

International Franchise Association
50th Annual Legal Symposium
May 7-9, 2017
JW Marriott
Washington, DC

A Deep Dive into Due Diligence from a Private Equity Seller or Buyer's Perspective

David Barr
PMTD Restaurants, LLC
Marietta, Georgia

Leonard MacPhee
Gardere Wynne Sewell LLP
Denver, Colorado

Ted Pearce
Bradley Arant Boult Cummings LLP
Charlotte, North Carolina

TABLE OF CONTENTS

	<u>Page</u>
I. Introduction.....	1
A. Predictable Cash Flow and Non-Employment of Significant Assets Increasingly Draw Private Equity Groups to Franchising.	1
B. Greater Sophistication of Private Equity Groups Demand Thorough Due Diligence.....	2
II. Overview of the Role of Due Diligence in the Acquisition of a Franchise Company.....	3
III. Parties or Players to a Private Equity Franchise Transaction and Their Respective Due Diligence Roles.	4
A. Franchise System Seller.....	5
B. Purchasing Private Equity Company.	6
C. Franchisor’s Management Team as the Second Purchaser.....	6
D. The Role of the Investment Banker.	7
IV. The Due Diligence Timeline in the Context of the Franchise System Sales Transaction.....	8
A. Notice of Sale and Initial Stage of Due Diligence.....	9
B. Completion of Due Diligence and Identification of Potential Buyer.	9
C. Closing.....	10
V. Key Franchise Issues and Information for the Private Equity Buyer.	10
A. Franchise-Specific Due Diligence.	11
(1) Item 8 and Purchasing Arrangements, Representations and Control by Franchisor.	12
(2) Item 11, Marketing & Advertising Arrangements and Advertising Fund Management.	14
(3) Item 19, FPRs, Unit Economics and Financial Statements.	16
(4) Item 20, Credibility of Franchisor’s Development Commitments and Terminations/Non-Renewals.....	17
(5) Franchise Agreement.	19
a) Territorial Protection.....	19
b) Reservation of Rights.....	19
c) Special Deals or Addenda to Franchise Agreements.....	20
d) Franchisor’s Ability to Modify the Franchise System and Operations Manual.....	21
e) Non-Traditional Venue Franchise Agreements.	22

(6)	Disputes with Franchisees, Franchisee Associations or Franchise Advisory Councils.	22
(7)	Joint Employment Issues.	23
B.	Other issues to be considered or reviewed.....	24
(1)	Intellectual property.	24
(2)	International Operations.....	25
VI.	Management as a Second Purchaser in a private equity Transaction.	26
VII.	Other Issues.....	33

Deep Dive into Due Diligence from a Private Equity Seller or Buyer's Perspective

I. Introduction.

The marriage between private equity and franchising is relatively young in the evolution of the franchise model. Since about the early 1990's the private equity suitor brought a dowry of high multiples in exchange for stable cash flow and limited capital employed in his business model. Providing an excellent exit vehicle for founders of franchise system, the marriage seemed more than both parties could have hoped. However, as both private equity groups and franchise systems have become more sophisticated, the marriage between both parties has become more complex, necessitating a deeper look and investigation of both parties before they consummate the partnership.

A. Predictable Cash Flow and Non-Employment of Significant Assets Increasingly Draw Private Equity Groups to Franchising.

One of the great advantages that a franchise system has brought to private equity investors is their predictability of cash flow. With a system's ubiquitous royalty stream and other income possibilities, the private equity buyer can better gauge its income stream during its period of ownership.

Another of the advantages of an investment in a franchise system is the fact that the primary assets of the franchisor are its franchise agreements and not large stocks of inventory, equipment, or bricks and mortar locations. Most franchise systems are comprised mostly of franchise and not company owned locations. Consequently the amount of annual earnings that need to be devoted to re-investment in bricks and mortar and hard assets is limited. When valuing a franchise system the amount of free cash flow, which may be considerably greater than is the case with a manufacturer, can command higher value multiples than a more traditional company.

B. Greater Sophistication of Private Equity Groups Demand Thorough Due Diligence.

Another contributing factor to the evolution of due diligence in private equity acquisitions involving franchise systems is the diverse portfolios of private equity groups that house more than one franchise system.¹ Further complicating these transactions are the fact that franchise systems may be comprised of multiple systems that are part of the same or similar industrial or service space.² Consequently there will be a host of different issues that may relate to the entire franchise platform of the selling franchise holding company. As an example, if the franchise platform maintains systems offering similar products and services, there may be territorial or encroachment issues that will affect all of the franchise systems if an additional one is added to the then-current portfolio of companies.

In addition to the foregoing, as valuations of franchise systems continue to drive enterprise sales prices even higher, a purchasing private equity group likely will be more cautious in judging the quality of earnings of a target franchise system. As discussed further in this paper, there are many components of a target company that will influence the quality of earnings investigation of a private equity group, necessitating a deeper dive in its review of the

¹ Roark Capital often is the first private equity firm to come to mind in discussions of private equity ownership in franchise systems, with ownership in franchise systems in the restaurant industry (e.g. Focus Brands, CKE Restaurants, Corner Bakery Cafe), automotive industry (e.g. Driven Brands), fitness industry (e.g. Anytime Fitness) and healthcare (e.g. Great Expressions Dental Centers), among others. But, increasingly, private equity firms are acquiring franchise systems—NRD Capital acquired Frisch’s Big Boy restaurants in 2015 and Fuzzy’s Taco Shop in 2016. See J. Maze, *Frisch’s acquired by NRD Partners in \$175M deal*, NATION’S RESTAURANT NEWS (May 22, 2015), <http://www.nrn.com/mergers-acquisitions/frisch-s-acquired-nrd-partners-175m-deal>; R. Ruggless, *NRD Capital buys 70% stake in Fuzzy’s Taco Shop*, NATION’S RESTAURANT NEWS (Feb. 26, 2016), <http://www.nrn.com/finance/nrd-capital-buys-70-stake-fuzzy-s-taco-shop>. L Catterton private equity firm expanded its portfolio to include franchise systems Noodles & Company and Pure Barre. See J. Maze, *Noodles & Co. sells \$31.5M in shares to investment firm*, NATION’S RESTAURANT NEWS (Mar. 14, 2017), <http://www.nrn.com/fast-casual/noodles-co-sells-315m-shares-investment-firm>; G. Tan, *Catterton Buys Majority Stake in Pure Barre*, WALL STREET JOURNAL (May 1, 2015), <https://www.wsj.com/articles/DJFLBO0120150501eb51k379a>.

² In addition to the numerous examples of different restaurants operated within the same franchise system (e.g. Hardee’s and Carl’s Jr.), other industries are taking advantage of efficiencies in operating different concepts within the same franchise system, such as Grease Monkey International, which earlier this year acquired Speedee. B. Davis, *Grease Monkey buying Speedee business from TBC*, TIRE BUSINESS (Feb. 3, 2017), <http://www.tirebusiness.com/article/20170203/NEWS/170209972>.

company's performance, capital employed in achieving the performance results and the company's future prospects both in the franchise system and in its market segment.

II. Overview of the Role of Due Diligence in the Acquisition of a Franchise Company.³

A private equity firm typically selects M&A counsel to represent it through the acquisition of a franchise company as it would a non-franchise company. Typically, due diligence of franchise companies focuses on financial, compliance and risk assessment components, including the royalty stream, advertising fund contributions and management and risk of franchisee non-performance, with heavy emphasis on the franchise system's compliance with applicable federal and state franchising regulations and the franchisor's contracts with its franchisees. Other common requests for information include any litigation pending against the franchisor and whether there are outstanding claims brought by the franchisor against its franchisees. As a franchisor's management of advertising funds historically has been a hot-button issue in the franchise industry, a prospective buyer likely will ask how the franchisor was administering the advertising fund is administered and whether its franchisees have made any claims against the franchisor based on its administration of the fund (particularly where the franchisor was handling the fund as a trust, which could have saddled it with a fiduciary duty in the administration of its advertising program). Other requests and inquiries that may be included in a buyer's due diligence that frequently arise with respect to franchise companies but that are not unique to franchising are environmental issues focusing on real estate held by the franchisor (although this arises more often in certain industries that are more environmentally-centric, such as automobile painting) and whether a franchisor's real estate or other third party contracts are

³ The authors provide a high-level overview of the due diligence process in the sale of a franchise company to provide context. For an in-depth discussion of due diligence in the acquisition of a franchise company, see the relevant chapters in L. Vines & C. Noyes, *Mergers and Acquisitions of Franchise Companies*, (2d. Ed. 2014) and G. Knack, G. Brown and J. Holland, "Looking Under the Hood: Conducting Due Diligence in Franchise Transactions," 47th Annual Legal Symposium (2014).

assignable, terminable upon notice or (such as in situations involving special venue/concessionaires as noted in Section V.A.5(e) below.

The approach to due diligence is typical of a franchise system acquisition; it is an approach, the results of which can be made potentially more beneficial to the buyer or seller by deepening the “dive” into the issues. For example, a deeper dive would include: (A) evolving landscape of franchising (e.g. changes in the economy and franchise-related regulations and the valuation of the franchise system in light of those changes); (B) purchasing arrangements (including credibility of rebates paid to the franchisor and margin of franchisor’s revenue comprised of such rebates); (C) compliance rate of franchisees generally with the franchise system standards; (D) facts underlying transfers (including multiple transfers of the same location, or “churning”), re-franchising, terminations, non-renewals and failure of multi-unit franchisees to meet development obligations; (E) degree to which franchisees are in agreement with the franchisor with respect to marketing and advertising programs, purchasing arrangements and initiatives for investment in future development; (F) methods for communicating operational standards and enforcement of those operational standards and degree of control over franchisee operations; and (G) restrictions on the franchisor with respect acquiring additional franchise systems or operating with non-traditional venues or different channels of distribution. The information that results from this “deep dive” into the franchise system is necessary to accurately assess the current value of a franchise system and identify potential risks to such value that may arise in the future. This paper focuses on the “deep dive” issues in Section V.

III. Parties or Players to a Private Equity Franchise Transaction and Their Respective Due Diligence Roles.

Before taking a deep dive into what a prospective buyer will investigate before making a bid for a franchise company, it will be helpful to understand the due diligence function from the

perspective of the different parties and the time line of a private equity merger, acquisition or disposition of a franchise system. As private equity purchases move quickly (often with the seller being pushed by the investment banker and the franchise system owners to complete the deal), it is important that each party know its responsibility and the expected time line.

A. Franchise System Seller.

The franchise system seller will be under the most pressure because it will be the entity that will be producing the most documents and information to the prospective buyers, although the seller also will receive information from the prospective buyers in connection with conducting its own due diligence. From the seller's perspective, it will want to provide access to documents and information reasonably requested by a prospective buyer (including agreements, charts and studies). The due diligence phase is delicate for the franchisor's management team because the franchisor will be judged on all aspects of its records, from the condition in which it maintains its files to which files were and were not made available to the prospective buyer. As will be discussed later, at some point during the sales process, the management team that initially is loyal to the seller will become loyal to the buyer and the strategy of the seller and its management team may become misaligned.⁴ If there are multiple bidders, then a franchise management team may have some flexibility as to the extent of the due diligence data base. With multiple bidders, a buyer may not have the luxury of doing as deep a due diligence dive as desired because competing bidders that are anxious to close the sale may not be as concerned with conducting extensive due diligence, particularly if a prospective buyer's requests for information from the seller are unfocused and amount to little more than a fishing expedition.

⁴ For example, documents or information excluded from the data room may be questioned by the buyer and may cause the buyer to consider whether certain members of the management team are trustworthy, so the management team's motivation with respect to disclosure may become inconsistent with the seller's strategy during the sales process.

B. Purchasing Private Equity Company.

The private equity buyer will want to review all documentation and information related to the franchise system so that it can make its best informed decision regarding the price to bid for the target company. To facilitate making its decision, the private equity buyer requires quality of information, not simply quantity of information. A seller making available the standard franchise documents such as the franchise agreement and the disclosure document is insufficient. The buyer will want to understand whether the terms of the agreements and disclosure documents provide the flexibility for the buyer to prosecute its business strategy, or conversely, whether these documents will restrict that flexibility. For example, the buyer will want to understand whether the agreements restrict the buyer from operating or subsequently acquiring competitive business or limit the buyer's ability to make modifications to the franchise system (including with respect to approved suppliers, geographic territories, operation in non-traditional venues, distribution of products and services in alternative channels and degree to which the buyer may reshape the brand and related marketing initiatives).

In addition, the buyer will seek documentation evidencing the strategies and tactics of the franchisor's management team to determine whether such management team has fostered growth and development of the system. The buyer also may seek confirmation that the franchisor commissioned reports or studies to determine not only the health of the franchise system but also the health and future of the market place for the franchisor's goods and services.⁵

C. Franchisor's Management Team as the Second Purchaser.

There is a common misconception that the purchase and sale of a franchise system involves only two parties—the buyer of the franchise system and its seller. However, there is a

⁵ If no studies have been commissioned, then this may signal to the buyer that the franchisor is satisfied with the status quo. Alternatively, if a study was commissioned but the results of such study show limits to the growth of the market place, then such results may impact the multiple that the buyer is willing to pay for a franchise system.

third party to the transaction that warrants due diligence: the management team. Most likely, and which will be discussed in greater detail later in this paper, the management team of a franchise system will be asked to invest into the purchase of the franchise system, either in the form of an investment of a portion of its earnings from the previous acquisition by a private equity group or, if this is the first transaction involving a private equity group, an investment of a significant amount of each member of the management team's own assets.⁶ In addition, the buyer will conduct its own due diligence of the management team to determine whether the buyer wants to partner with the members of the management team or whether it prefers to replace the members with a new management team. By the same token, the management team will conduct due diligence of the private equity group to determine whether the group's intentions for the franchise system align with the culture and principles of the franchise system the management team has created.

D. The Role of the Investment Banker.

Another often overlooked player in a franchise system acquisition is the investment banker. The investment banker's role includes not only finding a suitable buyer for the franchise company but also to shepherd the transaction through to its conclusion. The investment banker likely has a vested interest in the transaction because, at least in part, its compensation will be based on a percentage of the franchise system sales price. Accordingly, once the investment banker has facilitated securing an interested buyer, it is motivated to ensure there are no unforced errors that may unnecessarily result in the loss of the transaction. Consequently, the investment banker will insert itself into much of the sales process, especially in the due diligence phase of the transaction (including requesting notice of and opportunity to review everything the seller is

⁶ It is not uncommon for a lender that will provide financing for the private equity buyer to condition its agreement to fund the loan in part on such equity investment of the franchisor's management team.

producing in response to the buyer's requests), and will try to paint the best picture of the franchise system to maximize the purchase price. Think of the investment banker as the gate keeper of what information is to be shared with the buyer. It wants to eliminate as much white noise as it can in order to get the deal done, so documents that have not been requested by the buyer but that the seller intends to produce will be questioned by the investment banker.

IV. The Due Diligence Timeline in the Context of the Franchise System Sales Transaction.⁷

The familiar adage "time kills deals" rings true particularly in the context of a franchise system sale because of the potential strain of a pending sale on franchisor-franchisee relationships. Lengthy due diligence may raise concerns from franchisees regarding the stability of the system and speculations regarding what skeletons may be lurking in the franchisor's closet. To facilitate a smooth due diligence period, the seller should conduct its own preliminary due diligence to organize the documents the seller knows it will be required to produce and identify any problem areas so that the seller may resolve the problems or strategize its approach to minimize the potential effect of those problems on the value of the sale.⁸ This preliminary due diligence period also provides the opportunity for the seller to prepare initial seller's disclosures and begin considering limitations and caps it may want to include on its post-closing obligations. The advantage of this preparatory phase of due diligence is that the prospective sale is known to only a limited number of the seller's personnel and advisors, so the seller may engage in careful

⁷ The timeline discussed in this paper is based upon the authors' experience in sales involving franchise systems; however, numerous factors may impact significantly the time period within which due diligence must be completed, including the seller's motivations for disposing of the franchise system and the aggressiveness of competing buyers for the purchase of the system.

⁸ Initial document gathering may include copies of (1) all annual renewal filings (including orders of effectiveness) and exemptions under business opportunity laws made during the prior five fiscal years, including redline copies of FDDs; (2) all executed franchise agreements and area development agreements and any amendments thereto; (3) all notices of default, notices of termination and forbearance agreements; (4) all litigation matters, including pending and closed matters as well as pre-litigation settlements; and (5) copies of operations manual, training manual and other written directives communicated to franchisees.

consideration of its records and franchise system without the pressure of demonstrating consistent progress toward a closing.

A. Notice of Sale and Initial Stage of Due Diligence.

In most cases, the due diligence phase will commence upon the franchise company's owners' notification (often in conjunction with the investment banker selected to facilitate the transaction) to its management team that the franchise system. The company's general counsel should be included in the initial meeting as the general counsel typically is the point of contact on due diligence matters for the buyer(s)' counsel and should be apprised of the expected timeline within which the owners expect the sale to be consummated.⁹ The early stages of the due diligence phase (typically 20-30 days following the seller's notice of intent to sell) also will include preparation of a confidential information memorandum ("CIM") that will be signed by the seller and by all potential buyers and their respective consultants. The CIM provides the seller the opportunity to become familiar with the information each potential suitor will want to review as well as the other franchise systems owned by such suitors and other industries in which they are involved.

B. Completion of Due Diligence and Identification of Potential Buyer.

Following execution of the CMM, the final stage of the due diligence period typically lasts 30-60 days (although the time period may vary substantially depending upon numerous factors, including the size and complexity of the franchise system, completeness and availability of records and issues that may be discovered during the due diligence period). During this stage, the parties may execute a letter of intent or memorandum of understanding as to the terms of the

⁹ If the seller does not have a general counsel or if the general counsel is inexperienced in the sale of a franchise system, it is critical to retain experienced outside franchise counsel to guide the seller during the due diligence process and in preparing seller's disclosures with respect to representations and warranties made regarding the franchise system.

purchase agreement, and the management team will populate the data room with documents and information responsive to the buyer's requests. This stage may also include meetings with the buyer and various departments within the franchise system, including the franchise development, legal, operations and finance/accounting departments. During this stage, the management team and buyer have the opportunity to become familiar with each other and their expected roles post-closing. At the conclusion of the due diligence period, the prospective buyer is identified either by auction or exclusivity.

C. Closing.

The period from the conclusion of due diligence to closing (typically 30-75 days, depending upon funding of financing, if any, and Hart-Scott-Rodino filings, if applicable) is comprised of finalizing financial and quality of earnings investigations (including review of current interim financials, which, if inconsistent with the established business model may result in re-trading of terms of the sale) and solidifying plans with respect to the post-closing management team.

V. Key Franchise Issues and Information for the Private Equity Buyer.

The private equity buyer will need to be advised on key and unique aspects of a franchise business. Minimally, the review to be conducted by counsel relevant to identifying these material points will fall into at least three buckets: 1) franchise sales and disclosure law requirements, 2) the franchise agreement terms, and 3) the relationship with franchisees. Data derived from a review of materials in these buckets may impact directly on the value of the business, including risks to the stability and continuity of the revenue stream and the predictability of revenue, as well as the costs that may be incurred by the franchisor. The following outlines documents to be reviewed and issues to be evaluated, with specific emphasis on categories in which private equity buyers should consider making a "deeper dive" than

historically has been the case. The first section addresses the franchise specific issues that franchise counsel typically handles in the due diligence process. The second section identifies categories of review that are often handled - at least initially - by other counsel but have franchise specific issues or nuances.

A. Franchise-Specific Due Diligence.

The logical place to begin due diligence is the disclosure document, which provides insight into the franchise system and its financials and “demographics.” Due diligence will include a review of the current disclosure document for compliance with FTC Franchise Rule disclosure requirements and state law requirements in the applicable registration states.¹⁰ In addition, comparisons of the form of disclosure document issued in recent years will reveal the degree to which the franchisor has made changes to the franchise and area development agreements and to the franchise system, each of which might be material to the assessment of the franchisor, the status of the franchisees’ compliance with the franchisor’s most current standards and terms of the current franchise offering, and valuation of the franchise system. In this regard, review of the methodology used in preparing and information disclosed in Items 8, 11, 19 and 20 is important to obtaining an accurate assessment of the condition of a franchise system.

¹⁰ Part of franchise state law compliance is registration of the FDD with certain states’ franchise examiners. To determine compliance with the registration requirements, franchise due diligence counsel should review registration orders dating over a time period representing the longest applicable statute of limitations. We typically use a five-year time period. In addition to the registration orders themselves, a review of correspondence between the franchisor and the state franchise examiners should be undertaken. The comments may be indicative of the completeness of the FDD. Additional information that franchise due diligence counsel must review includes: (1) list of states that the FDD is registered; (2) registration files for each registration state during the appropriate “look back” period; (3) Notes used in the preparation of the FDD, often interviewing the counsel assisting with FDD is helpful with respect to follow-up questions and concerns; (4) all communications with state examiners regarding the registration of FDD - likely in state files; (5) any stop order or other orders of discontinuance; (6) receipts showing the dates of disclosure to the franchisee (and compare to the dates the franchise agreements were signed).

(1) Item 8 and Purchasing Arrangements, Representations and Control by Franchisor.

In addition to confirming that Item 8 complies with the disclosure requirements set forth in the FTC Franchise Rule,¹¹ the buyer's due diligence also should include a review of the franchisor's purchasing arrangements; this includes mandatory or required product purchases, use of approved and sole supplier arrangements, and adherence to product specifications and standards, as well as revenue the franchisor derives from product purchases. Counsel should request a list of all supplier contracts and copies of the material ones. The buyer's investigation should include an analysis of the franchisor's renewal rights and conditions that must be met to exercise such rights under supply agreements with material suppliers and whether the terms of such agreements are subject to re-negotiation by the supplier upon renewal. In addition, the buyer should consider minimum volume purchase commitments under the supply agreements and the franchisor's right to modify such commitments. Finally, the buyer should analyze the franchisor's right to terminate its agreements with suppliers and exit the purchasing arrangements, and further, in the event it exercises such right to terminate, the obligations of the supplier to participate in an orderly transition to a new supplier.¹²

The buyer's due diligence of a franchisor's purchasing arrangements also should include analyses of data on rebates and other allowances the franchisor receives from vendors, including how such rebates and allowances are used and whether the franchisees are supportive of these financial arrangements. In addition to evaluating the revenue to the franchisor and its sustainability, this information should be compared and evaluated to determine compliance with

¹¹ 16 C.F.R. § 436.5(h) (2008).

¹² Private equity groups that maintain a portfolio of multiple franchise systems within the same or similar industry may seek to leverage efficiencies in their supply chains across systems by consolidated purchasing of certain products or services with a single supplier, so flexibility in exiting existing purchasing arrangements between the franchisor and its suppliers may be important to a prospective buyer.

the disclosure requirements and if the supply arrangements raise any red flags with respect to the relationship with franchises. If franchisor is receiving significant revenue from products purchased directly from the franchisor or from fees added to the purchase price by the franchisor or a supplier who then passes on all or some part of the added fees to the franchisor (referred to as commissions, mark-ups or rebates), there may be reason to further evaluate the sustainability of the revenue stream and/or the franchisees' relationship with the franchisor. Sometimes, when a significant percentage of a franchisor's revenue is derived from required franchisee purchases, franchisees are more likely to question whether the price they are paying for products is fair or competitive. The frequency and volume of complaints by franchisees about purchasing requirements can signal a potential issue with a franchisor's purchasing arrangements. Ultimately, a lack of franchisee acceptance of purchasing programs casts doubt on the buyer's reliance on the purchasing revenue continuing or at least continuing as forecasted in the future.

In evaluating the credibility of purchasing arrangements, the buyer's review may include whether the product price paid by franchisees compares reasonably with pricing for similar products in the market, whether the price includes valuable services or other benefits, and whether franchisees could realistically purchase the products or obtain comparable pricing in the market. Buyers also should consider the degree to which the products are proprietary to the franchisor or otherwise tied to the franchisor's trademarks and brand standards.

Further, the due diligence should include an evaluation of the franchisor's relationships with its suppliers. For example, what quality control obligations and key performance indicators must the supplier satisfy and what indemnity obligations does the supplier have to the franchisor and franchisees in the event it fails to satisfy such quality control obligations or key performance

indicators? Has the supplier consistently met quality control obligations or satisfied key performance indicators?

Finally, the buyer may consider the limitations imposed on its ability to make changes to the supply chain by purchasing cooperatives or buying groups (if any) in which the franchisees take part in managing the supply chain, including supplier selection and application of incentives or rebates provided by suppliers. The motivations of the franchisees with respect to supply chain management (e.g. maximizing quality while minimizing cost and favorable credit terms) may differ from the motivations of the buyer to maximize profits of the franchise system through purchasing arrangements that increase the franchisor's revenue.

(2) Item 11, Marketing & Advertising Arrangements and Advertising Fund Management.

In addition to ensuring that the disclosure obligations with respect to advertising and technology set forth in the FTC Franchise Rule¹³ have been satisfied, due diligence on behalf of a private equity buyer should include evaluation of the marketing and advertising undertaken by the franchisor and any marketing and advertising fund. This includes evaluation of the rights and obligations in the franchise agreement, as well as the actual treatment of the marketing (or advertising) contributions in the financial statements and in practice.

The buyer should consider the restrictions on use and allocation of the funds, requirements to hold funds in a separate account, the reporting obligations of the franchisor and auditing rights of the franchisees. If the franchise agreement (or communications to franchisees) creates a fiduciary or confidential relationship with respect to the funds, added analysis is required to ensure the franchisor has segregated the marketing fund from other accounts, and maintained appropriate records of the amount and type of expenditures made from the marketing

¹³ 16 C.F.R. §436.5(k) (2008).

fund. From those records, review of the uses of the funds should be made to evaluate whether the franchisor may have used funds for purposes that are not permitted. This area of review also impacts the relationship with franchisees, as the use of the marketing fund is a frequent source of complaints by franchisees. Finally, the buyer should review the performance of any national, regional and local advertising funds including P&L statements, reports showing contributions, expenditures and deliverables including creative, production and media related to the franchisor's advertising and marketing programs.

In addition to the foregoing, counsel also should undertake a careful review of the terms of the franchise agreements concerning the franchisor's right to allocate and modify marketing fund contributions and required local advertising expenditures as well as any restrictions concerning the use of the marketing fund. For example, is the description of the marketing activities for which funds can be used restricted to certain activities? Some older agreements may permit only more traditional uses such as the purchase of print or TV ads and may not permit paying for overhead or in-house expenses incurred in administering the marketing fund. Do the limitations on the franchisor's use of the marketing fund restrict any plans of the buyer with respect to brand re-image of the franchise system? Further, the buyer should review the franchisor's existing policies with respect to social media and other digital media campaigns implemented by franchisees, including the franchisor's right to set guidelines with respect to such social media campaigns to increase their efficacy for and minimize risk to the brand.

Finally, the buyer should examine the performance of any loyalty programs and gift card programs, including reimbursement commitments to franchisees, obligations to third party service providers that maintain such programs and the programs' compliance with applicable law. With respect to hardware and software utilized by franchisees (particularly the POS and

any proprietary software), the buyer should investigate whether there is consistency in the POS system approved for use by the franchisor and actually in use by franchisees across the franchise system; whether the franchisor has access to data regarding the performance of franchised units and whether the franchisor may require the franchisees to upgrade or change any existing hardware or software making up the POS system.

(3) Item 19, FPRs, Unit Economics and Financial Statements.

If the franchisor includes financial performance representations in its Item 19, the unit-level financial performance information provides initial insight into the historical financial health of the franchisor and its franchised units. Given that financial performance representations often come under scrutiny in franchisor-franchisee disputes, the buyer should take special care to ensure the franchisor's Item 19 complies with the requirements of the FTC Franchise Rule.¹⁴ Moreover, the data should be compared with financial information provided separately in the course of due diligence such as unit sales reports, unit profit and loss statements, supplemented financial performance representations and the substantial data used to formulate the financial performance representations made in the Item 19. This permits analysis of the "reasonable basis" of the financial performance representations, the key driver for evaluating any financial performance representation.¹⁵ Omissions in information supporting the financial performance representations as well as sampling issues and inaccurate bases or assumptions for representations made signal potential issues of concern about a financial performance representation's "reasonable basis." In addition, the buyer should review any media claims with respect to franchise unit performance and supplemental financial performance claims, including those made to support a franchising program for company-owned units. Further, an Item 19—

¹⁴ 16 C.F.R. §§ 436.5(s) (2008).

¹⁵ 16 C.F.R. §§ 436.5(s)(3), 436.9(c) (2008).

or the absence of an Item 19—may be material in evaluating future growth expectations, as it can be a powerful sales tool.

(4) Item 20, Credibility of Franchisor’s Development Commitments and Terminations/Non-Renewals.

The FTC Franchise Rule requires that a franchisor disclose in Item 20 the current number of franchised units, by state, and the changes to those numbers through terminations and non-renewals, as well as information on transfers.¹⁶ This information provides necessary information for planning the due diligence scope. For example, for evaluation of compliance with state sales laws, Item 20 provides information about the number of franchisees in each registration state. It also provides trending information with respect to transfers and the number of franchisees entering or exiting the system. The buyer should pay special attention to the footnotes in Item 20 which may reveal units that have changed hands multiple times within the same fiscal year. Frequent occurrence of multiple transfers within the same fiscal year (or, “churning”) may be indicative of potential issues for the franchise system within a specific market, seasonality and availability of real estate issues, or indicative of a system-wide weakness.

Analysis of the franchise companies’ terminations and non-renewals should be made. As part of franchise due diligence, the buyer should review the correspondence between the franchisor and troubled franchisees. This may show a problem with the system or with the relationships with franchisees, assist counsel in determining whether the franchisor has complied with the franchise agreement and applicable state relationship laws, and importantly, highlight information important to determining whether any franchise litigation is of material concern to the deal.

¹⁶ 16 C.F.R. §436.5(t) (2008).

The number of franchisees that have left the system, including transfers, may show “red flags” in the system. As noted above, an initial source of information is found in Item 20 of the disclosure document. A high percentage of transfers, relative to the total number of units, could be an indicator that existing franchisees have lost faith in the brand or other relationship issues. In a similar vein, a large number of unopened units (also disclosed in Item 20) could be an indicator that the system has grown too quickly and there is a shortage of sites or the franchisor is decreasing the number of units it opens. The buyer should review carefully the Item 20 tables to determine the turnover rate and consider contacting former franchisees identified in the disclosure document to determine why these former franchisees are no longer in the franchise system.

Even if the number of franchisees leaving the system does not cause concern, the franchisor’s right to terminate or not renew is regulated in franchise relationship statutes and many states require good cause for termination or nonrenewal and many impose notice requirements. It goes without saying that determining if the franchisor has complied with those laws and notice or other requirements of the applicable franchise agreement is important. The due diligence should include review of the correspondence between the franchisor and franchisee with respect to the notice of default and supporting documentation.

Renewals, both recent history and the number of upcoming renewals, will shed light on the ongoing value of the system. This review may include any or all of the following: (A) the renewal dates of all of the franchisees in the system; (B) the number of franchise agreements eligible for renewal in the three years post-closing; (C) the number of franchise agreements that were eligible for renewal during the buyer’s look-back period that were not renewed by the franchisee (including any demographic and related market trends of such non-renewals); (D) the

number of franchisees that were eligible for renewal and failed to renew yet continue to operate their franchise units; and (E) the management team's strategy for motivating franchisees to exercise their renewal rights.

(5) Franchise Agreement.

Reviewing each franchise agreement is usually not necessary or possible within the budget and time parameters for the due diligence. Therefore, due diligence review of franchise agreements often focuses on the standard (or master) form of franchise agreements attached to the applicable disclosure document over an appropriate look back period and as well as whether the actual franchise agreements have been significantly negotiated. Often, for both the agreement review and the explanation of compliance with registration and sales laws, a statistically reasonable sample size is selected for review, including specifically reviewing for addenda or amendments reflected negotiated changes.

The review of the standard form of franchise agreements should focus on the key terms with respect to both parties' rights, restrictions and obligations and changes to those key terms over the years. To the extent there have been changes to key terms, it will be important to determine the number of franchisees with materially different terms. Below is a list of some of the key terms to be reviewed and evaluated.

a) Territorial Protection.

This review should determine with the franchisor has granted franchisees territorial exclusivity. If so, evaluation of the scope is critical to determine whether the restrictions on the franchisor will limit anticipated or potential growth of units or other distribution channels.

b) Reservation of Rights.

In reviewing the franchise agreements, the buyer should determine the nature and breadth of the license granted in the franchise agreement and the exceptions and reservations delineated

for the franchisor. For example, whether the franchisor has reserved rights as to its ability to sell to customers in any protected territory and with respect to potential future markets and alternative channels of distribution, such as internet sales, captive markets, other retailers, and national accounts (if applicable) may be important to the valuation of the company.

In addition, due diligence should include comparison between the disclosures in the disclosure document and the franchise agreement to ensure the disclosure document accurately reflected the rights granted to each franchisee. Surprisingly, inconsistencies between the franchise agreement and the disclosure document arise and can blur rights granted to franchisees.

c) Special Deals or Addenda to Franchise Agreements.

The buyer also must evaluate the degree to which the franchisor has agreed to amendments of the franchise agreement over the years. The less uniform the signed franchise agreements, the more review will be necessary to ensure that standard rights and obligations are uniform and can be relied upon in evaluating the system and valuing it. Administration costs associated with different franchise agreements alone could impact the valuation; but, more importantly, negotiated addenda could materially impact the franchisor's right to receive revenue or impose obligations on the franchisor that a buyer would view as material to any valuation assessment. Due diligence therefore requires review and cataloging the negotiated deals.

In addition to identifying key terms that were negotiated to evaluate the franchisor's rights and restrictions and uniformity with respect thereto, this evaluation should also include a review of whether the franchisor complied with franchise sales laws in negotiating changes to the standard form franchise agreement. In some states, negotiated changes to franchise agreements require compliance with negotiated change rules.¹⁷ Consideration also should be given to

¹⁷ See Ca. Corp. Code §31109.1 (requiring a franchisor to register material changes of negotiated franchise sales). Other than in California, franchisors and franchisees have the right to negotiate changes to the franchise agreement

whether the “one-off” deals can be eliminated at renewal because the franchisor is required to sign the standard then-current agreement as a condition to renewal of the franchise.

In addition, search and evaluation of other, less obvious amendments of terms is required. For example, review of communications to the system in which the franchisor makes promises or changes system standards can create an obligation or waiver of rights. For example, in rolling out a new POS system or upgrade, did the franchisor promise economic assistance, or did the franchisor indicate it would forgive prior defaults in a “new day” communication regarding system or even monetary requirements? These communications with the franchisee community could be to an individual franchisee, a select group of franchisees, with franchisee advisory council or association, or system-wide. Further, review of the sales process to protect against pre-signing representations creating a similar risk of the buyer bearing different rights and obligations is important.

d) Franchisor’s Ability to Modify the Franchise System and Operations Manual.

The degree to which the franchise agreements allow the franchisor to implement necessary changes over time is critical. For example, does the franchise agreement incorporate or supplement the operations manual (broadly defined to include other manuals and standard-implementing documentation) and permit the franchisor to unilaterally modify it. Also, do the franchise agreements permit the franchisor to modify and change the system trademarks with new trademarks? Have the manuals and other data been updated regularly? Is there a risk that old standards have been incorporated into the franchise agreement and now bind the franchisor? And does the franchise agreement expressly require franchisees to update and remodel their outlets periodically?

prior to sale without the need to register the amendment with state regulatory agencies unless the changes are repeated in multiple franchise sales such that the changes constitute an amendment to the franchise offering.

e) Non-Traditional Venue Franchise Agreements.

Many franchisors grant franchisees the right to operate in non-traditional venues, such as malls, stadiums, and airports. Typically, these franchise units involve a relationship between the franchisor, a concessionaire/licensee and a facility owner. The concessionaire/licensee has an agreement or lease with the facility owner. The concessionaire's right to continuously operate in the facility is important, as it impacts any evaluation of the reliability of revenues flowing to the franchisor. For example, the facility owner typically will be able to terminate the facility lease upon notice, thereby causing a default and termination event under the license agreement with the concessionaire.

(6) Disputes with Franchisees, Franchisee Associations or Franchise Advisory Councils.

A private equity buyer should be apprised of the existence and information regarding any franchisee advisory council or independent franchisee association. There are several areas of inquiry and documents to review if there is an advisory council. For example, does the council advise the franchisor or does it have any advice and consent privileges? Further, how often does it meet, what issues does it consider and discuss, and how is representation determined? Based on a review of the by-laws, the power, if any, of a council can be ascertained—that is, whether it is purely advisory or has actual power over how the franchisor operates any aspects of the franchise system. The minutes of meetings and communications to and from the council can also be revealing because those documents show the level of discussions, how the powers granted by the bylaws are implemented, and the role the council plays in actuality within the franchise system and with respect to the franchisees.

If the system has an independent franchisee association, review of it and correspondence with the franchisor may reveal system issues or concerns with the relationship. A similar review

and analysis of it should be conducted, including: How and when was it organized - does the franchisor recognize the association? What percentage of the franchisees are members of the association? How often does the association meet? What are the core issues that are addressed by the franchisee association? What is the correspondence between the franchise association and the franchisor? And, how does the franchisor use the franchisee association - does it seek or obtain advice and, if so, on what issues; does it seek or obtain consent - e.g. with respect to changes to the franchise agreement, operations manual?

Even if there is no franchisee association, counsel's review should include a review of complaints by franchisees, as well as threatened litigation or arbitration claims and actual documents relating to any litigation or arbitration. The pleadings and correspondence should be requested from the franchisor and reviewed. This review also can provide a check on the compliance with the disclosure requirements of Item 3. If serious allegations against the franchisor or common complaints are prevalent, they should be thoroughly investigated. This could show a risk of litigation or large-scale defections from the system.

Another source of information to evaluate the relationship between the franchisor and franchisees can be franchisees themselves. It is often a sensitive issue for counsel representing a private equity buyer to interview existing (or former) franchisees due to the confidential nature of the deal and concerns over disruption if the word gets out prematurely. Thus, the timing and processes to be used to avoid those issues should be reviewed with management.

(7) Joint Employment Issues.

While this issue has faded in the eyes of some franchisors given the current political environment, it continues to be a key consideration given the continuing unpredictability regarding how the issue will be handled by federal and state agencies, as well as developing common law in the courts. Indeed, there is ongoing disagreement about what constitutes "joint

employment.” However, the touchstone of any inquiry is control and it will remain relevant for a variety of reasons the degree to which the franchisor directly or indirectly exercises control, and it is worthwhile for the buyer to evaluate the franchisor’s right to exercise control (or reservation of rights to exercise control) the essential terms and conditions of the franchisee’s employee’s employment. This assessment should include review of the franchise agreement terms, training programs, operations manual, POS software, and any requirements related to the franchisees’ employee hiring, discipline, supervision, scheduling, and direction.

B. Other issues to be considered or reviewed.

In the dynamic between the lead deal counsel and franchise counsel, other areas of inquiry may be important to the private equity buyer, depending upon the structure and maturity of the franchise system, including real estate issues (e.g. real estate owned by franchisor and sublet to franchisees), intellectual property, international operations, marketing studies and consumer issues and corporate governance. Often, lead counsel will review some or all of these areas but coordination is essential to ensure these topics are considered. This paper examines in further detail unique issues that may arise with respect to intellectual property and international operations.

(1) Intellectual property.

The service marks and trademarks (including logos) identify a franchise system. The due diligence must include review of the primary marks and registrations to assess their distinctiveness and overall strength. In addition, checking that the franchisor has protected and policed its trademarks (both within the franchise system and from potential infringing use by third parties) is germane to this analysis.

The buyer should ask whether the seller has registered all key domain names relating to the marks and the targeted franchise system. The buyer should determine whether the seller has

maintained control over key domain names respecting the franchise system domestically and in foreign markets where the seller currently conducts activity or may plan to do so in the future. Key questions, then, include: (A) Does franchisor own the marks or are they licensed from another entity? (B) Are there intercompany licenses reflecting such arrangements? (C) Status of all marks (i.e., registered or pending, domestically or internationally)? (D) Are there any abandoned marks? (E) Are there any outstanding third party claims affecting the marks?

(2) International Operations.

It is not uncommon for a franchise system to structure its domestic and international programs differently to facilitate management of franchisees abroad, often through master franchise arrangements that obligate the master franchisee to provide copies of disclosure documents used in connection with the offer and sale of franchises in its territory and confirmation of any filings required to comply with laws in the applicable jurisdictions as well as communicate regularly with the franchisor regarding compliance of the sub-franchisees with the franchise agreements and franchise system standards. However, all too often, the franchisor has little insight into the operations of its brand abroad. Accordingly, in connection with the buyer's due diligence of the franchise system, the buyer should take care to investigate the franchisor's relationships with its master franchisees, including: (A) the form of disclosure document used and whether such disclosure document complies with franchise law, if applicable; (B) whether the terms of the franchise agreements executed by the master franchisee and its sub-franchisees are inconsistent with the franchisor's form of franchise agreement, and further, whether any sub-franchisees are in breach of their respective franchise agreements or otherwise operating outside of an executed franchise agreement; (C) whether master franchisee is in compliance with its obligations under the master franchise agreement (including payment obligations and obligation to maintain a letter of credit); (D) any pending litigation involving the master franchisee and/or

any sub-franchisees with respect to the franchised units; and (E) whether there is privity of contract between the franchisor and the sub-franchisees and to what extent the franchisor must rely on the master franchisee to enforce the terms of the franchise agreements with sub-franchisees.

VI. Management as a Second Purchaser in a private equity Transaction.

As discussed previously, there are really two buyers in an M&A transaction involving a franchise system when private equity is involved. Of course, the first purchasing party is the private equity group itself. The second buyer is often the management team because its members will be given the opportunity to invest their personal monies into the transaction. In fact, failure to do so will send a signal to the private equity buyer that management is not truly committed to the transaction. Not only will the management's decision not to invest dampen the enthusiasm of a buyer, but it may also undermine its ability to secure 3rd party financing as a lender will want to see management's participation in the transaction in order to garner additional confidence in its decision to finance the transaction.

Accordingly, since management will be a buyer in the transaction, it behooves the management team to conduct separate due diligence of the private equity buyer. Likewise, management must be aware that the private equity buyer is conducting corresponding due diligence on the management team. In order for the relationship between the private equity group and the management team start on the right foot, there are a number of issues that management must understand and resolve before it will be truly ready to engage into a transaction.

It should be noted that each private equity buyer is its own entity with its own personality and expectations. Therefore, even if the current private equity transaction is the second or third private equity transaction for the company management must take the time to understand the dynamics of the specific transaction and its potential partner.

A. Understanding the goals of the private equity Purchaser.

As stated above, not every private equity group is the same; thus each private equity transaction may be driven by a different strategy depending upon the needs of the underlying private equity fund and the development needs of the franchise system. While it is true that every private equity transaction is predicated on growth and profitability of the franchise system, the question is what is the time line for that growth and profitability to be accomplished? For example if the franchise system is a young system with immediate growth potential, the private equity buyer may want to increase the resources of the company in order to accelerate or jump start that growth. Likewise, if the private equity buyer views the management team's capabilities as a good fit for managing multiple franchise systems it may want to use that team to leverage the buyer's desire to add multiple brands to the franchising platform in order to create a multi-branded franchisor to operate within a specific industry space such as the restaurants or automotive businesses.

There also could be other reasons for the investment. The private equity buyer may believe that the system is bloated, but capable of additional growth. If the projected hold time of the franchise system is to be calculated in months and not years, the private equity buyer may be only interested in cutting much of what it considers to be unnecessary expenses, and then "juicing up" whatever growth it can. Then it will seek to resell the system under the aegis of having cleaned up a malfunctioning system for the benefit of the next buyer. For each of these strategies the management team must determine if the direction of the franchise system post transaction fits with its desires and needs. If the management team does not have a good understanding of the post transaction strategy before the deal is concluded, what it learns post

transaction could make for an unpleasant and unproductive relationship with its private equity buyer.

B. Synergies the Private Equity Group Seeks to Accomplish in the Transaction.

Unless the belief is that the franchise system is sorely under-resourced, a private equity buyer will look at the demographics of the franchise systems to determine if there are any personnel cuts or franchising procedures that make the franchise company ripe for cuts. This process is endemic in a private equity transaction, especially if the transaction involves the purchase of multiple systems at the same time to be managed by one or a combined set of franchise managers. The management team will want to know as early as possible what cuts will be made and what procedures will change. As an example, will there be cuts made to the number of operations' representatives or visits that operations representatives make to the field? How will the transaction affect the training curriculum or the number of times that training is to be conducted? What about the development budget? In connection with the sale of the franchise system, the management team likely will have shared with the private equity buyer a budget model for the company on a post-transaction basis. If the private equity buyer accepts the results, will it accept the tactics that the management team believes is necessary to accomplish those results? Again, it is critical for the management team to understand the strategy and tactics of the buyer before it will be ready to invest into the post transaction company.

C. Expected Hold Time of the Private Equity Group.

An important aspect of any private equity transaction is what will be the hold time by the investor? In other words, how long does the private equity group intend to own the franchise system before it either refinances it or remarkets it to another buyer. These time horizons can dramatically affect the development and growth strategy of the franchise system. If management

believes that international development of the franchise system is a natural next step to growth but the buyer is looking at a short term hold time, this dichotomy may impact the collaborative relationship between management and private equity group. Again, if the management team is not on-board with a private equity group's strategy, it will be difficult to interest the team to invest in the transaction. Conversely, if the hold time will be in years as opposed to months management may well have the opportunity to continue with its pre-transaction strategy.

D. Expectation of the Management Team's Investment in the Franchisor.

As should already be apparent to the reader of this paper, there will be an expectation that the management team will make a significant investment in the post transaction company. This investment is likely to provide the management team with significant equity growth opportunities. These opportunities naturally beg the question of how far down into the management ranks these opportunities will be afforded. At least from the management's perspective, the more people in the company that are incentivized to contribute to the development and profitability of the company the easier it will be to keep these individuals motivated to the post transaction strategy of the company.

E. Structure of the Management Team's Investment.

Once it will be determined who within the company will participate in the equity pool then it behooves management to understand how the equity pool will work. The first order of business will be to determine how much management will be asked to invest, whether this is a first time transaction with participants being asked to invest new funds or whether the investment will come from roll-over funds from a previous ownership structure of the franchisor. The management team and the private equity Group should look for the most expedient tax friendly vehicle to accomplish this roll-over investment into the franchise company.

F. The Operating or Shareholders' Agreement.

Once the management team understands how much and how the roll-over will be accomplished then it will want to see the post transaction operating agreement or shareholder agreement, which will among other things outline what constitutes a liquidating event and how and when the members of management will be able to liquidate its investments. The provisions in either of these agreements must spell out what happens to an investor's investment if they should leave the company prior to such liquidating event. Will they be able to maintain that investment in the company post-employment, or will the managers or shareholders of the corporation or limited liability company have the discretion or right to repurchase those shares or units and at what value? Will there be a fixed valuation at the time of the early sale of shares or units?

The operating or shareholder agreement must also lay out under what conditions an investor can lose its roll-over investment when it leaves the company. In other words, with respect to any initial or roll-over investment made by an executive, are there any conditions upon which it would forfeit its roll-over or initial investment. Since the investment constitutes an investor's moneyed investment, unless the units become worthless then there should be no reason or condition that would result in an investor's forfeiture of its roll-over or initial investment.

Another area that must be understood by management is what anti-dilution rights will be accorded to these equity holders if other investors are given an opportunity to invest in the post transaction vehicle. Likewise, upon an offer of sale of the company by the majority owners, will the minority shareholders, which will of course be members of management be required to adhere to drag-along and/or tag along rights which will both obligate them and give them the

right to participate in any material transaction that the private equity group decides to enter into on a post transaction basis.

A management team will most certainly want to be “calling the shots” wherever possible. It will neither want to be micro-managed by the private equity group, nor have no communications with the owner between quarterly meetings. A management team most likely will want regular input, but will want to be able to carry out its strategy and tactics. The management of the target company was instrumental in selling the franchisor or franchisee(s) predicated on a defined business strategy. So it behooves the management team to understand the terms of not only the operating agreement but any loan or financing documents that may become part of the transaction. One thing that it will want to know is what decisions will be reserved for the board or the shareholders, in what is usually termed “fundamental decisions.” If a franchisor wants to grant its franchisees financing for the initial franchise fee, back royalties, or system-wide improvements, will the operating agreement grant to the franchisor such flexibility, or will that be a decision reserved for the board, the shareholders, or the funding source? These are issues that a management team needs to understand from the outset if they are expected to perform at their optimal value.

G. Employment Contracts.

From a compensation perspective it is realistic for a management team to expect that it will receive some form of written employment agreement that will set forth the expectations, rights, and obligations of the manager in its continued employment with the investor. While this paper is not intended to be a comprehensive dissertation on employment contracts, some basic terms that a management team needs to understand, is how far down the management chain will employment agreements be granted? What will be the compensation? How often is it reviewed?

What will be the term of the Agreement, and under what terms may it be terminated, and what severance can be expected upon termination? In addition, will there be opportunities for annual performance bonuses and how are they earned. These are all fair questions that a manager will want to know before it considers its investment options into the newly organized franchise company.

H. Stock Option Plans.

As part of any compensation plan for managers the private equity buyer likely will offer its key managers an incentive stock option plan. These plans come in all varieties, but from a management's perspective it will want to know, how far down the employment chain will extend. There is a belief that the more people within the franchise system that are tied to the success of the system the more likely the management team will be able to employ its strategy successfully. There are of course basic components to these plans better known as ISOs. From a management team's perspective it will want to know how many shares or units will be allocated to the plan, and who will determine which employees receive these incentive options and how many shares will be accorded to them. ISO's are usually based on both longevity and performance vesting. Often they are split between the two to both reward the employee for longevity and performance. The plans should contain an acceleration provision that allows for the shares or units to be accelerated upon a liquidating event- or sale of the company. What acceleration means is that both the un-vested time options will become immediately vested at the time of the liquidating event as well as the un-realized performance options that have not yet had time to be subject to the performance vesting. The options also should address how they can be forfeited- termination for cause- and what rights, if any, does the employee have to exercise its option to convert its options to equity upon leaving the employment of the franchise company.

In private equity transactions stock options are powerful incentives that, in addition, to the roll-over equity, can become tremendously valuable upon a liquidating event.

VII. Other Issues.

In addition to the due diligence issues discussed above, a management team will be involved in other very important obligations as part of concluding a sale to a private equity group. If the franchisor has the services of a general counsel it will be responsible for making sure that the schedules to the sales agreement are in place and accurate. Schedules to a sales agreement essentially act as either a supplement to a representation and warranty made in the sales agreement, such as identifying all of the intellectual property of the franchise company, or highlighting an exception to a representation and warranty. For example a representation may state that the franchisor has no active litigation or claims, EXCEPT as set forth in schedule xx. In that situation a franchisor would be expected to list all of the current litigation or claims that exist in the franchise system. The preparation of the schedules can be a daunting task and are often relied upon when an issue arises post-transaction. Schedules are not to be taken lightly, and the person(s) preparing them will need to spread its inquiry net far and wide to ensure that it includes all facts, documents, and other matters that will make up the schedules.

In addition to the Schedules a management team will be required to sign a separate document that warrants and represents that its warranties and representations set forth in the sales agreement are true and accurate based on some knowledge standard, which could include “to the best of their knowledge” or “to their knowledge.” The representations and warranties contained in the sales agreement are in many ways determined by the due diligence that has been conducted as part of the transaction. Therefore a comprehensive dive into due diligence will be key to the management team- usually the chief executive officer, the general counsel, and the

chief financial officer- being able to provide the purchasing private equity group with an accurate view of the target company.

The deep dive into due diligence may also find its way into the any financing documents that will become part of the sales transaction. In many cases the bank or other credit facility will piggy back on the original due diligence conducted on behalf of the buyer, but there may be additional due diligence requests made by the credit facility that may go further in depth to some of the financial issues for the company, such as how many promissory notes has it accepted from franchisees. From a franchise company's perspective, the covenants contained in the loan documents can be different and more exacting on a management team, so it behooves the managers to understand these covenants in the context of their operations. Once the loan documents are signed they are difficult to amend. If it does become necessary to amend this document the creditor will charge a steep fee to undertake such modifications.

Due diligence in a franchising transaction is a comprehensive undertaking. In addition to the normal business practices that will be reviewed in an M&A transaction, there are many intertwining franchise issues that must be understood by the buyer in order that it receives no post transaction surprises that could undermine its investment as well as the health of franchise system.