and then close structure, the parties need to consider the specifics of the franchise system and try to foresee the most likely possible events that should be addressed. For example, which party will bear the responsibility of the loss of a key customer, key supplier, or key employee during the interim? What about a natural disaster or sudden market downturn? Conversely, if the seller receives some significant financial benefit during the interim, will the windfall go to the buyer or will the seller receive some credit for the increase in value of the company?

B. Pre-Sale Actions

An M&A transaction is a fluid process, with different parties, advisors, and attorneys and their respective roles and involvement varying throughout the process. As noted above, in certain phases, franchise counsel for the seller will be more heavily involved than

[17] Kevin Mills, et al., *Representation & Warranty Insurance—Current Market Trends*, Harvard Law School Forum on Corporate Governance (Dec. 22, 2019) https://corpgov.law.harvard.edu/2019/12/22/representation-warranty-insurance-current-market-trends/.

buyer's franchise counsel, and vice versa. For the purposes of this discussion, the authors have established arbitrary divisions for the process, to highlight certain activities and roles for franchise counsel. These are (i) the pre-sale activities, primarily for the seller's counsel; (ii) the transaction process, including the purchase agreement and diligence process; and (iii) the pre-closing, closing, and post-closing period.

1. Sell-Side: Preparing the Company for Sale

When discussions arise about putting a franchise system up for sale, a large part of the role of in-house franchise counsel is to perform pre-offer due diligence.[18] This will allow time to identify issues and potential liabilities, and where possible, correct deficiencies before a potential buyer performs due diligence. Obviously, a system that has good compliance practices in place and has followed them as part of its day-to-day operations will be far ahead in this process. However, even the best run systems need to double check to make sure that there are no surprises awaiting them once a buyer's team starts their due diligence. Barring a distressed asset sale or a hostile takeover[19], which can shorten the due diligence period considerably, counsel may have between a few months and two years or more to accomplish this. During this time, making sure the right team is in place is critical to success. In addition to the legal team, in-house franchise counsel also will work with members of the finance and accounting teams, as well as senior management, to understand potential areas of concern and also make sure that the company's procedures and practices are consistently followed.

In-house counsel can put a plan together for management that identifies all of the likely areas of due diligence a buyer will want to review. This will serve several purposes. First, such a plan makes everyone aware of potential problem areas so that there is an opportunity to correct them to the extent possible or at least be prepared to address them with potential buyers. Second, it can allow management an opportunity to address the scope of due diligence up front so that the parties can agree to focus on the key areas and eliminate added expense and other negative consequences resulting from spending time on nonmaterial areas.

Typical due diligence involved in any company sale includes many so-called non-franchise matters, such as checking entity organization, ownership of the assets, outstanding liens, status and ownership of any intellectual property, pending or threatened litigation, company-owned real estate, environmental issues, and employment-related issues. Because the key element and asset of a franchisor is likely the franchise system, the franchise agreements and other documents related to the operation of the franchise businesses are the specific areas that franchise counsel will focus its efforts on reviewing. While buyer's franchise counsel will submit due diligence requests,[20] seller's counsel should be prepared and start populating the data room. Some of the key areas and documents will include:

- FDDs and Registrations. All FDDs and state registrations, double checking to confirm that the franchisor was registered in all states where franchises were sold

[18] If the franchisor seller does not have in-house franchise counsel, or if the in-house counsel does not specialize in franchise law, outside franchise counsel will often be relied upon to undertake many of these functions, and provide the advice described *infra* Sections III. A and III. B.

[19] Although a discussion of these types of transactions is outside the scope of this paper, this topic will be discussed as part of this 43rd Annual ABA Forum on Franchising. *See* W-10: Franchise Agreements in Bankruptcy Cases and Business Restructurings-The Problems and Issues that Bankruptcy Can (and Cannot) Solve.

[20] See discussion of buyer's due diligence process *supra* Section III.A.8 and *infra* Section III.C.1.

during the lookback period[21], and that there were not any lapses in registration. All ancillary registration materials, such as franchise seller and broker registrations and advertising registrations should also be reviewed, and confirmed that the materials had been filed with the appropriate states.

- Active Franchise Agreements. Complete copies of all of the active franchise agreements, as well as copies of all of the ancillary documents, will need to be reviewed and uploaded. Ancillary documents include side letters, amendments, exhibits, personal guarantees, security agreements, certificates of insurance, landlord's consents on leases, and the franchisee entity's organizational documents. For seller's franchise counsel, this is the time to clean up franchisee certificates of insurance since a failure to have this buttoned up can expose the seller to potentially significant liabilities and can require significant time to fix during the transaction. Confidentiality, non-compete and non-solicitation agreements for franchisee employees and contractors is another area that can take quite a while to bring up-to-date since the documents have to come from the individual franchisees.

- Non-Compliant Franchisees. The seller will be in a stronger position if it can show it has established processes and procedures regarding franchise defaults that are both communicated to the franchisees and also enforced. Seller's franchise counsel will need to gather all notices of default and termination sent during the lookback period, as well as any checklists or other documents demonstrating that the franchisor has been engaged in good practices regarding enforcing the terms of the franchise agreement against non-compliant franchisees. Franchise counsel also will want to review whether the notices of default and termination meet all state termination law minimums for notice and cure periods, and have complied with the notice periods in the franchise agreements. For any franchisees under an active default or nonrenewal notice or in the process of being terminated, franchise counsel should confirm that all state relationship law requirements have been followed. If not, revised notices should be issued where possible, to bring the notices and cure periods in line with what is required by the applicable state laws.

- Dispute Resolution. Pending or threatened litigation or other dispute resolution mechanisms between the franchisor and franchisees or former franchisees is another area that should be reviewed. Clearly, counsel should include all dispute that are disclosed in the FDD. In addition, counsel should gather litigation and other proceedings that may be part of a diligence request, even if it is not required in the FDD. For example, employment or joint employer claims, or actions in which the franchisor has been named under vicarious liability theory could be relevant to the buyer's inquiry. Franchise counsel should confirm that the company has properly documented the default or other underlying basis of the dispute. Extensive litigation or pending claims may prompt prospective buyers to either adjust the purchase price, require reserves be built into the deal, or to request specific indemnification to address any significant cases to cover future expected liabilities.

[21] "Look-back periods are retrospective time limitations placed on representations and warranties." Andrae J. Marrocco, *Negotiating Critical Representations and Warranties in Franchise Mergers and Acquisitions—Part I*, 36 FRANCHISE L. J. 1 (2016). Many franchise M&A transactions will not be longer than five years because this is the longest statute of limitations period for many franchise law claims. In the authors' experience in the current seller-friendly market, the look back periods tend to be only two or three years.

Franchise counsel should make management aware of this so that they can either get authority and attempt to settle some of the claims before the sale process begins, if possible and appropriate, or at least forewarn management that this will be considered by potential buyers.

- Advertising Fund and Advertising. The pre-sale period is the time to review advertising materials and the advertising fund to ensure that all contributions have been properly segregated and accounted for in compliance with the terms of the franchise agreement, that all required audits have been performed, and that the expenses that have been charged to the fund are allowed. Given the significant potential liability related to the management of advertising funds, buyer's counsel likely will request that that the purchase agreement specifically addresses the handling of any deficit or the transfer of any excess funds from the seller to the buyer since the obligations to the franchisees will remain. The buyer may seek a specific warranty that all advertising funds have been properly accounted for and all obligations satisfied by the franchisor. Therefore, seller's franchise counsel should proactively address these issues.

- Key Supplier Relationships. Critical supply contracts and arrangements will need to be reviewed to determine whether they can be assigned. If there are any exclusivity provisions, those must be analyzed to determine what types of conflicts may exist with certain potential buyers or the existing suppliers of those buyers. This could be of particular concern if the buyer is a competitor in the same industry as the franchise system.

- Other Documents. Depending on the nature of the franchise system and of the industry in which the franchised businesses operate, there are likely to be other documents to review and make available for the buyer. For example, the franchisor may have loaned money to the franchisees and there are promissory notes, there may be loan guarantees to third party lenders, or the franchisor may have subleased locations to some franchisees.

2. Date Room Preparation

In addition to the usual corporate organizational and financial documents compiled in every transaction, the data room in a franchise transaction also will contain all of the key documents for the franchise system. Below is a high-level list of franchise-specific documents that would be applicable to the document review stage for many (if not all) franchise system acquisitions:

- Copies of all FDDs, as well as blacklines showing the changes from year to year (or within a year if there were amendments or state-specific versions)

- State registration orders and comment letters for each of the applicable states

- Financial Performance Representation ("FPR") substantiation data (if applicable)

- Copies (in smaller franchise systems) or schedules (in larger franchise systems) listing all active franchise agreements with all addenda, exhibits, amendments, and ancillary documents (guarantees, security agreements, landlord consents, etc.),

as well as the applicable signed receipts for the FDD and franchise agreement to document the franchisor's observance of required waiting periods

- Relevant correspondence and pleadings regarding all pending disputes, defaults, terminations, and refusals to renewal
- List of terminated and transferred franchises
- Copies of all executed termination, transfer, and related release agreements
- Advertising fund documents, including accountings, schedules of expenditures, reports to franchisees and franchisee associations, franchisee correspondence, and complaints
- Franchise sales/development materials and ads, including evidence of state advertising filings where applicable
- Documents related to franchisee associations and franchisee advisory committees/councils, including reports and minutes from their meetings, if available
- Operations manuals, as well as materials for franchise sales training programs
- Key supplier contacts, as well as schedules of rebates and commissions from system-wide purchases

A sample schedule of data room "folders" (but not an exhaustive list of all documents) is included as Appendix B to this paper. In theory, if not always in practice, the data room will contain all of the documents requested by buyer's counsel as part of its due diligence document requests.

3. Buy-Side Pre-Transaction Work

Outside franchise counsel's role in advising the buyer will often extend beyond pure franchise legal issues. The fundamentally critical roles for franchise counsel will include assessing the seller's compliance with franchise laws, determining whether there are problematic provisions in the seller's franchise agreements, and crafting appropriate franchise-specific reps and warranties for the purchase agreement. Franchise counsel can help shape deal counsel's understanding of the franchise business and franchise system, which impacts deal counsel's diligence, the purchase agreement, financing, and negotiations with the seller, among other aspects of the transaction. Franchise counsel also can advise the buyer on franchise industry best practices that may shape a buyer's perspective of the seller, the industry of the target of the transaction, and specific diligence issues. If the buyer is new or relatively new to the franchise business model, franchise counsel can provide guidance on practical legal and business issues, such as analyzing the risk of any franchise law violations. Consequently, it is important that franchise counsel has early access to the data room and frequent conversations with the buyer in order to provide the most value by enhancing the buyer's understanding of the franchise business and the transaction.

While it is helpful for franchise counsel to be involved early in the deal process, it also may be difficult to include franchise counsel until the buyer has identified a target, undertaken some

preliminary diligence (which is typically in the realm of financial and business diligence), and retained corporate (sometimes referred to as “deal”) counsel. It is critical for franchise counsel to understand the strategy and approach of the buyer. Therefore, franchise counsel should be engaged as early in the process as possible.

a. Preliminary Document Review

Buyer counsel's first two actions should be to (1) review several key documents, including the CIM and the current version of the target’s FDD, and (2) speak with the buyer's principal deal managers, and outside deal counsel for the buyer. The FDD review at the initial stage is designed to understand the target’s business and help shape the future franchise diligence, and is not intended to assess compliance with the franchise disclosure laws, which will come later. The FDD will provide key information that paints a picture of the target’s business practices and performance, such as the number of franchisees, the geographic scope of the system, the existence of international operations, the use of subfranchisors, area representatives, multiple-unit or area development agreements, special supplier or purchasing arrangements and/or rebates, franchisee associations, franchise litigation, franchise turnover through defaults or transfers, other brands in the portfolio, concerns over territorial rights and/or the ability to expand or merge with competing or complementary franchise systems. The CIM will provide a much more defined picture of the economics of the franchise system than what is available in the FDD, and will highlight the strengths of the franchisor and the franchise system (or at least the strengths that the seller and the investment banker wish to showcase). Together, a review of the FDD and CIM will be helpful in gaining a holistic view of the target and should prompt franchise counsel to focus on certain areas or issues during diligence.

b. Communication Between Outside Counsel and Buyer’s Team

Following the preliminary review of initial documents, franchise counsel should engage in discussion with the buyer and deal counsel to understand the strategy for the transaction and the post-closing operations. For example, does the buyer wish to engage in substantial franchise expansion, and if so, is there geographic white space to promote development, and if so, will growth be targeted with existing developers or new franchisees and developers? If the preliminary business diligence conducted by the buyer indicates pockets of underperforming franchisees, does the buyer wish to either implement a repurchase program or try and have some of the stronger franchisees acquire underperforming franchises? If so, do the terms of the franchise agreements include obstacles for that plan? Does the buyer wish to expand with future franchise system acquisitions, in the same or similar industries? If so, do franchise agreement provisions permit that?

While valuation is not typically part of franchise counsel’s role, particularly on the buy-side, it is desirable for franchise counsel to understand how the buyer is valuing the purchase and the basis for its pricing. Anticipated revenue streams from the franchise operations is a key component. But how is the buyer evaluating revenues from existing franchisees, expected development of new outlets by area developers and new franchisees, modifications for existing royalty streams (e.g., increases in the future?), and potential new revenue sources (e.g., through supplier rebates or as a direct vendor)? Franchise counsel can use that information to evaluate specific elements of the franchise system’s franchise agreements, such as restrictions or flexibility to change royalty or advertising fund fees in the franchise agreements, area developer compliance with development schedules (even if formal default notices have not been issued), or restrictions, or flexibility to modify supplier arrangements and/or the ability to use vendor commission payments or rebates.

Communication and collaboration are key elements to a successful franchise acquisition. In addition to providing substantive legal advice, another key topic of conversation is understanding each counsel's respective role in the transaction. While franchise counsel will clearly work on "franchise" issues, the lines between franchise and other issues can become blurred. A cursory review of the topics covered in the purchase agreement reps and warranties section in the purchase agreement will highlight potential overlaps between subject matter review by franchise counsel and other deal or specialist counsel. For example, trademarks and intellectual property, supplier arrangements, technology agreements, and labor and employment are areas where franchise counsel can lend guidance, take an active role, or defer to deal counsel. In many (if not most) franchise acquisition transactions, deal counsel will have its own specialty counsel to address those issues. Nonetheless, it is important that all counsel understand their respective roles to avoid over-stepping and increasing costs, as well as to avoid issues falling through the cracks.

C. The Transaction: Seller, Bidders and the Buyer

1. Buyer Diligence in a Franchise System Transaction

Franchise diligence is at the heart of the franchise counsel's role in these transactions. Franchise counsel is likely to understand the legal, economic, and business elements of a franchise system better than anyone on the buyer's team. The goal of diligence is to assess the health, strength, defects, and value of the assets of the franchisee system, and to identify potential risks.[22]

a. Franchise-Specific Issues in Document Review

A critical and substantive role for buyer's franchise counsel is to prepare franchise-specific diligence requests. Depending on when franchise counsel becomes involved in the transaction, the franchise diligence requests may be incorporated with deal counsel's diligence requests (and counsel will need to harmonize the requests), or there may be supplemental requests. Franchise counsel must be mindful of the buyer's strategy, and the potential phases of the transaction. While turning over every stone in diligence is sound legal practice, the buyer may only want to identify "red flag" issues at an early stage. Or, the buyer may wish to avoid being perceived as challenging to work with and will request a "light" diligence. Franchise counsel's knowledge and experience of the relevant legal issues and risks is critical here. Tailoring the diligence request to meet the needs of the deal and the client is paramount.

As noted above, seller's counsel should have started the process of populating the data room with relevant franchise-specific documents that are responsive to buyer's counsel franchise diligence list. Buyer's franchise counsel should not expect to receive all of the requested documents and files, nor to receive them promptly. Sometimes the seller's delay is strategic, but sometimes the seller and its counsel and advisors are overwhelmed addressing other issues. Therefore, buyer's franchise counsel must be prepared to identify critical requests, and those requests that can be scaled back, pursued later in the process, or possibly even ignored.

The buyer's franchise specific diligence should have both a macro and micro approach to the target franchise system, seeking an analysis of the overall franchise system, on a holistic basis, as well as the individual assets that comprise the franchise system – the franchise

[22] *See, e.g.*, Vines, *supra* note 6, at 77-127.

agreements and detailed aspects of the franchise operations. At the macro level, the buyer will assess system-wide legal compliance with franchise laws, and compliance with the franchise contracts, the knowledge and experience of senior level franchise management, the operations infrastructure including franchise sales, training, and franchisee support, and overall franchisee satisfaction. At the micro level, the diligence will review many of the documents identified in Section III.B.2, including the executed franchise agreements and development agreements, FDDs, FDD receipts, state registration documents, default and termination letters, termination notices, transfer consent documents, FPRs and substantiation of FPRs, the system operations manual, advertising fund and advertising coop documents, reports regarding the use of ad funds, supplier agreements, rebates and the use of rebates, third party franchisee satisfaction survey results, among others. Attached as Appendix C is a sample or generic due diligence request list, that provides additional details and additional potential document requests.[23]

Some of the franchise questions to raise in diligence, or issues to ferret out by diligence, include the following topics:

- franchisor compliance with the franchise sales, disclosure and registration laws
- franchisor compliance with the franchise relationship laws, and in particular termination and non-renewal
- franchisor compliance with existing franchise agreements
- compliance by the franchisees with existing franchise agreements
- area developer compliance with development obligations
- modifications or amendments to franchise agreements and development agreements that reduce the financial return to the franchisor or reduce the obligations of the franchisee or developer
- franchisor waivers of franchisee obligations, including payments, development obligations or deadlines, upgrading or modernizing the outlets, or adherence to brand standards
- franchisor waivers of enforcement of post-termination obligations such as non-competition agreements
- franchisee complaints, written or verbal, regarding franchisor support, services or contract compliance
- overall franchisee satisfaction, sometimes evidenced by third-party franchisee satisfaction surveys
- unusual or problematic contract terms

[23] *See, e.g.*, P. Thao Le et al, *Franchise Related Mergers & Acquisitions*, IFA LEGAL SYMPOSIUM Exh. B (2014); Alan R. Greenfield et al., *Mergers & Acquisitions: The Basics of Buying and Selling the System*, ABA 40TH ANNUAL FORUM ON FRANCHISING W-18 (2017) Appx. 1; Sandra Bodeau & Meg Montague, *Basics: Franchise-Related Mergers & Acquisitions*, IFA LEGAL SYMPOSIUM Exh. A (2016).

- training, manuals, or franchisee support services that might provide support for joint employment claims by third parties

- use of supplier rebates or commissions contrary to the franchise agreements and FDD

- evidence of franchisee compliance with insurance requirements

- the existence of data breaches in the system, and responses to same

- franchise system crisis response plans

- to the extent the franchise system has international operations, many of the issues above should be evaluated with respect to the countries in which the franchise system operates

The foregoing is not an exhaustive list, and any diligence request should be tailored to address the franchisor seller, specific aspects of the franchise system and the industry in which it operates, and the buyer's strategic objectives.[24] The scope of the document diligence will often be limited only by the time allotted in the transaction, the buyer's budget, and the nature of the target company. But franchise counsel must remember that it will rarely have unlimited time or funds. Moreover, the buyer is looking for counsel to be judicious in its approach, and only raise issues that can have an impact on the transaction.

b. Management Call

Document review and evaluation is but one aspect – albeit a large one – of franchise diligence. But there are many facets of a franchise system that are not reduced to paper and cannot be assessed simply by document review. In addition, when performing due diligence on a large franchise system, where the diligence must be tailored and targeted, and in some cases where diligence only entails a select representative sample of documents, a discussion with seller's management is both valuable and necessary. During typical acquisition transactions, buyer's management and counsel will have an opportunity to have at least one diligence call with seller's management. In most cases, franchise counsel will have a small window of time for questions for management, in an already compressed time frame. The management call can provide counsel with a "feel" for the management and internal legal processes, as well as answer specific questions raised by the document review or fill the gaps left unanswered in the documents. So it is important to identify key issues that are not readily apparently from the documents. Some examples include the following:

- a description of franchise sales and franchise compliance processes, including discovery days, responding to prospect request, franchise validation process, and FDD updates, registrations and "dark period" process

- defaults, terminations, and transfer, including the process the franchisor uses for franchisee notifications, and resolutions in lieu of formal default notices

- franchisee relationships and franchisee satisfaction

[24] For additional due diligence lists, please see the papers and their exhibits referenced *supra*, note 23.

- joint employment complaints, even if no claims were filed
- enforcement of non-competition, non-solicitation, non-disclosure, and no poach agreements
- territorial disputes or encroachment complaints
- modifications of royalties or other payment obligations
- other specific issues that have risen from the document diligence

The information obtained from the management call should assist counsel in providing advice and risk assessments to management of the buyer. In addition, it can be relied upon when providing the due diligence report to management, and in any diligence call with franchise counsel for a lender or a representation and warranty insurer.[25] If counsel for those third parties are experienced franchise practitioners, they will understand the limitations of franchise document diligence and should be able to appreciate the soft franchise diligence and facts that derived from these management calls.

c. Supplemental Diligence

The diligence process is often very fluid. After the initial round of document review, and hopefully a management call, franchise counsel can hone in on specific issues. In addition, counsel may be asked to submit a supplemental franchise diligence request. This list should be tailored to focus on (a) critical unresolved issues, and (b) unanswered document requests. Often counsel will be requested to prioritize the requests. This is an area where it is important to know your client, be keyed into the strategic and business aspects of the transaction, and to understand whether you and the buyer need to turn over every rock, stone, and pebble, or be more tailored. Therefore, counsel should avoid labeling all or many requests as “high priority.” This is another point in the process where experienced franchise counsel should be able to justify – to the seller, and to its client, the buyer – why certain diligence items are crucial.

d. Due Diligence Report

Franchise counsel will be asked to prepare and deliver to the buyer a report summarizing its findings during the diligence process of franchise issues, sometimes referred to as a due diligence memorandum or due diligence report. The length, detail and complexity will vary based on the deal, the buyer’s request, and potential other recipients of the due diligence report. It may also vary based on the buyer’s experience with franchising, the target industry, or even the target company. Costs and budgets will factor in as well.

The primary recipient of the due diligence report is the buyer. Some buyers desire a report that identifies only the most critical issues and concerns uncovered during diligence, often called a "red flag report.” Due diligence reports can be more detailed, with extensive charts and summaries of the findings to help clearly analyze the legal, financial, business, and franchise relationship risks. They may include descriptions of the franchise laws, and the potential impact of any franchise law violations, or franchise agreement breaches that may have been uncovered. Regardless of the length or complexity, franchise counsel’s report should clearly assess the risk

[25] See further discussion of rep and warranty insurer *supra* Section II.C.2 and *infra* Section IV.C.

and potential impact on the transaction – for the purchase agreement and post-closing operations. While not all buyers will ask counsel the following question, this inquiry should guide the ultimate conclusion and recommendation: "Have you seen anything that indicates that we should not do this deal?" The second question may be: "Can you quantify the risks, the likelihood of an adverse finding, and the financial impact should that risk ripen into a claim?"

In many transactions, the buyer (possibly a PE firm) will be borrowing a significant amount of money, sometimes 50% to 70% of the purchase price. The lending institutions will conduct their own diligence of their investment in the buyer.[26] The lending institution will request copies of the due diligence reports prepared from all of buyer's advisors and counsel, including franchise counsel. Therefore, franchise counsel should expect that the due diligence report will be reviewed and to some extent relied upon by lenders.[27] While counsel should always be truthful and honest, knowing that lenders will review the report may influence the tone of the due diligence report. If problems with the target have been identified, it is important to franchise counsel to explain clearly those problems, and associated risks, so that a lender has a complete picture. For example, assume the franchise system seller has 400 outlets, and franchise diligence has discovered that approximately 10 to 20 franchisees may have claims for damages or rescission due to an improper disclosure or timing of disclosure, or a potential franchise law violation. To an untrained ear, that may sound significant (and in fact it may be). However, if the buyer's counsel evaluates those potential defects and situations carefully, it may determine that a significant number are in non-registration states in which only the FTC Franchise Rule (and possibly a state "baby" FTC Act) will apply; and there is no private right of action for an FTC Franchise Rule violation. In addition, some of the potentially affected franchisees may be strong performers and very profitable, and would be unlikely to bring a claim. Or, there may be contract amendments signed subsequent to the potential violation in which the franchisor obtained a release. All of these mitigating factors, and other legal, regulatory, and business context should be included in the due diligence report.

Another potential recipient of the due diligence report is the Reps and Warranty Insurance carrier and its counsel, if RWI is purchased. Franchise counsel for the RWI carrier will utilize the due diligence reports to the buyer to inform its evaluation of the business and the risk. One aspect of RWI to be aware of is that many RWI policies will not provide coverage for (or will exclude) losses for breaches of reps and warranties if the breach was known by the policy holder. Therefore, if franchise counsel discovers defects in the target franchise system – for example, issues related to franchise law compliance, or contract enforceability – and those defects are highlighted in the due diligence report, if there is a breach of the rep, the buyer may not be able to recover its damages. In addition, depending on the policy and the carrier, as well as the scope of the non-compliance by the selling franchisor, the RWI Insurer may wish to exclude coverage for certain reps and warranties. Therefore, while franchise counsel should not cover or hide adverse issues, particularly because its client, the buyer, needs to understand them, franchise counsel should recognize how its report can impact other elements of the transaction and the buyer's protection.

---

[26] *See, supra*, Sections II.C.1 and *infra* IV.B.

[27] Before buyer's franchise counsel provides a copy of their diligence report to the lender, buyer's franchise counsel will often require the lender to sign a non-reliance letter which is a letter agreement stating that the diligence report was created for the buyer, and that the lender will not rely on the diligence report in making its determination, with some exceptions. These are commonly used by corporate counsel and other specialty counsel that create diligence reports that lenders consider in determining whether to lend to the buyer.

2. The Purchase Agreement and Disclosure Schedules – Incorporating Franchise-Specific Issues

In many franchise system M&A transactions, seller's deal counsel will create the first draft of the purchase agreement. If there is an auction process, this draft – sometimes referred to as the "bid" draft – will be included in the data room. It will be drafted in a "seller-friendly" manner. Nonetheless, seller's franchise counsel should carefully review the franchise-specific provisions of the draft, for both protection of the seller and clarity of interpretation and enforcement. Seller's franchise counsel should be prepared for and understand that these franchise-specific provisions, most notably the reps and warranties, will be changed and potentially expanded as part of the negotiation process.

One of the most critical roles of buyer's franchise counsel in an M&A transaction is to review, analyze, and revise the purchase agreement to incorporate the franchise aspects of the deal. This is where franchise counsel brings the depth and breadth of his/her experience, and shapes advice and contract provisions based on diligence, communications with buyer's management and deal counsel, and a savvy understanding of balancing the need to protect and represent the buyer, with the buyer's desire to close the transaction and acquire the franchise system.

There are generally four areas of a purchase agreement that reflect specific franchise revisions: a) reps and warranties, b) definitions, c) indemnification and RWI, and d) pre-closing covenants.

a. Franchise-Specific Provisions and Reps and Warranties

i. Franchise Reps and Warranties

The overall purpose of the reps and warranties in a purchase agreement is for the seller to make representations as to the quality of the assets being sold. Comparing the transaction to the sale of a house, the buyer wants assurances that the structure and components are sound, and if there have been problems (e.g., the hot water heater is fifteen years old and was last serviced five years ago), then adjustments in price, or pre-closing repairs, may be required. The same is true for selling a franchise system. Part of due diligence is designed to ferret out those actual and potential problems. The next step is to have the seller represent as to the soundness of the business and the franchise system. Appendix D includes a list of common representations and warranties included in the purchase agreement.[28] The buyer is acquiring the franchise system, which includes the existing franchise agreements and the expected revenue streams from ongoing franchised outlets, as well as the right to develop more outlets. Therefore, the seller, owners of the seller, and the certain management personnel of the seller should make the representations and warranties regarding the franchise system.

What can be a fly in the ointment? All sorts of potential legal and contractual issues can arise. The most significant area that typically arises for franchise counsel is compliance with franchise sales laws. Buyer's counsel will want to know whether the franchisor offered and sold franchises in compliance with the FTC Rule and state laws, or if one or more franchisees have

[28] Others have provided examples of representations and warranties for purchase agreements. *See, e.g.*, Vines, *supra* note 6, at Appx. A-2; Brian Balconi et al., *Franchise-Related Mergers & Acquisitions*, IFA LEGAL SYMPOSIUM Exh. B (2019); Sandra Bodeau & Meg Montague, *Basics: Franchise-Related Mergers & Acquisitions*, IFA LEGAL SYMPOSIUM Exh. A (2016).

grounds for rescission or damages. Some of the subsets of franchise sales law compliance that should be addressed in the reps and warranties include:

- Were the FDDs drafted properly, or were there material deficiencies or omissions?
- Did the franchisor properly register the FDD in the appropriate states?
- Did the franchisor timely deliver each FDD and obtain an FDD receipt?
- Did the franchisor provide financial performance representations outside of the FDD?
- Did the franchisor comply with franchise advertising, franchise salesperson, and franchise broker requirements under applicable state laws?
- Did the franchisor comply with the fourteen day and seven day rules regarding disclosure and contract execution?
- Did the franchisor include the required state addendums?
- Did the franchisor comply with state franchise relationship laws with respect to terminations, non-renewals, and transfers?
- Is the franchisor in default under any of the franchise agreements?
- Are there franchisees in default under their franchise agreements?
- Is the franchisor in compliance with other applicable laws, such as customer data protection, privacy, pricing, and rebates?

A representation regarding compliance with franchise laws can be very short, and very straightforward. For example, a rep that says that the franchisor complied with all franchise laws would cover all issues regarding federal and state franchise sales, disclosure and registration laws, franchise sales practices, business opportunity laws, and franchise relationship laws. But many purchase agreements include additional and more detailed reps that are, arguably, just subsets of the larger rep. One reason buyer's franchise counsel may request these additional reps is to force the seller and its counsel to focus on the details underlying the rep, and therefore identify issues ahead of time, in diligence or in the disclosure schedules. The detailed reps are not intended as a game of "gotcha," but to flush out specific compliance issues. The second reason for the detailed reps relates to post-closing enforcement, and interpretation of claims under the indemnification provisions of the reps & warranties insurance. For example, if the buyer wants or needs to make a claim, such as due to a franchisee rescission claim based on an improper registration or a financial performance representation under the indemnification provision, by having reps with specific franchise compliance issues identified, it will be clear that a definite breach of a rep has occurred, which will reduce the opportunity for the seller or its counsel to claim that they were not addressing that particular detail in the general rep.

These are a few of the issues that are evaluated in diligence. Then, the buyer will want the seller to provide reps and warranties that none of these events or situations exist. But there

is more to assessing the health of the franchise system than just compliance with franchise laws and franchise agreements.

A healthy franchise system includes strong franchise operators and minimal risk of franchisee unrest and dissatisfaction, or potential claims from franchisees or third parties. So a buyer will want to dig deeper into the franchise agreements and franchise relationships, and the reps and warranties will reflect that analysis. Some franchise-related reps and warranties that may be included in a purchase agreement include:

- The franchisees have complied with their insurance requirements, including naming the franchisor as an additional insured.

- The franchisor's collection, use, and reporting on advertising fund contributions and expenditures have complied with the franchise agreement obligations and the FDD disclosures.

- The franchisor has enforced the post-termination obligations against former franchisees, such as enforcement of the non-competition and non-solicitation agreements.

- The disclosure of any pending litigation or complaints filed, or a schedule of franchisee complaints regarding the franchisor's practices or compliance with the franchise agreements, even if there are no formal lawsuits or actions filed. This information, much of which should be gained from diligence, may highlight underlying system issues that have not yet bubbled up to the surface. Therefore, it is appropriate for buyer's counsel to request a rep that addresses such un-filed complaints.

ii. Other Reps and Warranties.

Similar to the discussion above regarding the detailed compliance with laws reps, there often are reps and warranties for detailed contract matters and franchisee relations. These reps and warranties regarding intellectual property, joint employer, and material contract modification are useful in forcing the seller to focus on the details that a buyer considers critical. Some of the general reps and warranties that may impact the franchise system include:

- Compliance with Laws. Purchase agreements have broad reps stating that the seller has complied with all laws.[29] Such a rep will generally overlap with one or more franchise reps that address compliance with franchise laws. That is beneficial for the buyer, and to the extent possible, buyer's franchise counsel should seek to retain this, and not permit "ring-fencing."[30] The representations

[29] This rep, like many others, may be limited in time to the previous two or three years, or limited by a materiality qualifier.

[30] "Ring-fencing, as applied to M&A purchase agreements, refers to limiting the scope of a topic, or in this case the topic in a rep and warranty, to one particular section or rep. For example, purchase agreements may provide that all reps and warranties regarding franchise matters are set forth in the "franchise matters" rep and no others. Therefore, any representation that a seller makes in the general "compliance with law" rep, or the "labor and employment" rep, or the "intellectual property" rep, will not apply to any franchise issues. For example, if the "compliance with law" rep is broader than the compliance with franchise disclosure laws in the franchise matter section, the seller would not be bound by the broader rep.

regarding compliance with applicable laws should specifically include the federal and state laws relating to franchising, including the FTC Franchise Rule, state franchise registration laws and regulations, state business opportunity laws, and state relationship and termination laws. Sellers may want to narrow this rep to material compliance during a pre-determined look back period since in a long-standing or large franchise system, it can be dangerous for a seller to generally represent that they have been fully compliant with all franchise laws at all times since the beginning of the business. Buyers, on the other hand, may push for as broad a definition as possible and require indemnity for any omission or action likely to lead to liability to a franchisee in the system due to the actions of the seller.

- Material Contracts. Purchase agreements will identify contracts that are material to the business,[31] and will include reps and warranties regarding those material contracts, such as enforceability, validity, and that there have been no material defaults under the material contracts. Franchise agreements may be specifically identified as a material contract, they may be captured by some other description in the rep,[32] or they may be specifically excluded. Franchise counsel for both seller and buyer will likely seek to modify the material contracts rep, and/or the franchise reps, so that there is no conflict, and most importantly, so that the seller is representing to critical contract enforcement and rights covering the franchise agreements.

- Intellectual Property. The intellectual property (or IP) reps and warranties will often be quite extensive, and will include not only trademark and trade secret matters, but license agreements, data privacy, copyrights, co-branding agreements and IP development agreements. Franchise rights and franchise agreements also may be included in this rep. Franchise counsel, in coordinating with the IP counsel on buyer's deal team, should ensure that the critical IP and trademark assets and licenses central to the franchise system are addressed in these reps. However, for ease of contract interpretation and enforcement, core franchise assets and franchise elements, such as franchise agreements, should be kept out of the IP reps and addressed only in the franchise reps.

- Labor and Employment. Generally, labor and employment reps in a purchase agreement will not involve franchise matters. However, in the last several years, with the rise of joint employer claims in franchising, and issues concerning the classification of franchisees as employees versus independent contractors, labor and employment matters will touch on franchising, and in some industries may be central issues in the franchise system. Therefore, buyer's franchise counsel should seek to include reps and warranties regarding joint employer and/or employee misclassification issues, whether in the labor and employment rep or the franchise rep, and evaluate the entire labor and employment rep to assure consistency and appropriate treatment. In some deals, buyer's management or deal counsel will instruct franchise counsel to "go light" in marking up the seller's purchase agreement draft, so as not to create an extensive red-line or create the

[31] Examples of material contracts include other purchase agreements in which the seller acquired other entities, debt financing agreements, real estate agreements, human resources agreements, licensing agreements, and other contracts that are integral to the function of the seller's business.

[32] For example, the franchise agreements may incidentally be captured in the representations and warranties regarding intellectual property.

impression of an overzealous lawyer seeking too many insertions. One method to limit the red ink in the franchise reps is to include these employment-related reps in the labor and employment reps and warranties section of the purchase agreement.

b. Definitions

One area of the purchase agreement that should not be overlooked by franchise counsel is the definitions section. While most of the definitions address business, economic, tax, and structural issues, there are a number of critical franchise-specific definitions. Some franchise definitions to address are:[33]

- Franchise Agreements. As noted above, this term should include all forms of franchise and franchise-related agreements, including license agreements, area development agreements, master franchise agreements, area representative agreements, and option agreements. It should include all addenda, amendments, side letters and exhibits. This litany of contracts will be useful because the seller will be making reps and warranties regarding the "franchise agreements" and the disclosure schedules will often include a list of current franchise agreements. Therefore, the detailed definitions will capture all applicable contracts that are part of the franchise system.

- Franchise Laws. As noted above, the seller will rep to compliance with franchise laws. Therefore, the definition of "franchise laws" should include federal, state and, if applicable, international, franchise laws, and should refer to the FTC Franchise Rule, state franchise disclosure laws, business opportunity laws, and state franchise relationship laws.

- Franchisor and Seller. Depending on the structure of the seller's ownership, the existence of a holding company, and other entities that may comprise the selling group, it may be beneficial to identify the franchisor entity, as well as any entity that owns, manages, or controls "company-owned" outlets, and affiliates that are suppliers to the franchise system. This helps with clarity in the reps and warranties.

- Knowledge. Many reps and warranties will be subject to qualifiers such as the "knowledge" of the company or the seller. The definitions generally define what is meant by "knowledge" and will limit knowledge to the actual knowledge of specified individuals, usually certain "C-suite" individuals. Some franchise reps and warranties may include a knowledge qualifier. However, many franchise-specific issues, such as those related to franchise sales and franchise law compliance matters, may not be known by certain higher level executives. A buyer who may agree to a knowledge qualifier in the franchise reps will want to know that even if a rep is so qualified by "knowledge," the knowledge qualifier does not eviscerate the rep completely because there is nobody identified in the definition of "knowledge" who does or should have actual knowledge of the franchise activities. Therefore, it is appropriate for buyer's franchise counsel to request that the definition of knowledge include specifically identified franchise executives for the franchise reps in the purchase agreement.

[33] For a discussion of other franchise-related definitions to address in a purchase agreement, *see* Greenfield, *supra* note 14, at 20–22; *see also* Vines, *supra* note 6, at Appx. A-1.

Depending on the nature of the transaction, the history of the franchises, changes in ownership of the seller, multiple brands, and other issues, there may be other franchise-specific issues in, or changes to the purchase agreement. Franchise counsel should not assume that the definitions are legal boilerplate or the sole province of deal counsel.

c. Indemnification

Most purchase agreements will include an "indemnification" section which contains, among other things, provisions in which the seller will indemnify the buyer for breaches of the reps and warranties. The indemnification provisions will often include a "cap" and a "basket," and these may cover the franchise reps, and franchise counsel's advice to buyer.

An indemnity "cap" is the maximum limit of the seller's exposure for breaches of reps and warranties. Certain reps and warranties are referred to as "core" or "fundamental" reps, such as the seller having title to the assets and the ability to sell the equity or assets, and the cap is often the sale price for the transaction. Most other reps, including the franchise reps and warranties, will have a much lower cap, possibly in the range of 10% to 15% of the total enterprise value or sales price.

An indemnity "basket" is the amount of losses or damages that a buyer incurs before the seller is liable for indemnification payments, similar to a deductible in an insurance policy. There are generally two types of baskets: true deductibles and threshold or tipping baskets. With a true deductible, the seller is responsible for all losses that exceed the basket amount. With a threshold/tipping basket, the seller is responsible for all losses, from dollar one, once the basket amount is reached. Although it can vary, a basket is often set at about 1% of the total enterprise value or sale price, but that level tends to decrease as the total enterprise value increases.

Franchise counsel needs to evaluate the scope of the indemnity, as well as the cap and basket, in light of the franchise reps and warranties and the diligence performed. If franchise counsel's evaluation of the franchise system through diligence discovers any defects in the franchise agreements or violation of franchise laws, franchise counsel should explain to the buyer the expected and potential damages should there be a breach of the franchise reps. For example, if franchise counsel has uncovered or suspects a handful of franchise sales may have violated the applicable state franchise laws, counsel should provide rough calculations as to the potential damages should an affected franchisee seek rescission or other damages. Whether those amounts are relatively small or modest compared to the basket, or whether they may exceed the cap, will factor into the buyer's negotiation with the seller over the indemnification.

Reps and warranty insurance ("RWI") has become more prevalent in M&A transactions in the last several years (at least pre-COVID), including in franchise transactions. Under a RWI policy, the buyer will recover losses from breaches of the seller's reps and warranties directly from the insurer. As the M&A market became more heated, with active auctions, and higher valuation multiples, sellers were less willing to provide indemnification. Therefore, a buyer's only recourse is to obtain (and pay for) RWI. The existence of RWI should increase a seller's willingness to provide more comprehensive or stronger reps and warranties, because the burden for a breach has shifted from the seller to the insurer. For franchise counsel, this dynamic could impact the scope of diligence, and scope – and limitations – in the franchise reps and warranties.

d. Pre-Closing Covenants

Pre-closing covenants are another crucial aspect of a purchase agreement in a sign-and-then-close transaction. Many pre-closing covenants address continuation of the business, in the ordinary course, prior to closing. But there are some franchise-specific issues that could be addressed (depending on the transaction and the franchise system), such as:

- the franchisor cannot terminate or not renew a franchisee, except in the ordinary course of business, or only with buyer's prior approval
- the franchisor cannot sell or close on the sale of a franchise, except in the ordinary course of business, or only with buyer's prior approval
- the franchisor will not amend any existing franchise agreements, or not make any material amendments to the financial or economic terms, territorial rights, or length of term of the franchise agreements, except with buyer's prior approval
- the franchisor will not communicate about the proposed transaction to the franchisees without the review and approval of the buyer
- the franchisor will not materially amend any contracts or arrangements with all or certain suppliers
- the franchisor will not make any public statements about the transaction, or file any documents with government authorities (including new or amended FDDs), without the buyer's prior approval

Hopefully, by the time there is a signed purchase agreement, the seller and buyer, and their management teams are working in a collaborative manner, based on trust developed during the courting, mating, and diligence processes, so that these types of limitations on the franchisor will be an accepted and natural outgrowth of the relationship.

e. Review, Comment on, and Possibly Revise Disclosure Schedules

Once a near-final version of the purchase agreement has been reached by the parties, the seller will prepare the disclosures schedules with all of the required information and data points.[34] Once prepared, buyers' franchise counsel should review the schedules for any franchise-specific disclosures, as well as related disclosures to ensure nothing slips through the cracks. For example, in addition to reviewing the franchise-specific disclosures, buyers' franchise counsel should consider reviewing the intellectual property schedule to ensure the franchising entity has the rights to license the trademarks to its franchisees. Another related disclosure schedule to review is the disclosure regarding ongoing litigation to determine if any litigation listed impacts the franchise representations, warranties, or disclosures. Also, as discussed earlier regarding the benefits of detailed reps and warranties, reviewing the disclosure schedules may highlight areas of franchisor deficiencies that were not identified during diligence.[35] Sometimes the earlier omissions were inadvertent oversights; but sometimes the earlier omissions and the

[34] *See, supra*, Section III.A.10.

[35] *See*, *supra*, Section III.A.11.

eleventh hour revelations in the disclosure schedules are strategic. The seller may wish to reveal these deficiencies when the buyer is very close to signing the purchase agreement and be less likely to re-open negotiations. In those situations franchise counsel, in collaboration with deal counsel, can play a vital role in helping its client, the buyer, understand these risks.

Franchise counsel should share with the buyer any discrepancies between the information the seller provided in the disclosure schedules and the information gathered during due diligence. This will allow the buyer to understand whether the schedules are complete and whether any revisions to the schedules are necessary. It is important to remember that nearly all of the disclosure schedules are embedded in the seller's reps and warranties, so the seller is representing and warranting the information in the disclosure schedules is true and correct as of the date of the purchase agreement. Any inaccuracies in the schedules could be considered a breach of the agreement on the part of the seller.

D. Closing and Post-Closing Period

1. Communication with the Franchise System

A selling franchisor has to decide when to communicate the sale of the system to its franchisees and how it will manage franchise sales during the process. While there is no duty under either the FTC Franchise Rule or state franchise statutes to disclose a sale to existing franchisees, franchisors don't want their franchisees to feel blindsided by the news. However, it can be difficult for a franchisor to know when it is the right time to disclose the news. If a franchisor discloses a pending sale too soon and the deal falls through, the announcement can cause unnecessary anxiety and create a distraction in the system. If the franchisor waits too long and the system learns of the sale from outside sources, the lack of a proactive announcement may create distrust and damage the franchisor's relationship with the franchisees. If the franchisor is a public company, there is the additional complication of compliance with federal and state securities laws, which regulate when the sale must be disclosed.[36] Each situation must be analyzed on its own facts, and franchise counsel plays a critical role here, by interacting closely with deal counsel and the seller.

2. Managing the Franchise Sales Process

Another decision the franchisor must make is when to enter a dark period for franchise sales and stop selling new franchises as a result of the transaction while it updates the FDD with the relevant new information regarding the sale and amendments are filed with the states. Federal franchise law requires franchisors to amend their FDD when there has been a material change to the disclosures.[37] A material change is not defined under federal franchise law; however, in publishing the amended franchise rule in 2007, "the FTC concluded that 'materiality' is determined . . . in franchise matters, by the reasonable prospective franchisee standard."[38] There is no hard and fast rule regarding what is a material fact, and materiality is highly fact dependent; therefore,

---

[36] *See* Basic Inc. v. Levinson, 485 U.S. 224, 109 S. Ct. 978 (1988); *see also* P. Thao Le et al, *Franchise Related Mergers & Acquisitions*, IFA LEGAL SYMPOSIUM at 29-32 (2014); Joel R. Buckberg and Richard G. Greenstein, *The Basics of Buying and Selling a Franchise Company*, ABA 28TH ANNUAL FORUM ON FRANCHISING W-11 at 45-51(2005).

[37] 16 C.F.R. §§ 436.7(b), (d).

[38] Marisa D. Faunce et al., *Assessing Materiality: What to Include and When to Amend*, ABA 35TH ANNUAL FORUM ON FRANCHISING W-9 (2012) (citing 72 Fed. Reg. at 15455).

there is no bright line standard as to when to amend the FDD when a franchisor is considering a merger or acquisition of the franchise system.

The decision regarding if and when to amend the FDD also impacts the franchisor's decision when to stop selling franchises. Federal and state franchise laws prohibit the sale of a franchise that is deceptive or misleading, which would include the omission of a material fact in the FDD. The two principal considerations a franchisor should include in their analysis of when to stop selling franchises include the likelihood the transaction will close, and the likelihood that the information regarding the transaction would be material to a prospective franchisee. This follows from the seminal case regarding disclosure of merger activity under the SEC's Rule 10b-5, *Basic v. Levinson*[39], which held that disclosures of merger activities should follow a flexible standard that weighs the probability that the transaction will be consummated, and its significance to the investors in the securities. In a franchise merger, for example, a potential merger between two competitors likely would be material to a prospective franchisee, but if the parties have only signed a non-disclosure agreement or even an LOI, there is still a low chance that the transaction will close. However, once the parties sign a purchase agreement (or at some other point the parties decide the scales tip toward a "high chance of closing"), the parties should consider stopping the sale of franchises and going dark until the FDD has been amended.

More conservative franchisors, as well as those who don't rely heavily on initial franchise fee revenue, may decide to stop selling franchises during the negotiations, through the LOI phase, and through the closing, and only recommence franchise sales after the FDD is amended. A similar conservative approach is to cease franchise sales early in the process, but amend the FDD (primarily in Item 1) to disclose that the franchisor is seeking investors or considering the possibility of a sale, and then resume franchise sales with the amended FDD. Another slightly less conservative approach – moving down the spectrum from conservative (stopping sales early) to more risky (not stopping sales until the FDD is amended after a closing) – would be to stop sales and amend the FDD to disclose a possible sale once an LOI has been signed or when the buyer's due diligence period ends. Another less conservative approach, but one many franchisors, sellers and buyers pursue, is to not cease franchise sales until a definitive purchase agreement has been signed by the parties. In many scenarios, the franchisor or the proposed buyer of the franchise system may not be willing to stop franchise sales until the point when the purchase agreement has been signed and all closing conditions have occurred. A potential buyer may not want to shut down the sales pipeline just before it acquires the system. The buyer and the franchisor may believe that the franchise system sale is a positive change that benefits the system, and would not be viewed as adverse.[40] In any case, franchise counsel's role will be to advise management (that is the franchisor seller and the buyer) and the franchisor's sales team regarding options, risks and requirements for the various situations to ensure compliance with the FTC Rule and state disclosure laws, and where necessary, update the FDD with the required relevant information.

[39] 485 U.S. 224, 109 S. Ct. 978 (1988).

[40] It is important to note that franchise material change rules and guidance are not predicated on only "adverse" material changes. However, from a practical, litigation risk perspective, it is the non-disclosed adverse material changes that are more likely to generate disputes.

3. Advise on Pre-Closing and Post-Closing Franchise Law Compliance

a. Prospective Franchisees

Although federal and state franchise laws do not specifically address when a pending sale must be disclosed to prospects, they do require that a franchisor provide prospective franchisees with all information that would be considered material in making a decision to purchase a franchise.[41] In a situation where one PE investor is selling its interest in a system to another PE firm, but current management is staying in place and no new lines of business are being added, the franchisor may be comfortable waiting longer to disclose the news, believing that prospects may not consider that change material to their decision about whether to move forward.

However, other situations may be significant enough that even a pending sale would be considered material. For example, if a franchise system is strongly associated with its founder who will not be staying post-sale, or if the franchisor is being purchased by a competitor, prospects may be more likely to consider that information very material to their decision to purchase a franchise. One way to handle this situation is to create a supplemental disclosure to the FDD advising of the potential sale, and that supplement can be provided to serious prospects[42]. This would need to be carefully drafted to emphasize that the sale may occur, but has not yet closed, in order to avoid a potential claim by a prospect who later argues that they entered into the franchise agreement because they were relying on the occurrence of the potential sale.[43] A variation on the "supplemental" disclosure is the preparation of a franchise system announcement, similar to an internal press release that would be provided to existing franchisees, that provides some basic information about the proposed deal, including an overview of what the transaction means for the franchise system, and including, if possible, information that might otherwise be in an amended FDD, such as Item 1 and Item 2 changes. This is often not done until the purchase agreement is signed. The franchise system can modify this announcement and provide it to prospective franchisees in the pipeline. While this may not meet the technical requirements of a state-mandated material change amendment, it can satisfy the FTC Rule requirements, and blunt any future claims that a prospective franchisee did not know of the franchise system sale prior to signing a franchise agreement.

b. Renewals, Resales, Add-On Franchises

Whether there is a duty to disclose a pending franchise system sale to an existing franchisee involved in a renewal, resale or the signing of a franchise agreement for an additional outlet may depend on whether the transaction involves an extension or assignment of an existing franchise agreement or the signing of the then-current new version of the franchise agreement. Under the FTC Rule and many state franchise laws, the renewal or extension of an existing franchise agreement, with no material changes in the agreement or arrangement, will not be

---

[41] 16 C.F.R. Parts 436 and 437.

[42] Under the FTC Rule, a franchisor must provide quarterly updates of its FDD to reflect any material changes. However, that update need not be a full amended FDD, but can be supplement or an attachment to the FDD. *See* FTC Franchise Rule Compliance Guide at 126 (May 2008) https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-rule-compliance-guide.pdf. However, such a supplemental disclosure is not permitted in all of the franchise registration states, and a full FDD amendment would be required.

[43] *See* discussion of supplemental disclosures in *Century Pacific, Inc. v. Hilton Hotels Corp.,* 528 F. Supp. 2d 206 (S.D.N.Y. 2007).

considered an offer or a sale of a franchise, and therefore, an FDD is not required.[44] In such a situation with the backdrop of a pending franchisor acquisition transaction, the renewing franchisee would not be treated as a new franchisee, and information about the transaction would not be required. Nonetheless, if the parties will be continuing under an existing franchise agreement, the franchisor could choose to advise the franchisee of the pending sale, to reduce the risk of a potential fraud claim. However, for a renewing franchisee or a transferee that is required to sign a new franchise agreement with materially different terms, these parties would be treated the same as a prospect and, under the FTC Rule, they would be entitled to the updated disclosure. This would present the franchisor with a choice: amend the FDD and disclose the renewing franchisee, thereby making the transaction public; or delay or defer the renewal, by executing a short term extension (which may hint that something is in the works); or bite the bullet and sign the renewal franchise agreement without an amended FDD or supplemental disclosure, hoping that the franchisee will view the M&A transaction positively.

Despite laws or regulations that state or suggest that a franchisor is not required to provide disclosure under the franchise laws and regulations, franchisors are subject to potential common law fraud claims, and state franchise laws that prohibit fraud and misrepresentation in the offer and sale of franchises. Therefore, franchisors may wish to consider whether to treat all renewals – as well as resales and add-on franchises, since they are new franchise sales – similarly to the treatment of prospective franchisees, as discussed in the preceding section. The seminal cases in this area, guiding franchisors on disclosure of pending merger transactions are *O'Neal v. Burger Chef Sys., Inc*.[45], and *Vaughn v. General Foods Corp*.[46] These cases, in which renewing franchisees claimed that the franchisor committed fraud for not disclosing a pending sale of the Burger Chef system to a competitor, stand for the proposition that a franchisor does not have a duty to disclose this type of transaction, absent unique facts establishing a fiduciary duty or franchisee reliance.[47]

Even if the franchisor permits the franchisee to continue on under the existing version of the franchise agreement, if the sale will cause material changes in the system, whether because of increased competition or because the franchisee will have to spend significant amounts of money on upgrades or other system changes, the franchisor may need to disclose the pending sale. If there are reasons that the franchisor is not ready to disclose the pending sale, as noted above, one option would be to enter into a limited extension of the existing franchise agreement until the sale of the franchisor is complete so that the franchisee or any potential transferee can make an informed decision about whether to continue operating in the system.

c. Engaging With Franchisee Associations

The state of the relationship between the franchisor and any franchisee association may determine when the franchisor discloses a pending sale to the association or permits the proposed buyer access to the group, perhaps under an NDA. In systems where relations between

[44] The FTC Compliance Guide specifically states that a franchisor is not required to provide an updated FDD under such circumstances. *See* FTC Franchise Rule Compliance Guide at 1, 19 (May 2008) https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-rule-compliance-guide.pdf.

[45] 860 F.2d 1341 (6th Cir. 1988).

[46] 797 F.2d 1403 (7th Cir. 1986).

[47] For additional discussion of these cases and the evaluation of whether or when to disclose a pending transaction to existing franchisees, *see* Thao Le, *supra* note 23, at 32-36.

the franchisor and franchisee association are collaborative and friendly, the franchisor may be willing to disclose a pending sale to the association leadership before announcing it publicly and also permit them to meet with designated members of the buyer before closing. In the best case, the association leadership may be willing to support the franchisor and reassure their fellow franchisees that the transaction can provide positive benefits, or at least, should not negatively affect their businesses. In systems where the relationship is adversarial, the franchisor may provide notice to the association at the same time it notifies the rest of its franchisees once the transaction has closed.

4. Draft or Review Seller's Draft of Post-Closing FDD

After the transaction closes, and possibly between signing and closing, there will likely be material changes in the franchise system such that an amendment to the FDD will be necessary. In some case, there will be a new franchisor, and a revised FDD will be required. Therefore, either seller's franchise counsel, or buyer's franchise counsel, or both, will prepare a revised FDD.

a. Possible Areas of Disclosure

Depending on the structure of the transaction, multiple items in the franchisor's FDD may need to be updated.

- Item 1. Changes to the franchisor entity for an asset purchase or changes or the addition of any parents or affiliates for an equity purchase need to be disclosed. Also, there may be aspects of the transaction and affiliates that may need to be disclosed. Any new lines of business also would need to be disclosed.

- Item 2. Any changes to the executive team would need to be disclosed.

- Items 3 and 4. Franchise counsel would need to disclose any litigation or bankruptcies whether related to new management team members, as well as any entity backing the franchisor financially or providing a guaranty of performance.

- Item 8. Any changes in the supplier arrangements, suppliers or rebates, particularly if an affiliate of the new franchisor or new equity owner will be a supplier to the franchise system.

- Item 11. Any material changes to key suppliers or requirements that franchisees purchase potentially expensive technology upgrades to run the business would need to be disclosed.

- Item 12. When a company or another franchisor in the same industry buys a franchise system, disclosure may be needed to reflect any changes to territorial rights or increased competition under different trademarks.

- Items 13 and 14. Any updates or changes to trademarks or other intellectual property, would need to be disclosed.

- Item 19. Another significant area of impact on the FDD is what can or must be disclosed regarding the franchisor's financial information and that of its franchisees. A selling franchisor may have a financial performance representation

("FPR") in Item 19 of its FDD. The buyer would need to have full confidence in the seller's data and calculations when deciding whether to rely on the seller's existing FPR. (This would be an instance where having a complete and well-organized data room, as well as evidence that the franchisor had consistently maintained complete and reliable records on franchisee performance would be very helpful to the buyer.) In cases where those assurances aren't available, the buyer may conclude that it would be prudent to remove the FPR and wait until it had owned the franchise system long enough to compile its own data on franchisee performance. However, following a more conservative position, by removing an FPR, might allow recent franchisees to claim that they had relied on the data in that FPR in making the decision to purchase their franchise that now appears suspect. Those franchisees could claim that if the FPR data wasn't reliable enough to be retained, it shouldn't have been used at all, which could give rise to liability for the new owner. The buyer may want to address this potential issue through specific reps and warranties. In most cases, if the FPR withstood the scrutiny of the diligence process, and assuming it is an historical FPR, Item 19 is unlikely to be revised.

- Item 21. Whether new financials will need to be included in the FDD and Item 21 revised will depend on whether the transaction was an asset purchase or an equity purchase. If an asset purchase, the franchise entity is new and so cannot rely on the prior franchisor's financials. An opening audit will need to be prepared. For an equity purchase, the financial statements can remain since the franchisor entity didn't change. However, franchise counsel would need to work with the accounting firm and corporate deal counsel to confirm that the franchisor's financial condition hadn't deteriorated or there was not a material change (particularly if the buyer took on significant debt in the transaction). While a sale generally infuses cash into a franchise system, the amount of debt taken on in a deal may be concerning to some franchise examiners. Additionally, if a new parent or affiliate entity will be guaranteeing the duties and obligations of the franchisor, a new guarantee would be required. The financial aspects of the transaction, including holding companies, investors, debt, and at what level or which entity took on the debt, require a close coordination between franchise counsel, buyer, and buyer's accounting firm and financial team.

The buyer also would want to perform a thorough review of any franchise advertising materials before allowing the sales team to continue using them. If the lines of business had changed, those materials may need to be updated and refiled with the applicable states before use.

b. Registrations and Amendments

The amount of time that it will take for the buyer to begin selling franchises once the deal closes will depend on whether the transaction was an asset purchase or an equity purchase. In the case of an asset purchase, once the FDD has been updated the franchisor entity must refile the FDD with all registration and notice states. Because the franchisor will have no operating history, it may not be able to rely on any of the state franchise exemptions that require an extended operating history, which will considerably lengthen the time for the registrations to be approved.[48]

[48] Many of the large franchisor exemptions require an extended period of operating history for the franchisor or its parent, including California, Illinois, Indiana, Maryland, North Dakota, Rhode Island and Washington. *See* CAL. CORP.

For an equity purchase, the buyer may be able to rely on existing exemptions, which will allow it to start selling franchises again much faster than if it had to wait for examiner review. In states where the franchisor was not exempt, franchise counsel will be able to file amendments, which should result in a faster turnaround than an initial filing. Pending transactions will be able to proceed once the amendment for the applicable state is effective. The sales team also can resume normal practices in talking to new prospective franchisees at that time.

IV. OTHER PERMUTATIONS AND PARTIES

A. Multiple-Unit Franchisee Transactions

As noted above, one of the growing areas in franchise M&A is the sale of large multiple-unit franchisee portfolios. These transactions may involve a founder-owned enterprise looking for a cash-out exit, or a founder-owned enterprise looking for a partial cash-out plus more capital to expand, or a PE-backed multiple-unit operation that has reached the end of its investment life and is selling to a larger PE fund that sees the opportunity for more growth. The franchise aspects of these transactions are less varied than the sale of a franchise system. Franchise law compliance is of concern to franchisors, but less so for a franchisee that is selling or seeking investors. The transaction will be controlled, in large measure, by the franchise agreements – is the selling franchisee in compliance with its franchise agreements? What requirements are imposed on the seller and buyer under the existing franchise agreements? What conditions will the transaction impose on the buyer to obtain the franchisor's consent? Consequently, franchise counsel's role has a heavy emphasis on contract compliance, as well as providing advice and guidance based on her/his knowledge and experience of typical franchise transactions.

In many multiple-unit franchisee transactions, the seller may not have in-house counsel, and may not have special franchise counsel. If franchise counsel is employed or retained by the seller, one prominent role for counsel is to evaluate whether the seller has complied with its pre-transfer obligations. Franchisor counsel may also be able to assist in responding to buyer's inquiries, or buyer's franchise counsel's inquiries as part of the diligence process or management call.

1. Pre-Transaction Work

A multiple-unit franchise owner that is seeking a PE investor, or is embarking on a large sale transaction, will likely retain an investment banker or similar advisor. The banker will work with the seller to develop a CIM and establish the internal valuation of the business. Franchise counsel for the seller can assist in this process by assuring that the investment banker is fully aware of the franchisee's rights and obligations, including both the potential upside issues, such as unrealized development rights or a positive relationship with the franchisor, and potential downside issues, such as uncured defaults or overdue remodeling obligations. The selling franchisee desires a smooth transaction, with as high a valuation as possible. Therefore, steps should be taken to remove any potential roadblocks or speed bumps. Counsel can assist in the internal, pre-sale (or pre-auction) diligence regarding compliance with the franchise agreement, development schedules, and sometimes more importantly, the relationship with the franchisor. Counsel for the seller should review the existing franchise agreements, as well as the franchisor's transfer policies and practices. For example, some franchisors may require that any CIM or similar offering materials must be reviewed and approved by the franchisor before they are issued.

CODE § 31101; 14 ILL. ADMIN. CODE § 200.202(e); IND. CODE § 23-2-2.5-3; MD. CODE REGS. § 02.02.08.10; N.D. CENT. CODE § 51-19-04; R.I. GEN. LAWS § 19-28.1-6; and WASH. REV. CODE § 19.100.030.

Also, while many franchise agreements include a right-of-first-refusal ("ROFR"), the franchisor may have specific policies regarding the timing and substance of the ROFR. Similar to the role of in-house counsel for a franchisor prior to the sale of the franchise system, counsel to a multiple-unit franchisee should use the pre-transaction period to "get the house in order."

2. Diligence

After the selling franchisee has started the process to seek suitors for the portfolio, much of the work will be borne by buyer's franchise counsel. From the franchise attorney's perspective, the diligence process in a multiple-unit franchisee transaction is less involved than the diligence conducted for the purchase of a franchise system. This is because the buyer of multiple units does not need to review the same compliance documentation or franchise system information, and also likely because the buyer usually has experience with the franchise system in which they are buying the units to operate. There are simply fewer franchise law compliance concerns for the prospective franchisee than the prospective franchisor.

Diligence for a multiple-unit franchise transaction should begin with a review of the CIM (to understand how the franchisee portfolio is being positioned for sale, and what elements of the business are targeted for growth)[49]. This would be followed by a review of the existing franchise agreements to determine the franchisee's ability to transfer the franchise agreements, the required transfer fees, the nature of any guaranty obligations that might be imposed on the new multiple-unit owner, and the performance and financial expectations under the existing agreements, as well as the then current version of the franchise agreement. In addition to the franchise agreements, franchise counsel also may want to review any litigation between the multiple-unit owner and the franchisor, how the franchisor has spent advertising money, and how the franchisor is or is not supporting the existing franchisee. Finally, the franchisor-franchisee relationship, irrespective of contract rights, will be critical to achieving a successful transaction.

3. Franchisor Consents and Transfer Requirements, Including Special Rules for PE Buyers

Virtually all franchise agreements contain very detailed requirements prescribing how and when a franchisee may sell, assign or transfer its franchise agreement, its assets, or ownership in the franchise entity.[50] These will apply whether the transfer is a single-unit deal, or a multiple-unit portfolio with hundreds of franchises. Among the pre-conditions to securing the franchisor's consent to a transfer are:

- The selling franchisee is in compliance with the franchise agreements and all other contracts
- The selling franchisee has paid all fees
- The buyer satisfies the franchisor's standards for new franchisees

[49] For example, a selling franchisee may promote the number of unexpired development rights under existing development agreements, or the vast swaths of undeveloped and non-granted "white space" for development. In those situations, buyer's counsel, as part of diligence should review carefully whether the seller has contractual rights to expand and if there are limitations on those rights.

[50] *See* Phyllis Truby et al., *Fundamentals 201:Transfers and Assignments in Franchising*, ABA 37TH ANNUAL FORUM ON FRANCHISING W-14 (2014).

- The buyer or seller agrees to remodel or bring the outlets up to the franchisor's then-current standards

- A transfer fee, usually a set amount calculated on a per-location basis, must be paid to the franchisor

- The buyer, or the franchisee with a new owner, must sign the franchisor's then-current franchise agreement

- The selling franchisee must have first offered to sell the business or ownership to the franchisor pursuant to a ROFR, and the franchisor has waived its ROFR.

In addition to the contract requirements, the franchisor may have other pre-conditions to approval, such as approving the ownership structure or financial leverage of the buyer, or confirmation that the buyer or its management team is not involved in competitive operations or ownership in competing businesses. Some franchisors, particularly those with large systems and/or a large number of PE investors with multiple-unit franchisees, have developed special forms, rules, and policies for reviewing and approving of PE ownership.

The transfer fee may also be a subject of negotiation between buyer and seller. Most franchise agreements require that the franchisee pay a transfer fee to the franchisor, and that may be $10,000 to $50,000 per franchise. There may be transfer fees for area development agreements, and even different fees for unexercised development rights. For large multiple-unit transfers, these fees can be substantial. While these are, by contract, the seller's obligation, in many transactions, the seller tries to push these fees to the buyer. If the franchise M&A environment is competitive, as it was before COVID-19, buyers often agree to pay these fees at closing. What is franchise counsel's role? Counsel should explain clearly to the buyer the magnitude and scope of the transfer fees, how they are calculated, and the typical apportionment for these fees. Also, in revising or negotiating the purchase agreement, it is important to specify clearly the scope of the "transfer fees." There may be other fees imposed on the seller by the franchisor related to the consent, prior defaults, or overdue obligations. If the wording or definition of the transfer fees is too broad or too vague, the buyer may be agreeing to pay fees and charges in addition to franchise agreement "transfer fees" that should be borne by the seller.

Nearly all franchise agreements require that the franchisee or the franchisee's owners sign a personal guaranty agreement to guarantee the payment of fees and other performance requirements. The form guaranty agreements are unlimited guarantees, meaning the guarantor is on the hook, often jointly and severally, for the entire financial performance of the franchisee. More often than not, PE firms, their managers and any lead investors, will not agree to sign unlimited personal guaranty agreements. This can be a stumbling block. However, if the franchisor is willing to permit – or desirous of having – PE ownership of its multiple-unit franchisees, it will need to accept variations on its guaranty requirements, and/or develop creative alternatives. Private equity will often agree to one of two alternatives. One option that is employed is a limited guaranty, from a corporate entity, in which the financial guaranty is capped at a pre-determined payment amount. This may include various covenants that if broken will trigger severe consequences, such as a default under all of the franchise agreements. Another option is to require the buyer to post a letter of credit, which is an economic guarantee from a creditworthy bank to the franchisor on the PE firm's behalf. These, and other variations, address the financial aspects of a guaranty.

Many franchise agreement guarantees also address personal obligations such as confidentiality and non-compete obligations. In addition, many agreements require that all "owners," which is broadly defined, must agree to these restrictions. A PE investor may be contractually prohibited from identifying all of its owners and investors (some of whom may be institutional investors such as public union pension funds), and these owners likely will not agree to many of these franchise agreement requirements. Therefore, franchisors will need to be prepared to address the different type of owners, and their respective involvement (or lack of involvement) in the franchise business. Some franchisors have developed special approvals, guarantees, confidentiality and non-compete agreements for these special relationships. Some of these have little or no restrictions on certain types of owners, but greater restrictions and controls as the level of investment increases and/or the level of involvement or access to confidential information increases. The onus of compliance will fall on the PE fund and its principal management team.

Another aspect of a multiple-unit transaction is determining whether the buyer (or the existing franchisee with new PE ownership) will assume the rights under the existing franchise agreements, or if the buyer will execute new franchise agreements with the franchisor. In almost all situations, the buyer must sign new franchise agreements. However, there may be the issue of whether the buyer will obtain a full term under the new franchise agreements or if the term will be amended to be consistent with the remaining term under the existing agreements. Obviously, this will impact the value of the multiple-unit franchise business. In addition, this may present an opportunity to negotiate with the franchisor and/or the lessor of the franchised outlet locations, to adjust the terms so each lease and new franchise agreement will be co-terminus.

Many multiple-unit franchisees are operating under area development agreements with unexpired development rights. As part of diligence, the buyer should learn the details regarding the status of development, delays or missed targets, and unexpired rights. But as part of the franchisor consent process, the franchisor may wish to renegotiate those area development agreements to require additional outlets and/or adjust the timing. Also, the buyer may wish to acquire additional rights (in the same territory, or in a new territory with a new agreement). Such a request may help secure franchisor approval.

Many of the foregoing issues will be reflected in the franchisor's transfer consent agreement. Therefore, while the multi-unit franchise M&A transaction is principally between the selling franchisee and the buyer or PE investor, the franchisor plays a crucial role.

4. Purchase Agreement and Disclosure Schedules

As discussed above, as part of diligence, buyer's franchise counsel will evaluate whether the seller is in compliance with the existing franchise agreements, area development agreements, and other requirements of the franchise system. The purchase agreement will include reps and warranties that confirm that the buyer is in compliance with the franchise agreements, is current in its remodel and re-equipment obligations, and has received the required consents – or that the required consents, including the franchisor's transfer consent, is a closing condition. While the reps and warranties are far less extensive than those in the purchase agreement for a franchise system sale,[51] there may also be more detailed reps and warranties depending on the business, such as representations regarding customers,[52] compliance with insurance requirements,

[51] *See, supra*, Section III.C.2.a.

[52] For example, if the franchise is a gym or fitness studio, the number of "members" is critical to the renewal and performance estimates.

payments of certain fees, or not being in default under the franchise requirements, even if the franchisor has not issued a formal notice of default.

The "definitions" section of the purchase agreement is another area where franchise counsel can add value. A clear definition of "existing franchise agreements," "development requirements," and "new franchise agreements," and any franchise system specific terms will aid in understanding and enforcing the purchase agreement. Without clear franchise-related definitions, there may be confusion on what the parties actually agree to in the rest of the purchase agreement. Clear franchise definitions set the parties up for success in negotiating the rest of the purchase agreement, in closing the transaction, and in moving forward post-closing.

The pre-closing covenants in the purchase agreement must address the franchisor's consent role, even though the franchisor is not a part of the purchase agreement. The closing will include: (i) the termination or transfer of all existing franchise agreements, (ii) the execution of the franchisor's consent to transfer agreement, (iii) the payment of the transfer fee, (iv) the execution of all franchise agreements and related documents, and (v) any other required documents which the parties acknowledge need to be transferred, such as leases or supplier agreements.

Generally, the franchise-specific disclosure schedules for a multiple-unit franchise M&A transaction are less involved than in franchise system transactions. Here, the disclosure schedules should include the list of franchise agreements and locations (and any details for which the seller is providing representations). Because those existing franchise agreements will be terminated (in most cases) and new agreements signed, the list is used primarily to list the underlying assets of the business. But, the more important issue is that the franchisor, through the transfer consent, is agreeing to sign new franchise agreements for those identified locations, as of the closing. The disclosure schedules, along with the reps and warranties, will ferret out any significant or material defaults under the existing franchise agreements, such as overdue payments, or remodeling or refurbishment requirements that are overdue.

As discussed earlier, the franchisor plays a significant role in these transactions. So, even if the seller and buyer have agreed on all of the deal points, and if the franchisor has granted its consent, it is the franchisor that can dictate the closing. In many cases, the franchisor will need to create new franchise agreements for each location, with the various exhibits and schedules for each one, so that there is a smooth transition at closing. Therefore, the franchisor's ability to efficiently, accurately, and promptly have the franchise agreements and other documents ready for a closing is one more potential speed bump.

B. Franchise Counsel for Lender to Buyer

As discussed in Section II.C.1, in many PE investments (whether acquiring franchise systems or multiple-unit franchisee portfolios), the purchase price will be paid in cash at closing, but the PE firm likely will borrow a portion of the purchase price from a commercial or investment lender. The lender will conduct its underwriting diligence by evaluating the target company, its economic track record, and opportunities for growth. The lender's interest in the franchise target company is similar to that of the buyer—whether the target company has strong financial operations, good growth prospects, and most importantly, the ability to continue to generate revenue to service the debt (owed to the lender). Therefore, many of the franchise issues discussed above in Section IV.A.2 as part of the buyer's diligence also will be investigated by the lender and its franchise counsel. These include, among others, (a) strong unit economics of the franchises, (b) franchise growth in both number of outlets and revenue per outlet, (c) a lack of, or a relatively small amount of franchisee litigation and franchisee dissatisfaction, (d) the inverse of

that, satisfied franchisees, and (e) franchisor compliance with franchise laws to mitigate the likelihood of franchisee lawsuits or claims for damages or rescission.

Despite a diligence goal similar to that of the buyer, the lenders will not conduct the same diligence that the buyer conducted. Rather, the lender will rely in large measure on the buyer's diligence. It will review and analyze the due diligence reports provided to the buyer by its counsel, including franchise counsel, and other advisors.[53] Lenders will often retain corporate or finance counsel to assist in their diligence, underwriting, and the writing and negotiation of the lending documents. Finance counsel will then retain franchise counsel, as a specialist, to assist with the franchise aspects of the loan. While franchise counsel to the lender will seek to review many of the same documents as the buyer, franchise counsel will often have very limited time and opportunity to conduct diligence on behalf of the lender. Franchise counsel may have limited access to the data room and franchise-related documents, and will rarely have the opportunity to speak with seller's management. Therefore, franchise counsel to the lender will rely heavily on the buyer's franchise counsel's diligence. Franchise counsel must utilize its knowledge and experience in franchising, franchise compliance, franchise agreements and franchise relationships to assess the adequacy of the buyer's counsel's franchise diligence. They may look into the scope of the diligence, the number of documents evaluated, and the questions and issues raised with seller's management. Franchise counsel also will need to conduct a "gut check" to gauge the thoroughness of diligence, and the soundness of the conclusions. Experienced franchise counsel to lenders also will look to the experience of the target franchisor's franchise counsel, and the buyer's franchise counsel. While nothing is a substitute for first-hand investigation, the knowledge and experience of other franchise counsel can be a factor in the overall evaluation of the seller.

If lender's counsel discovers open or unresolved issues, counsel may request follow-up from buyer's franchise counsel, or additional review, and a supplemental review or conclusion. Lender's franchise counsel also may conduct its own independent investigation or evaluation.

All of this must be done in an extremely compressed time frame, and often against a backdrop of a buyer who is eager to sign a purchase agreement, a seller who wants a signed deal, and the business and management team of the lender who have previously evaluated the business and financial aspects of the transaction and wish to lend to the buyer. This, therefore, is another point in the transaction where experienced franchise counsel must exercise discretion, read and understand his or her client's goals, objectives and risk tolerance, and provide business counseling along with legal conclusions.

C. Franchise Counsel for Rep & Warranty Insurer

The role of franchise counsel for the Rep and Warranty ("RWI") insurer is very similar to that of franchise counsel to lender. However, the RWI insurer's emphasis is on the accuracy of the reps and warranties, the diligence undertaken by the buyer, and the likelihood or risk that the seller has or may breach one or more of the reps and warranties. So, the RWI insurer may focus its efforts with respect to franchise issues, such as franchisor compliance with franchise laws, franchisor and franchisee compliance with the franchise agreements, and the risk of franchisee defaults, terminations, and claims against the franchisor. While lender's counsel must conduct its diligence and evaluation in a short time frame, the RWI insurer will be conducting its underwriting of the risk of the deal in a timeframe that may be shorter and even more compressed than that afforded to the lender. The RWI insurer may have no more than forty-eight hours to

[53] *See, supra*, Section III.C.1.d.

conduct its underwriting and diligence. Consequently, counsel to the insurer will have to rely on buyer's counsel's diligence report, and a review of relatively few documents. In many deals, franchise counsel to the RWI insurer will participate in a call with franchise counsel to the buyer, and will use that conversation, along with the diligence report, to gauge the depth and breadth of the buyer's franchise diligence, and to assess the potential risk of a breach of a franchise rep. Counsel's experience and knowledge regarding the issues discussed above (with respect to the lender's diligence, and buyer's diligence, such as franchise law compliance, accuracy of the FDD, franchisee defaults, franchise agreement compliance, and franchise satisfaction), will play a critical role in this aspect of the transaction.

V. OTHER ISSUES

A. Providing Advice Based on Past Experience

Lawyers are, in the vernacular of a bygone era, "counselors." And as counselors, or advisors, the franchise lawyer can deliver additional value to its client in M&A transactions by providing advice and guidance based on its past experience in dealings in a particular industry, with a particular type of buyer or seller, in connection with a particular issue, or even with a particular brand, franchisor, or PE firm. Clearly, this advice cannot breach the solemn attorney-client confidentiality restrictions. As has been discussed earlier in this paper, the franchise lawyer's role goes beyond simply managing and drafting contracts, by providing guidance on how issues identified in those classic lawyer roles can impact the transactions, and may suggest alterations in the client's approach to the negotiations and the client analysis of current or potential risks. One of the more frequent questions posed to franchise counsel in these transactions (no matter the party, the type of transaction, or the buyer or seller) is "is this 'market'?" That is, is the issue confronting the client, or the demand or request from the other side, or the potential consequence, something that is typical for this type of transaction. The following are some examples of these types of questions, and how franchise counsel can add value:

- *We may want to do "X"; can we?*

In some transactions, the buyer, particularly in the case of a PE firm, may have a strategic plan to modify the system after the transaction. It may impact territories, product or service offerings, supplier arrangements, rebates, or a host of other changes that may fit within the broad category of "operations." The question may be understood as do we have the "right" to do "X"? Many times the answer is yes, but the better answer may be "yes, *but* …" or, the answer may be "you will have the *right* to do 'X', but is it the *right thing* to do X.". This is where franchise counsel can rely on her expertise and experience. The desired path may be legally and contractually permitted, but it may rile up the franchisees or certain segments of the franchise community. It may negatively impact future franchise sales. It may disrupt existing supplier relationships. Therefore, franchise counsel should explain the practical ramifications. Franchise counsel should advise the client on franchisee communications, and the methods, processes and timing for critical franchisee communications. The suggestions may include involving the franchise advisory council (if there is one) and/or large or influential franchisees in the process. Understanding the franchisor-franchisee relationship and how franchisors successfully navigate the sometimes tricky road and avoid land mines is essential in advising franchise M&A clients.

- *Walk us through the franchisor transfer process*

As discussed above, multiple-unit franchise transactions are increasing in number and size, and some franchise systems have more of these multiple-unit franchises with PE or financial

sponsors than others. The transfer process, as described in the franchise agreements and FDDs, reveals very little about the detailed transfer approval procedures and requirements. When does the franchisor get involved in the process; what level of review is expected of the franchisor; does the franchisor require review and approval of a CIM, or an LOI; when does the franchisor require the identity of the prospective purchaser; what level of review and vetting of the prospective purchase is expected; how does the franchisor address personal guarantees and sophisticated ownership structures that are typical of PE investment; does the franchisor utilize special forms for PE ownership; are there transfer conditions that appear immutable, etc. To the extent franchise counsel knows this information, it should be shared early in the process with the client. But not all of these questions can be answered by all franchise lawyers, particularly if he or she has not worked on a similar transaction with this brand. However, counsel can and should utilize its experience with other brands to provide this advice. The author's experience is that many buyers have smart and creative business and legal personnel on their team, and with this knowledge, along with counsel's willingness to be creative, explore options, and not be fearful to launch a trial balloon that may be shot down, the franchise lawyer and its client can often find solutions to these challenges.

- *What sort of financial statements are required before and after closing?*

One would think that the FDD financial statement requirements would be relatively straightforward, based on the FTC Franchise Rule and NASAA's FDD guidance for Item 21. However, that is not the case, particularly when there is a myriad of ownership structures that can be employed with respect to a franchisor acquisition. Layer on top of that the existence of leveraged debt as part of the transaction, new equity investments, and the timing of the transaction (whether during, prior to, or after an FDD renewal and annual update), the potential uncertainty of how a prospective franchisee (or its franchise counsel several years in the future) or state examiner may view changes in financial condition as "material" or "adverse," the need for new financial statements may be murky. There may not be a clear answer for every situation. Therefore, franchise counsel should provide guidance regarding the rules and regulations, the state examiner and state registration perspectives, and the franchise or franchisor counsel perspective, based on franchise counsel's knowledge and experience. Also, understanding the timing and cost of post-closing franchise sales activities, and the ability to communicate those variables in a clear and concise fashion, will serve the client well.

- *Please provide "middle of the road" comments and changes; we don't want to appear too aggressive.*

Franchise counsel love this request! Just as "middle of the road" (or take a "light touch" or "it's ok to be aggressive") from a political perspective will vary based on one's position, the interpretation of this sort of request varies based on the client's previous deals and experience, Therefore, franchise counsel needs to draw on its experience in transactions with similar (or the same) buyers and sellers, as well as the corporate deal counsel with whom franchise counsel is working. One of the critical functions of franchise counsel is helping to get the deal closed. Recognizing and accommodating deal counsel's and the client's request, while not abdicating franchise counsel's role to provide meaningful advice and protect the client's interest, is paramount.

- *What is the likelihood that "X" (for example, franchise law violations) will negatively impact us post-closing?*

As discussed earlier, franchise counsel's experience in addressing every day, real world franchise compliance issues is critical to advising the client as part of diligence. As many franchise lawyers will say, it is difficult to find a franchise system that is 100% clean, with no actual or perceived franchise law violations, but not all franchise law violations are the same. Some may be "foot faults," where others may reflect systemic rules violations. Some may be the equivalent of occasionally exceeding the 55 mph speed limit by going 58 or 59, and others may be reckless driving of 85 mph. (It is unlikely that large, successful franchise systems are ones that "drive" at 85 or 90 mph and flaunt the rules.) Franchise counsel needs to be able to explain the differences to their clients – and most importantly explain the practical effects.

B. System Changes Post-Closing

While all buyers tend to make some changes when they acquire a franchise system, changes at the franchisee level can vary greatly. Many PE buyers may look for ways to cut some costs at the corporate level, either through increased technology or the elimination of any redundancies, but overall, they may be more likely to allow the franchise system to continue on as it had under the previous owner. On the other hand, a system purchased by either a competitor or another entity in the same industry may experience major changes, both at the corporate and franchisee level. Major changes to a franchise system can cause significant franchisee discontent if not handled properly. While communication of the new vision and rationale for the changes being made are the responsibility of the management and marketing teams, in-house franchise counsel can assist in this process by providing advice to new management regarding disclosure obligations triggered by the changes, as well as advice concerning state relationship and termination statutes should problems with the franchisees arise.

C. Supplier Arrangements

In some cases, one of the more valuable assets acquired in an acquisition can be the key supplier contracts. In such cases, the buyer will want to make every effort to maintain good relations with those suppliers, as well as seek to extend any favorable contracts. In cases where a system is purchased by a competitor, there may be conflicts in the supply chain and the new owner will need to analyze its options. If there are redundant suppliers, the period of overlap can be used to evaluate whether one supplier is better than the other so that changes can be made when the current contracts end. In other cases, it may be that the new owner's increased access to capital permits it to seek relationships with larger suppliers that provide a better benefit at a lower cost to the franchise system.

D. Technology Changes

As with other areas of life, technology can be both a blessing and a curse. In some acquisitions, the new owner is willing to invest in new and improved technology that will allow the franchisees to better compete in the marketplace. However, conflicts can arise regarding the cost of such improvements and the ability of the franchisor to force franchisees to adopt the new technology. If this is an intended course of action by the buyer, franchise counsel during the due diligence period should have thoroughly reviewed all versions of the active franchise agreements to determine how much leeway the franchisor has to enforce such changes. Even if the agreements give the franchisor broad authority to require such changes, franchise counsel will

need to work with management to ensure that the scope of such changes does not trigger any potential claims under the franchise relationship laws.[54]

E. Re-Branding

One of the most complex activities occurs when a system is purchased and the new owner intends to rebrand the original franchisees, either to the new owner's brand or to a completely new brand. A full discussion of this is outside the scope of this paper but there are resources that cover this topic in detail.[55]

VI. CONCLUSION

The franchise lawyer in franchise mergers and acquisitions is critical to the successful completion of the transaction. Whether the deal is the acquisition of one or more franchise systems, or of a multiple-unit franchise portfolio, and whether the buyer or seller is a franchisor, a private equity fund or other financial sponsor, a strategic acquirer, or another multiple unit franchisee, the franchise counsel's role should be, and will be, much greater than simply reviewing regulations and contracts to assure that the seller has complied with applicable franchise laws and franchise agreements. The franchise counsel must utilize his or her full range of talents, being first and foremost an advisor and counselor. Whether counsel is in-house or outside counsel, or represents the buyer, the seller, or another interested party such as a lender or rep and warranty insurer, counsel's role will extend beyond the corners of the purchase agreement. Counsel will need to draw on his or her knowledge and experience in franchising – from operations, to franchisee relations, to FDDs and registration, to franchise agreements, to franchisor/franchisee disputes, to implementing system changes, to supplier relationships, to trademarks and intellectual property, and much more – to guide the client.

By engaging in the transaction process early, communicating and collaborating with the corporate deal counsel and client's deal or management team, the franchise counsel is able to shape critical aspects of the transaction, from the preparation for the deal, to the documents, and then the negotiation and closing. With those skills, and the franchise background and experience, franchise counsel can navigate potholes, proactively deal with any issues that arise before they can complicate or kill the deal, and lead the parties to a successful closing of an often complicated transaction.

---

[54] Wisconsin Fair Dealership Law, at WIS. STAT. § 135.01 et seq.; Minnesota Franchise Law, at MINN. STAT. § 80C.14; California Franchise Relations Act, CAL. BUS. & PROF. CODE § 20000 et seq.; Hawaii Franchise Investment Law, HAW. REV. STAT. § 482E-6.

[55] *See* John Chambers et al., *Rebranding Franchise Networks*, 26TH ANNUAL IBA/IFA JOINT CONFERENCE (2010); *see also* Richard L. Kolman & Kerry L. Bundy, *System-Wide Change: Rising to the Challenge: The Business Imperatives and Legal Limits on Imposing Significant Change to a Franchise System*, ABA 25TH ANNUAL FORUM ON FRANCHISING W-12 (2002).

APPENDIX A:
Bibliography of Select Franchise Mergers and Acquisitions Publications

Publications:

AMERICAN BAR ASSOCIATION, MERGERS AND ACQUISITIONS OF FRANCHISE COMPANIES (Leonard D. Vines & Christina M. Noyes eds., 2nd ed. 2014).

AMERICAN BAR ASSOCIATION, FRANCHISING: CASES, MATERIALS, & PROBLEMS (Alexander Meiklejohn ed. 2013), Chapter 14 "Mergers and Acquisitions of Franchise Systems" (Mark A. Kirsch and Lee J. Plave, authors).

ABA Forum on Franchising Annual Forum Presentation Papers:		
Title	**Authors**	**Year of Publication**
Touchstones in Successful Acquisitions Involving Franchise Systems	Jan S. Gilbert Lou Hedrick Jones	2001
Buying and Selling Company- Owned Units	Jeffrey B. Brams Brian B. Schnell Phyllis A. Truby	2004
Basics of Buying and Selling a Franchise Company	Joel R. Buckberg Richard G. Greenstein	2005
Litigation After Acquisition of a Competing Franchise System	Kirk Reilly L. Seth Stadfeld Les Wharton	2006
Financing, Liquidity and Growth Capital Tools – From Traditional Lending to Private Equity and Venture Capital	Kenneth R. Costello H. Scott Pressly	2007
Anatomy of the Sale of a Brand	Charles S. Modell Mark A. Robertson	2008
The Fundamentals of an M&A Transaction in a Franchise System	Victoria T. Blackwell Kevin P. Hein	2010
Competing Brands Under Common Ownership	Charles S. Modell Sherin Sakr	2014
From LOI to Closing: Getting an International Franchise Deal Done	Kerry Olson Frank Robinson Kendal Tyre	2014
Advanced Issues in Franchisor Acquisitions	Joel R. Buckberg Emily Decker	2016

ABA Forum on Franchising Annual Forum Presentation Papers:		
Title	**Authors**	**Year of Publication**
Mergers & Acquisitions — The Basics for Buying and Selling the System	Alan R. Greenfield Christina M. Noyes Sherin Sakr	2017
Trademark Clearance and Investigation Considerations Before Acquisition of a New Concept	Christopher P. Bussert Jason S. Adler	2019

International Franchise Association Legal Symposium Presentation Papers:		
Title	**Authors**	**Year of Publication**
Mergers and Acquisitions Involving Franchise Networks	Kenneth Kaplan Mark A. Kirsch James Rubinger	1999
Acquisitions of and Mergers Involving Franchise Networks	David Kaufmann Steve Peden Les Wharton	2000
Mergers & Acquisitions	Patrick Meyers Andrew Perrin Les Wharton	2001
Acquisitions and Sales of Franchise Companies	Charles S. Modell Donna Christopherson Mark Siebert	2005
Financing Growth of Multi-Unit Franchisees	Too Anders Randy Evans Colvin Leonard J.H. Snow	2005
After the Acquisition: Legal Issues Affecting the Integration/Conversion of Acquired Units	James Rubinger Brian Schmidt Charles Bengochea	2006
Getting the Deal Done: A Private Equity Case Study	Dina Dwyer-Owens Duke Johnston Sean McAvoy Stuart Baxter	2007
A Seller's Guide to Preparing to Sell the Franchise System	Mark A. Kirsch H. Scott Pressly	2009
The New Shifting Sales Paradigm: Private Equity, Multi-Unit Developers, Joint Ventures	Jan Gilbert Jack Wixted Mark Friedman	2010

International Franchise Association Legal Symposium Presentation Papers:		
Title	**Authors**	**Year of Publication**
The Franchise System Post-Private Equity Investment	Joel R. Buckberg Peter D. Holt Stephen Aronson	2011
Negotiating with Private Equity Owned Franchisees	Stephen Hagedorn Nick DeCarlo Charles Modell	2012
Attracting Private Equity – What Prompts Private Equity Interest in Acquiring Your Network?	David Kaufmann Tom Donaldson Stephen Aronson	2013
Looking Under the Hood: Conducting Due Diligence in Franchise Transactions	Grayson Brown Jeremy Holland Gaylen Knack	2014
Basics: Franchise-Related Mergers & Acquisitions	Sandra Bodeau Meg Montague	2016
Basics Track: Franchise-Related Mergers & Acquisitions	Michael Bidwell Andrae Marrocco Brian Romanzo Andrew J. Sherman	2017
A Deep Dive into Due Diligence from a Private Equity Seller or Buyer's Perspective	David Barr Leonard MacPhee Ted Pearce	2017
Basics Track: Franchise-Related Mergers & Acquisitions	Jason Fulton Tony Marks Peter Viitre	2018
Basics Track: Franchise-Related Mergers & Acquisitions	Brian Balconi Richard Morey Mike Weinberg	2019

APPENDIX B:
Sample Schedule of Data Room Folders

Below is a list of types of folders that are used to categorize documents for a data room:

1. Corporate Documentation
2. Intellectual Property
3. Litigation
4. Permits & Licenses
5. Insurance
6. Financial Documentation
7. Real Estate
8. Suppliers & Products
9. Human Resources
10. Information Technology
11. Distribution & Advertising
12. Material Contracts
13. Franchise Documents
    a. FDDs
    b. Franchise Agreements & Related Agreements
    c. Notices of Default, Termination, Non-Renewal
    d. Franchise Advisory Council Documentation
    e. Operations Manuals & Related Documentation
    f. Franchise Sales Compliance Documentation
    g. Franchise Sales Pipeline

APPENDIX C
Sample Due Diligence Request [56]

ABC, LLC

Preliminary Due Diligence Checklist of Franchise Related Documents

Please provide the documents and lists described below with respect to each franchise program which currently exists or which may have existed. Certain documents may be responsive to more than one request below. In order to avoid duplication of effort, please cross-reference previous or subsequent responses.

[Note to reader: the following list can be further segmented into individual document checklists, or can be condensed into broader categories. The former can be daunting to, and imposing on, the company that is the subject of the due diligence, but detailed checklists will make easier the task of indexing and reporting the results. In addition, the due diligence checklist should reflect specific aspects of the target franchise company, its business, and its industry.]

I. FRANCHISE DOCUMENTS AND FILES

A. Franchise Agreements — List of Agreements Executed with Franchisees

1. Chronological list (and copies, if not provided in response to I.B.2.a. below) of all executed franchise agreements (including standard franchise and non-traditional franchise agreements), identifying the outlet and whether:

a) in operation (with original owners);

b) executed, but not yet in operation;

c) transferred but still in operation with date of transfer;

d) terminated; or

e) reacquired.

2. All forms of franchise agreements currently in effect (including any amendment made to standard forms of the documents), accompanied by a list for each such form, showing:

a) dates of use; and

b) the exact location (or identifying number) of each franchise outlet covered by each different form.

B. Current Franchisees

1. A list of all ABC franchisees, in the U.S. and elsewhere, including all current franchisees under franchise agreements.

[56] This sample due diligence request list is based on previously created requests lists. *See*, Vines, *supra* note 6, at Appx. B.

2. Franchisee files for each franchisee listed in #1 above, including:

a) franchise agreement, with all negotiated changes and amendments;

b) any state-specific addenda to the franchise agreement;

c) signed acknowledgment of receipt of FDD;

d) lease or sublease of the premises (if applicable);

e) financial and tax records, and other data and reports (indicating financial status of the outlet and the franchisee entity);

f) loans or other collateral agreements (with ABC, an affiliate, or a third party);

g) notes of discussions with prospective franchisees who later signed a franchise agreement;

h) periodic reports submitted by franchisees, or created by ABC, concerning the franchisee's operations;

i) correspondence or other documents indicating potential or actual problems or lawsuits;

j) any personal guarantees; and

k) any collateral assignments of any franchise agreements to secure franchisee loan obligations, or comfort letters with leaders.

3. A schedule of, and copies of, all correspondence and materials related to franchisees in default under franchise agreements, leases, loans or other contracts with ABC or its affiliates, and a description of such default.

4. A descriptive list of all persons who are in process as prospective franchisees (including applicable geographic area).

5. Description of any discussions with prospects or existing franchisees relating to the renewal, amendment or opening of any franchise.

6. Information on the status of royalty payments (up-front fees or continuing, and advertising).

C. Development Agreements, Option Agreements, and Other Agreements

1. A chronological list of development agreements, option agreements, area franchise agreements, subfranchise agreements, master franchise agreements, joint venture agreements, license agreements, and other agreements (collectively, "Other Agreements") offered, used, or currently in effect, and including any amendment made to a standard form, showing:

a) whether still in effect or terminated; and

b) if in effect:

(1) the territory(ies) covered by the agreement;

(2) the number of outlets subject to the agreement;

(3) the number of outlets developed versus the number to be developed;

(4) whether the developer is meeting its development schedule; and

(5) the date of expiration.

2. Area franchisee/Developer/Optionee files for each area franchisee, developer, or optionee, etc. (if not provided above).

3. List of, and copy of, any other area agreements, or any other contracts (not previously disclosed) which may bear on any rights to be granted.

[Note to reader: if the preliminary review of the system reveals special contracts or situations, it is appropriate to investigate these other areas. For example:]

a) [agreements with ABC, Inc. for reciprocal franchise rights for co-branding operations;]

b) [reacquisition of area franchisees; and]

c) [other brand license or franchise agreements.]

D. Former (Terminated, Nonrenewed, Transferred) Franchisees as of _____[57]

1. Information for franchisees of ABC whose franchise agreements were transferred and/or terminated:

a) List of, and copies of, all correspondence and materials related to terminated franchisees, including allegations of contract breaches or violations of law;

b) A list of all termination or nonrenewal notices sent to franchisees, either pending or implemented;

c) List of, and copies of, all correspondence and materials related to transferred franchisees;

[57] Counsel should review the applicable statute of limitations issues when determining which files to review, over which time period.

d) Franchise files (unless provided above) from:

(1) terminated franchisees, and

(2) franchisees who transferred their franchise; including:

(a) copies of the acknowledgment by franchisees of receipt of offering circulars; and

(b) executed agreements (e.g., assignment and assumption agreements; termination and transfer agreements); releases (if executed); and related documentation.

2. Former franchisees of ABC who have threatened or initiated action against ABC, or raised allegations of improper or illegal actions.

3. A list of all termination or nonrenewal notices sent to franchisees, either pending or implemented.

E. Other Franchisee Defaults

1. A list of all franchisees in default with respect to any payment of fees or royalties.

2. A list of any other defaults by franchisees which could have a materially adverse effect on the franchise program.

II. FDDs AND FRANCHISE REGISTRATIONS (INCLUDING ADVERTISING AND FRANCHISE SELLER AND BROKER REGISTRATIONS)

A. General

1. A list of all jurisdictions in which the franchisor is qualified to do business and a list of all jurisdictions in which the franchisor conducts business or sells franchises, and a description of the business conducted in each jurisdiction.

2. Any registration applications pending, or in the process of being prepared for filing, under any state franchise or business opportunities registration act.

3. A docket showing the current effective dates of registrations, notice filings and exemptions, and expiration dates.

B. Unit Franchises

1. Schedule by state of all state franchise and business opportunity registrations and exemptions for single-outlet, or unit franchises, including effective dates, expiration dates and lapse periods from [**date**] until present

2. Copies of all correspondence with state and federal (if any) franchise and/or business opportunity law administrators.

3. All disclosure documents, including exhibits and state addenda, if any, used, marked to indicate:

a) dates of use; and

b) jurisdictions in which used.

4. Copies of franchise sales advertisements, brochures, etc. used by ABC and applications filed with state franchise law administrators for approval of such materials, if any.

5. List of franchise sellers and franchise brokers employed or hired by ABC, and copies of state salesperson registration forms, if any.

6. List of all franchise sellers and franchise brokers who had been hired or retained by ABC and who are not currently employed by ABC.

C. Master Franchise/Subfranchisees/Other Agreements ("Other Agreements") (If ABC has offered other forms of agreements in FDDs that are separate from the FDD that includes the unit franchise agreement), provide:

1. Schedule by state of all state franchise and business opportunity registrations and exemptions for other agreements, including effective dates, expiration dates and lapse periods from [**date**] until present.

2. Copies of all correspondence with state and federal (if any) franchise and/or business opportunity law administrators.

3. All disclosure documents, including exhibits and state addenda, if any, used, marked to indicate:

a) dates of use; and

b) jurisdictions in which used.

4. Copies of franchise sales advertisements, brochures, etc. used by ABC and applications filed with state franchise law administrators for approval of such materials, if any.

5. List of franchise salespersons and franchise brokers employed or hired by ABC, and copies of state salesperson registration forms, if any.

6. List of all franchise salespersons and franchise brokers who had been hired or retained by ABC and who are not currently employed by ABC.

III. FINANCIAL PERFORMANCE REPRESENTATIONS: FRANCHISE EARNINGS CLAIMS OR SALES/FINANCIAL PROJECTIONS

A. Instructions to franchise sales staff or franchise broker(s) regarding the making of representations regarding financial performance.

B. Copies or descriptions of all financial performance representations, earnings claims, or other earnings, revenue, profit, or financial statements or projections made or provided to prospective franchisees (in the FDD or not in the FDD).

C. All financial information that was provided to a prospective franchisee for any situation in which a company-owned outlet or a franchised outlet was sold to a new franchisee (even if this was not a "financial performance representation" under franchise disclosure rules.

D. Requests by prospective franchisees to review substantiation of FDD Item 19 data, and ABC's response to those requests, including the material and information provided or reviewed.

E. Correspondence with prospective franchisees regarding earnings claims, financial performance representations, and other financial data.

IV. SYSTEM OPERATIONS (MANUALS, ETC.)

A. Operating manuals currently in use for the ABC system.

B. Previous versions of operating manuals.

C. All correspondence with Franchisees providing new or modified manuals, directives, specifications, etc.

D. A description of all training programs provided to franchisees in the last three years, including copies of all written materials provided to franchisees, and instructions from ABC to the training staff.

E. Monthly and annual payment, receivables, and receivable aging reports for franchisees for royalties, advertising payments, and other regular payment obligations of the franchisees. [Note to reader: this varies by system, but may include, for example, software or computer license fees.]

F. Credit Card processing agreements.

G. System privacy policies, and any franchisee privacy policies, including all correspondence or complaints related to franchisor or franchisee compliance or violation or privacy policies or privacy laws.

H. Agreements and arrangements with third parties and with franchisees regarding the use, sale, and administration of gift cards, reloadable stored value cards, and other frequent purchaser or customer preference cards, including legal compliance policies.

I. Any consumer or governmental complaint or inquiry regarding ABC or franchise compliance or allegation of non-compliance with consumer protection laws, credit card processing, gift card operations, or any other commercial or consumer matter.

J. Information on any independent franchisee association or franchisor-sponsored franchise advisory council, including copies of bylaws, meeting minutes or other

material correspondence or communications involving any franchise advisory council and/or franchisee association.

V. SUPPLY AND DISTRIBUTION

A. Agreement(s), if any, between ABC and its affiliates related to supply and/or distribution of products or services.

B. All supply and distribution agreements between ABC and any suppliers, distributors or agents, by which ABC receives monies or rebates from the supplier.

C. Reports and records of all rebates, commissions and allowance received by ABC and/or its franchisees in the most recent 3 years, and the allocation, uses or distribution of those monies to franchisees, to the advertising fund, to the franchisor, and/or other parties, entities and purposes.

D. All supply and distribution agreements between ABC and its franchisees.

E. All vendor lists.

F. Copies of plans or studies regarding the possibility of ABC becoming a supplier of products, equipment or goods to the franchise system.

G. Documents concerning approval or disapproval of suppliers, including all correspondence on the subject.

H. A list and description of any delinquencies in the settlement of suppliers' accounts during the past 12 months.

I. The franchisor's outstanding purchase commitments.

VI. INTERNATIONAL

A. A list of all foreign jurisdictions in which the franchisor conducts business or sells franchises, and a description of the business conducted in each jurisdiction.

B. Agreements: Copies of all agreements and other documents relating to system expansion in foreign countries, including:

1. any Master Franchise or Development Agreements;

2. any Franchise Agreements; and

3. Any joint venture or similar arrangements.

C. Disclosure Documents: Franchise disclosure documents used with respect to the offer and sale of franchises in foreign countries.

D. Intellectual Property: Any trademark, service mark, or copyright registrations or applications in foreign countries.

VII. REAL ESTATE, OTHER ASSETS, FINANCING

A. List of outlets (franchised) where ABC has an interest in the real estate, indicating whether ABC is the lessor, prime lessee or lease guarantor, and copies of leases, subleases, or guarantees to which ABC is a party.

B. All loans, notes, guarantees, lease guarantees, installment contracts, equipment leases, equipment purchase agreements, or other financing arrangements in which ABC or one of its affiliates is a party to the agreement or receives monetary or non-monetary compensation for such financing (whether or not such arrangement is disclosed in the FDD).

VIII. INTELLECTUAL PROPERTY

A. A schedule of all trademarks, service marks, trademark registrations, trade names, brands, copyrights, patents, trade dress, Internet domain names and web pages, recipes and all other intellectual property rights whatsoever owned, franchised or used by ABC, and/or any affiliate, or any related entity, in the U.S. and elsewhere, including registration numbers and expiration dates. The response to this request should include:

1. Trademark, service mark, copyright, and patent applications and registration certificates;

2. Trademark, service mark, copyright, and patent application and registration prosecution files;

3. Search reports and opinions for all copyrights, patents, marks, brands, trade dress, and names used in the System;

4. Documents concerning or relating to infringements, conflicts or objections to use of the various copyrights, patents, marks, brands, trade dress, and names associated with the system, whether the objections were made by, or received by ABC and/or any affiliate;

5. All agreements concerning or relating to the various copyrights, patents, marks, brands, trade dress, and names associated with the system, including, without limitation, license agreements, work for hire agreements, settlement agreements, assignments, security agreements, coexistence agreements, and concurrent use agreements;

6. Evidence of registration of all trademarks, service marks, trade names, brands, trade dress, copyrights and patents owned, licensed or used by ABC at the state and federal level in the U.S., and internationally;

7. Documents relating to unauthorized third party uses of the trademarks, service marks, trade names, trade dress, brands, copyrights and patents owned, licensed or used by ABC and/or any affiliate;

8. Questions about ownership and the right to use computer software, advertising or [recipes] [if applicable];

9. A list of all computer software used in the franchised business, whether owned, leased or licensed, and copies of all related leases and license agreements; and

10. Any agreements with third parties concerning the marks; particularly co-branding agreements.

B. A schedule of all disputes, infringements or other actions regarding any trademarks, service marks, trademark registrations, trade names, brands, copyrights, patents, trade dress, Internet domain names and web pages, recipes and all other intellectual property rights owned, licensed or used by ABC and/or any affiliate in the U.S. and elsewhere.

C. A schedule of, and copies of, all recipes and formulae related to preparing proprietary products and other food and bakery items that are offered, or were offered, at any restaurant or other food service operation in the system. Include, as well, a schedule of any secret and proprietary plans developed by ABC and/or any affiliate for the preparation of food items in, or operation of, an ABC restaurant. [Note to reader: modify this request, as necessary, for the franchise system being investigated.]

D. A schedule of, and copies of, all architectural plans and/or designs, specifications and models, for any and [all restaurants, kiosks, food service businesses.] [Note to reader: modify this request according to the system] or other operations under the ABC marks, including renderings and drawings of all buildings, and interior and exterior layouts and designs.

E. A copy of all intercompany or affiliate agreements related to for use of any of the ABC marks.

F. A list of all computer software used in the franchised business, whether owned, leased or licensed, and copies of all related leases and license agreements.

IX. LITIGATION & DISPUTES

A. Information related to any pending, threatened, or alleged action or other claims against ABC involving operation of its franchise program, or its operation under the franchise laws.

B. All information used to support and prepare the Item 3 disclosure in all FDDs referred to in Section II above.

C. Responses to auditors' inquiries regarding actual or pending litigation or disputes.

D. Copies of all consent decrees, judgments, settlements and other dispositions of legal proceedings pursuant to which the franchisor has continuing or contingent obligations of a material nature.

E. Any orders, directives or inquiries received from the FTC or any state franchising, business opportunities, or other regulatory authority relating to franchising or business opportunities activity.

F. Any inquiries from any state in the past five years relating to state tax liability for sales, income or other taxes arising out of the relationship with franchisees in the state.

G. Any inquiries from any federal or state authority or claims made by franchisees in the past five years claiming the franchise relationship was an employment relationship.

X. ADVERTISING

A. List of any public figures used in advertising.

B. A description of any marketing or advertising fund (domestic and/or international), the amount of monies currently in the funds, whether the fund is a trust, whether the franchisor contributes to the fund, how fund monies were used in the past year, and what happens to the funds if the franchise system is sold.

C. A description of any national accounts program and how franchisees participate in the program.

D. Copies of all franchise advertisements and brochures.

E. Any agreements with the marketing committee related to the advertising fund.

F. Organizational documents of, meeting minutes of, and correspondence with, the advertising fund [and/or the entity that administers the fund].

G. Internal reports, and any reports given to franchisees, with respect to the collection and expenditure of marketing and advertising contributions.

H. An account of advertising deposits currently held, and any correspondence with franchisees relating to advertising deposits.

I. Copies of all organizational and governing documents of any advertising cooperatives.

XI. OTHER

A. Copies of all laws and regulations specific to the industry in which ABC operates.

B. Copies of all press releases issued in the last three years.

C. Determine whether franchisees have obtained insurance and whether such insurance permits naming the new officers and directors of the acquired franchisor as additional insureds.

D. Information on predecessors and affiliates of the franchisor.

E. Determine whether the franchisor has recorded any document reflecting its rights of first refusal with respect to any property owned by franchisees which is used for the franchise operation.

F. Determine whether the franchisor has consented to a collateral assignment of any franchise agreement to secure any franchisee loan obligations or entered into a comfort letter with a lender, and copies of such collateral assignments or comfort letters.

G. All material correspondence generally circulated to franchisees during the last twelve months.

APPENDIX D:
List of Common Franchise-Related Representations and Warranties

Titles of typical representations and warranties for the seller of the franchise system in the purchase agreement regarding franchise matters:

1. Franchise System
2. Franchise Agreements
3. Violations of Franchise Agreements
4. Right of First Refusal or Option
5. Franchisee Funds
6. Disputes and Litigation
7. Forms of FDDs
8. Forms of Franchise Agreements
9. Financial Performance
10. Jurisdictions
11. Compliance with Franchise Laws
12. Territories
13. Sales Agents
14. Rebates; Products
15. Advertising Councils
16. Consents
17. Non-Competes
18. Enforcement
19. Franchisee Employees
20. Insurance

See also the papers cited at footnote 28 for sample language for reps and warranties in purchase agreements.

BIOGRAPHIES

MARK A. KIRSCH

Mark Kirsch is a partner at Lathrop GPM, LLP in Washington, D.C. For over thirty years, Mark's practice has focused on domestic and international franchising and distribution matters across a wide spectrum of industries. He represents and counsels clients on various corporate, commercial, licensing, franchise, and business development matters. A significant portion of Mark's work involves franchise mergers and acquisitions, including representing private equity funds, franchisors, and other investors in acquiring (and selling) franchise companies, multiple brand franchise systems, and multiple unit franchise portfolios.

Mark also serves as an informal operating partner and advisor to Atlanta-based investment firm 10 Point Capital, which specializes in investing in franchise companies. Mark is active in the franchise industry, including past service as chair of the International Franchise Association's Supplier Forum, and was a member of the IFA's Board of Directors. He has been a frequent author and speaker at industry and bar association seminars about a variety of issues including branding, licensing, franchising, and distribution.

Mark's recognitions in the franchise and legal community include Chambers USA, America's Leading Lawyers for Business, the International Who's Who of Business Lawyers, and Best Lawyers in America. Mark received his B.A. in Economics from the University of Rochester, and his J.D. from The George Washington University.

CHARLENE YORK

Charlene York is General Counsel for Worldwide Express, LLC, parent company of the Worldwide Express and Unishippers brands, and is located in Dallas, Texas. She is responsible for overseeing all legal and compliance functions for all Worldwide Express subsidiaries. Prior to joining Worldwide Express, Charlene was a partner in the Washington, D.C. office of Akerman LLP, where she specialized in franchise and intellectual property matters.

Charlene has been a frequent speaker and has written numerous articles and papers on franchise law topics for the International Franchise Association and the American Bar Association, including as a chapter co-author for "Exemptions and Exclusions Under Virginia Law" in the American Bar Association's EXEMPTIONS AND EXCLUSIONS UNDER FEDERAL AND STATE FRANCHISE REGISTRATION AND DISCLOSURE LAWS (Leslie D. Curran and Beata Krakus ed. 2017). She is a member of the American Bar Association Forum on Franchising and currently serves on the Corporate Counsel Steering Committee. Charlene received a B.A. in Political Science from Trinity University and her J.D. from Baylor University.

*** *** ***

The authors wish to acknowledge and express their deep appreciation to **Hannah Holloran Fotsch,** an attorney at Lathrop GPM, for her invaluable assistance in writing this paper.