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Basics: Franchise-Related Mergers & Acquisitions

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A. Introduction

For almost the past decade, the market has witnessed strong interest in the acquisition of companies which own and operate franchise systems. Although the market has also seen many large, multi-unit franchise businesses changing hands, we will focus on the transfer of entire franchise systems, i.e. the selling of the franchise brand, or franchisor, itself. This paper gives on overview of the deal process, examining franchise-specific issues. It first examines what a seller of a franchise company should consider in readying itself for sale to optimize the company's franchise value. It also looks at the metrics investment bankers and sophisticated buyers use to assess valuation. Next, it turns to the deal itself, including reaching a letter of intent and conducting the critical due diligence that a prudent buyer should follow before closing the transaction. Finally, it reviews key components of the purchase agreement and what the seller and buyer can expect. Although generally, this paper is limited to the pre-closing process, we consider the pre-merger and post-merger disclosure obligations of the seller and buyer, as well as ways for a selling owner-manager to stay involved in the business. Substantial portions of this paper have been used or adapted from the 2016 International Franchise Association ("IFA") paper of the same name.[1] For additional information on this topic, there have been a number of IFA articles and presentations during the past several years,[2] and they have been excellent sources in developing this paper.

B. Overview of Deal Process

Who are the players and what needs to happen to accomplish the sale of a franchise system? Below is an overview of the deal process. A more detailed discussion of the topics follows in later sections of this paper.

1. Who's Buying? Since the rebounding of the overall market since the late 2000s, the franchise industry has enjoyed strong interest and many franchise brands have been transferred to either strategic buyers or financial sponsors.

   (a) Strategic buyers—those who are already in the franchise industry or business sector—often seek to add units and market share by capturing competing or similar brands, or brands that target the same consumer strata. For example, in recent years, Kahala Brands acquired Baja Fresh, Pinkberry and The Counter to add to its portfolio of restaurant and food brands. Another type of strategic buyer often stems from the third party at the table in any franchise system transfer: the franchisees of the brand. Often in situations where turn-around strategies are important to a

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[1] *See* Sandra Bodeau and Meg Montague, *Basics: Franchise-Related Mergers & Acquisitions*, in IFA 49TH ANNUAL LEGAL SYMPOSIUM, (2016).

[2] *See* Gaylen Knack, Grayson Brown, Jeremy Holland, *Looking Under the Hood: Conducting Due Diligence in Franchise Transactions, in* IFA 47TH ANNUAL LEGAL SYMPOSIUM, W14 (2014); P. Thao Le, Reeves McGee, Breton Permesly, *Basics: Franchise-Related Mergers and Acquisitions; in* IFA 47TH ANNUAL LEGAL SYMPOSIUM (2014); Mark Kirsch, Scott Pressley and Patrick Walls, *A Seller's Guide to Preparing to Sell the Franchise System, in* IFA 42ND ANNUAL LEGAL SYMPOSIUM (2009); Victoria Blackwell and Kevin P. Hein, *The Fundamentals of an M & A Transaction in a Franchise System, in* ABA 33RD ANNUAL FORUM ON FRANCHISING, Tab W18 (2010).

struggling system, a group of franchisee may band together and buy the brand to protect their investment and leverage their brand-specific savvy.[3]

(b) Financial sponsors--typically private equity firms seeking strong investments for their fund portfolios are attracted to the long-term royalty streams or product distribution capabilities of franchise companies. For example, Cleveland Avenue became a strategic partner and majority investor in Pizza Rev, TZP took a stake in Snap Fitness, BIP Investment Partners purchased Tropical Smoothie Café, and Catterton recently acquired the fast-growing Pure Barre franchise system.

2. Ready, Get Set… The seller will need to lay the legal groundwork to be ready to sell. This includes assessing the franchise agreements, securing all intellectual property rights, resolving potential claims, evaluating the sales process and developing a clear message on future growth opportunities, such as adding services, revamping marketing initiatives, and seeking expansion internationally. This exercise is sometimes referred to as "Seller Due Diligence" or "Reverse Due Diligence".

3. Assessing Valuation and Working with an M&A Advisor. The seller will want to meet with an experienced M&A financial advisor, such as an investment banker, to find ways to maximize value. These advisors will run through typical factors that drive a premium valuation for the company. The M&A advisor will conduct internal information gathering and prepare marketing materials to distribute to potential buyers. If a seller is in a strong bargaining position, investment bankers can bring substantial additional value to the sale by canvassing these potential buyers and, in some cases, conducting an auction process.

4. Basic Deal Structure – Stock vs. Assets. The seller will want to consider its preferred sale structure in consultation with its tax, legal and M&A advisors. As in non-franchise M&A transactions, the selling franchisor typically prefers to sell the equity securities of the franchise company, rather than have the franchise company sell assets, for various reasons, including liability (all of the company's assets and liabilities stay with it, and so accrue to the buyer), comparative simplicity of transfer (less need for third-party consents and approvals) and tax considerations (real estate transfer and other sales taxes can be avoided, thus preserving more value for the parties, and the seller may be able to shelter its capital gains from the stock sale under a lifetime exemption). Buyers, on the other hand, often prefer asset deals, where they can cherry-pick assets and liabilities, as well as employees.

In a "stock" deal structure, the transfer of the equity securities of the target may be through a direct sale of the securities or by merger. In a direct sale of securities, each owner would be a party to the purchase agreement

[3] In 2012, a group of franchisees from Long John's Silver's and another group from A&W purchased franchise systems from YUM! Brands.

would agree to sell their securities to the buyer. If the target has a large number of equity owners or equity owners that may not voluntarily want to sell their securities, a direct sale may be burdensome or impractical.

In those instances, a merger is the legal method to accomplish a stock deal. In a merger, the parties to the transaction are the entities involved (and likely key owners), rather than all of the securities holders. So long as the target entity obtains the requisite approvals, state law would subject all holders to the transaction, subject to any dissenters' or appraisal rights. Thus, the merger structure allows the buyer to acquire the target without each equity holder agreeing to sell its securities to the buyer.

The most common merger structure is where a wholly owned subsidiary of the buyer (the merger sub) merges with and into the target and the target would become a wholly owned subsidiary of the buyer. The consideration is paid by the buyer to the equity holders of the target. This structure allows for the target entity to continue as a legal entity and continue its operations.

As noted above, some may prefer an asset sale over a stock sale because the buyer can select which assets it will purchase and which liabilities it will assume. The asset transaction may be preferable in some respects but may be more complicated because consents of third parties and regulatory authorities may be required.

5. <u>Letter of Intent</u>. The M&A advisor will normally require that each possible buyer sign a non-disclosure agreement of the confidential information it will receive to evaluate the deal. Highly interested buyers will be asked to submit and negotiate a letter of intent (LOI) addressing all key financial and legal terms.

6. <u>Buyer Due Diligence</u>. The scope of due diligence will depend on whether the transaction is structured as an equity or asset sale, or a merger, the speed and complexity of the transaction, the awareness of sellers personnel of the pending transaction, the geographic scope of the seller, how a buyer intends to use the business or assets after closing, and other related issues. Depending on the type of buyer, the seller may wish to limit the scope of the due diligence. In particular, the seller may need to restrict access to confidential information for a strategic buyer who is a competitor to minimize any advantage the competitor could gain if the deal falls through.

7. <u>Seller Due Diligence</u>. In addition to the reverse due diligence described above, the seller should also perform an investigation and analysis of the proposed buyer, especially with regard to its financial wherewithal (and hence its ability to close) as well as their reputational and operational suitability as a partner, if the seller or its principals are planning to retain a level of involvement post-closing or if the seller is receiving a material amount of the purchase price post-closing.

8. Purchase Agreement. Typically, the LOI contemplates that the parties will sign a "definitive agreement", which means a negotiated purchase agreement, within a stated time period, or lose exclusivity. This allows the seller the ability to move on if the buyer is moving too slowly but gives the buyer some time to gets its due diligence completed. The purchase agreement is usually negotiated concurrently with preliminary due diligence. The negotiations will focus on a comprehensive set of representations and warranties related to the business, as well as conditions to the closing and the covenants of the parties. In addition, the indemnification provisions, including the determination of any "dollar one" liabilities and other liabilities subject to a basket, and the cap on liabilities will be negotiated. The results of the due diligence will feed into the negotiations, as the buyer will seek more favorable terms and more risk reducing provisions if the buyer's investigations reveal potential or actual post-closing liabilities.

9. Closing the Deal. With nearly all asset deals, and with most stock deals or mergers, the purchase agreement will be signed with the expectation that the actual transfer of the target company will occur at a later date. During the time period between signing and closing — typically 30-60 days (but with substantial variations) — the parties will seek any third party consents required to transfer the assets or business. At some point in the selling process, the parties will want to consider how the pending transaction should affect franchise sales. Also, the buyer will want to prepare amendments to the franchise disclosure document (FDD) in a stock deal, and create its own FDD in an asset deal, in order to minimize the time period where sales will need to go "dark," i.e., stop selling franchises.

10. Franchise Sales Issues During the Deal Process. Both federal and state laws regulating franchising focus on providing prospective franchisees with material information regarding the franchise being purchased. These laws generally require an amendment when there is a material change in the information presented in the FDD. The guidelines under which the FDDs are prepared do not specifically address disclosure obligations with respect to a pending sale of a franchise system.[4] Nevertheless, the required disclosures may be impacted by the pending sale and, depending on the circumstances, common law may require disclosure of a potential or pending transaction. The seller and buyer will want to consider a number of business and legal concerns to determine how to address this disclosure issue. See Section F for a more detailed discussion of suspension and amendment concerns during the deal process.

C. Preparing to Sell a Franchise Company

The heightened interest in the market regarding the franchise sector has sparked interest in selling, especially with owners approaching retirement age and looking for a liquidity event. Sections C and D highlight key legal and valuations issues for the seller to

[4] Harris J. Chernow and Charles S. Modell, *Mergers and Acquisition of Franchise Companies,* ABA PUBLISHING, Second Edition (2014) (Vines, Leonard D and Noyes, Christina M., Editors), at 29-33.

consider in the sale of a franchise system and the proactive steps the seller can take to improve the company's purchase price. Preparation includes reducing liabilities, addressing franchisee performance, and heading-off issues that may negatively affect the purchase price.

1. Assess the Franchise Agreements.[5] The seller's franchise agreements are contract rights that often serve, along with its trademarks, as the franchise company's most valuable assets. Savvy buyers will review the franchise agreements in depth to determine the quality and reliability of the royalty stream they are purchasing. To prepare for this review, a seller should track the versions of the franchise agreements in use in the system and make note of any significant variations among them. Create a log of each version, noting key changes, especially in royalty and other fees and rights granted or reserved.

   In addition, legal counsel should review whether the franchise agreements give the franchisor flexibility in responding to dynamic changes in the marketplace. Can the franchisor update the system, add new product lines, change suppliers, and add products or services that could not have been anticipated when the franchise was first sold? Can the franchisor change the trademark? If not, the franchisor will need to change its franchise agreement going forward. Are there franchise agreements where the territory granted is too large, creating an impediment to future expansion? If so, the franchisor may want to negotiate with the franchisee to reduce or split up the territory.

   As franchises come up for renewal, the franchisor should require that the newest version becomes the basis for the renewal. If older versions are not soon up for renewal and have little flexibility, lower fee structures, or other troublesome provisions or omissions, the franchisor should consider embarking on an incentive program to encourage franchisees to enter into the newest version. These steps will bring welcome flexibility and standardization to the system and make the franchisor more attractive as an acquisition target.

2. Secure Intellectual Property Rights.[6] Imagine taking the franchise name off retail units and trying to promote the business. Picture a competitor setting up shop with the same trade dress and a confusingly similar name across the street. Understandably, buyers will closely examine the strength of the seller's trademark and other intellectual property rights because they often form the foundation of the franchise system. If the franchisor has failed adequately to protect and police its trademarks, or if there are other legal concerns regarding the ownership or validity of its intellectual property rights, the franchisor's value will be seriously affected.

[5] Sandra Bodeau, John Brower & Gaylen Knack, *Selling the Franchise System: Laying the Legal Groundwork to Optimize Value,* FRANCHISING WORLD, April 2013 at 66-68.
[6] *Id.* at 66.

Consequently, the seller should conduct an audit of its intellectual property. The seller should create a list of all intellectual property it uses or licenses, and evaluate the strength, validity and status of its intellectual property, including both trade secrets and intellectual property that is subject to registration in various jurisdictions. The seller should determine if there are any concerns, and then establish a game plan to address those concerns. Whether the franchisor follows-up with cease and desist letters to infringers or takes a more conciliatory approach with a third-party who may hold conflicting rights to the trademark, the franchisor should attempt to resolve as many of these conflicts as possible before going to market.

3. Resolve Litigation and Reduce Potential Claims.[7] Significant ongoing or threatened litigation can cast a cloud over the value of a company. Because a buyer often will evaluate such litigation on a worst-case basis, ongoing litigation, proceedings or threats can disproportionately reduce the valuation given to the franchisor. Moreover, a buyer may insist on being indemnified against the litigation in the purchase agreement. When this occurs, the seller will be put in the undesirable position of having significant exposure post-closing, often without the ability to fully control what occurs in the litigation. Because of this, a seller who is a party to significant litigation against it should renew efforts to get the litigation resolved before embarking on the sale of the business.

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

One note of caution, however, not all franchise laws in all jurisdictions permit releases of claims under those laws. As is emphasized in greater detail below, when preparing for or conducting an international transaction, it is essential to obtain the advice of local counsel to help determine the risks inherent in the proposed transaction and to determine what can, and cannot, be done to minimize those risks.

4. Shore up the Sales Process.[8] Each seller should conduct a comprehensive franchise sales compliance audit before bringing the franchisor to market. This sales audit will determine whether the sales force has followed disclosure and registration laws consistently. Do all receipts document that the franchisor has followed proper compliance procedures? Have

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[7] *Id.* at 67.
[8] *Id.* at 67-68.

franchisees complained about promises made outside the contract? Upon finding non-compliance issues, the seller should implement compliance training and other tools (e.g. checking for receipts, adopting closing acknowledgements, and seeking releases) to minimize future issues and to cleanse past missteps.

5. Enhance the Legal Underpinnings for Growth.[9] One of the most significant factors which boosts a franchisor's valuation is a buyer's belief that it can significantly expand the franchisor's business after the purchase. The seller should do as much as it can to establish the legal underpinnings for this growth. One focus can be the provisions of existing franchise agreements. The seller should create sufficient flexibility in the franchise agreement to permit expansion geographically, by product or service, or through alternative distribution channels.

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

6. Evaluate Royalty Stream and Opporutnities for System Growth. As discussed in more detail below with respect to valuation, a buyer will evaluate individual franchise unit economics. Franchise unit economics may be a tool for validating or disputing the seller's projections and business plan. Unit economics may be a proxy for evaluating the health of the franchise system - from both the perspective of top-line unit gross sales and bottom line profitability (or shrinking losses). The economic health of the system will guide a buyer's own determination of the strength and growth potential of the existing royalty stream. It will also help frame a buyer's evaluation of the potential for organic unit growth or decline. It is almost axiomatic that, franchisees that operate franchises that achieve positive financial outcomes are more likely to speak well of the system in the franchise sales process, organically develop new units, and satisfy area development schedules. On the other hand, poor unit economics may sow the seeds of discontent and revolt among franchisees and may further portend requests for refunds of area development fees for units that will not be developed or threats of litigation.

7. Never Too Early to Start – Franchisor Best Practices to Assure a Smooth Sale Down the Road. As was noted in the various examples of seller due diligence in this section, a lot of work must often be done to clean up past issues and shore up standard practices of the franchise company in order

[9] *Id.* at 68.

to assure potential buyers of the value the company represents. It almost goes without saying that the more care the seller takes in its operations and compliance practices, and in its record-keeping, from the date of its inception, the less work will need to be done to clean up the mess when it comes time to sell. Further, systems can be put into place early to help a seller populate a meaningful “data room” with diligence materials in advance of an LOI being signed or shortly after signing. It is never too early to consult with counsel and to start doing things right, and a long track record of compliance with best practices can translate into seller credibility in the eyes of the buyer, and real additional value that the buyer may be willing to pay.

D. Assessing Valuation

The seller's M&A advisor, usually an investment banker, will play a critical role in assessing valuation. The M&A advisor will look at unit-level economics, quality of earnings, and projected revenue streams from royalties and other fees, and from product sales into the franchise system, either by the franchisor or its affiliate, or from incentives or rebates paid to the franchisor based on franchisee purchases:

1. Royalty Stream. Buyer's place a greater value on royalty income versus up-front franchise fees, product sales or rebate income. Buyers will evaluate how the overall royalty stream has been growing historically as well as how it is projected to grow based on tenured franchisee performance, anticipated ramp from newer franchisees, and new expected franchisees in the pipeline (i.e., those who have signed a franchise agreement and are expected to open).

2. Same-Store Sales Growth. Buyers will look at franchise-level revenue trends (on a franchisee-by-franchisee basis) to assess the growth imbedded in the system. Even if overall system revenue is growing, if franchisees are not demonstrating positive same-store sales growth trends, valuation will be negatively impacted. Stagnant same-store sale trends for long-tenured franchisees could demonstrate some level of complacency at the franchisee-level. The franchisor will need to address what it is doing to re-energize the system (or particular franchisees). Sometimes stagnation in growth suggests that one or more franchisees may need to be worked out of the system to fuel future growth. Strong same-store sales growth trends support a higher valuation.

3. Company-Owned Contribution. While company-owned stores are often valuable to a franchisor for training, testing, proof of concept and overall EBITDA generation, buyers will reduce valuation for businesses with significant EBITDA exposure to company-owned stores. Sellers with more than ~25% of EBITDA from company-owned stores should expect a sum-of-the-parts valuation which reflects a portion of the business being valued closer to a franchisee than a franchisor. Furthermore, company-owned stores significantly increase complexity and liability of a pure-play franchisor.

4. Franchisee Profitability. To the extent possible, buyers will want to evaluate franchisee profitability to assess the health of the franchisees — are the franchisees making money? Happy, profitable (and wealthy) franchisees can have a positive influence on valuation.

5. Franchisee Payback. To help assess the strength of the franchise model, buyers will want to understand the payback or return-on-investment to franchisees. What is the start-up cost for the average franchisee? What is the anticipated payback period for that investment? Generally, a payback period of less than 3 years is viewed positively. A long payback period may suggest that the franchisees are not making a suitable salary for their efforts, which could impact the franchisee renewal, transfer or failure rates in the system, thus, potentially negatively impacting valuation.

6. Franchisee Tenure and Renewal Rates. In the absence of having franchisee income statements, buyers will look to overall franchisee tenure and renewal rates as a factor in determining the overall health of the franchise system. Seeing high renewal rate and long-tenured franchisees provides support for a healthy franchise system, and thus, potentially a higher valuation. Buyers will evaluate future renewals and want to understand the probability of franchisee renewal as this could significantly negatively impact the future royalty stream (and valuation) in the case of non-renewals (assuming it is not a franchisee that should be encouraged to leave the system in any event).

7. Franchisee "Class" Data. Buyers will want to assess how certain franchisee classes have performed over time. Are 9-year old franchisees continuing to grow? How has the initial ramp period for franchisees changed over time (faster ramp, slower ramp)? How has the average unit volume or average revenue increased over time for each franchisee class? Perhaps more recent classes of franchisees are achieving higher revenue at a faster rate than older franchisee classes — a sign that the franchisor is selecting better franchisees and training them better (for instance). Classes that continue to perform well and can demonstrate a strong growth trajectory over time, can substantiate what newer franchisees should be capable of achieving, which in turn, can help substantiate the projections and support a higher valuation. Buyers will also assess the level of franchisee churn in the system and benchmark it against other franchisors – higher levels of churn will result in lower valuations based upon concerns around sustainability of royalty streams, quality of support, business model and franchisee selection.

8. Franchisee Pipeline. Buyers will want to assess the franchisee pipeline and how it has changed over time. Diligence would include number of inquiries and sources of inquiry, contacts actually made with the franchisor, FDDs sent out, Discovery Days, and ultimately franchise agreements signed. A higher conversion is not always better — attracting high quality franchisees who will be successful is the key to building a sustainable franchise system. That being said, a large number of signed franchisees waiting to open

provides support of the ongoing growth of system revenue and royalties (and thus, higher valuation).

9. Competitive Landscape. Franchise concepts that are brand leaders in their industry category or have developed a "different mouse trap" will attract higher valuations.

10. Technology Systems. Franchise concepts that have invested in a strong information technology system that can track key performance indicators across the system and accurately track franchisee revenue (and hopefully profitability) will be viewed more attractively by buyers. Having access to data at the franchisee level is extremely valuable for a franchisor to evaluate what is working in the system — and what is not. Also, being able to share the data across the franchisee system is an extremely important tool for benchmarking and creating friendly competition across the system to drive growth. A robust technology platform can translate into a higher valuation for a franchisor.

11. Litigation. While there are inherent conflicts within any franchise system, substantial litigation between the franchisor and franchisees can be a telling sign that something is not working in the model. It could be that management at the franchisor is not supporting the franchisees to help them be successful. It could be that the economics of the model do not work, and franchisees are unhappy with their return on investment. Litigation implies complications, and complicated deals do not get rewarded by a high valuation.

12. Cyclicality of the Business/End-Markets. Even though the great recession is far behind us, buyers have not forgotten the pain they may have felt with other businesses during that time frame. In diligence, they will look back prior to 2008 to understand how the recession financially impacted the franchisor and franchisees. A high-degree of cyclicality will result in a lower valuation. On the flip side, those concepts that performed well during the recession will garner a higher valuation as it supports the "downside" future case should we hit another recession in the coming years. Having some degree of visibility on what the "worst case" could be for an investment, impacts the current valuation.

13. Capital Expenditures. Generally, franchisors tend to have low capital expenditure requirements, which is why franchisors, generically speaking, tend to trade at higher valuations as compared to "company-owned" competitors. However, if substantial investment is required for something such as a new information technology platform, this could negatively impact valuation.

14. Franchisor vs. Franchisee Valuations. Franchisees tend to trade at lower valuations than franchisors for a number of reasons: (i) franchisees do not control the brand and IP, (ii) franchisees are required to invest in their business, (iii) franchisees’ rights to operate can expire or terminate with the

> franchise agreement; (iv) franchisees by "definition" are not unique — there are many other businesses exactly like theirs in which to invest — it is a franchise after all, (v) bad franchisees can bring the brand down, and (vi) the franchisor is ultimately the conductor of the train.

In summary, based on financial theory, the valuation is derived by determining the present value of the expected future cash flows of a company. The more support that can be given to substantiate the achievability of a company's expected future performance (thus lowering the risk of a buyer's ability to achieve future cash flows), the higher the potential valuation a company might garner.

E. Letter of Intent

As previously stated, the M&A advisor will ask interested potential buyers to submit and negotiate a letter of intent (LOI) addressing all key financial and legal terms. Typically, the LOI will give the selected buyer exclusivity (normally at least 30 days, but frequently longer) to complete due diligence and sign a definitive purchase agreement. In addition, The LOI may specify an outside "drop dead" date at which time the parties will part ways. The LOI also outlines some of the key terms for the purchase agreement and leaves other terms to be negotiated between the parties, as are "customary." The seller normally benefits at this stage from a detailed LOI, with significant economic terms hammered out in advance. For example, any seller financing, buyer holdback of purchase price, escrow requirements and indemnity baskets or caps are helpful to specify. Although the LOI is normally non-binding, except with respect to exclusivity and a few other provisions, the LOI establishes a basis for good faith negotiation. Once the LOI is signed, the due diligence period can go forward quickly.

F. Franchise Sales Issues and Suspension and Amendment Concerns During the Deal Process

Both federal and state laws regulating franchising focus on providing prospective franchisees with material information regarding the franchise being purchased. These laws generally require an amendment when there is a material change in the information presented in the FDD. But the guidelines do not specifically address disclosure obligations with respect to a pending sale of a franchise system.[10] Nevertheless, the required disclosures may be impacted by the pending sale. For example, in Item 1, the FTC Rule[11] requires disclosure regarding the other business activities of the franchisee, the parent company of a franchisor[12] and the franchisor's affiliated programs.[13] Item 2 requires disclosures regarding the directors, officers and management of the franchisor. In Item 12, the FTC Rule requires the disclosure of certain goods, services, trademark, and territory issues information if the franchisor or an affiliate operates, franchises, or has present plans to operate or franchise a business under a different trademark and the business sells or will sell goods or services similar to those the franchise will offer.[14] If the

[10] Chernow & Modell, *supra* note 4, at 29-33.
[11] The "FTC Rule" refers to the Federal Trade Commission Franchise Rule as amended.16 C.F.R. § 436.1, *et seq.* (2007).
[12] *Id.* at § 436.5(a).
[13] *Id. §* 436.5(a).
[14] *Id. §* 436.5(I)(6)(iii).

seller intends to sell new franchises before the deal is finalized, the seller will need to evaluate carefully the decision regarding amending the FDD in order to avoid a sales violation. At the state level, some state franchise laws have a general requirement that the franchisor may not omit to state a material fact in any disclosure document,[15] and some states include a change in control in ownership of the franchisor and/or a change in management as examples of material changes.[16] In addition, state common law may require the disclosure of material information.

The decision as to when to stop selling franchises, i.e. "go dark", or disclose a pending sale by amendment[17] will be fluid and heavily fact-based; often, in practice, there is not a bright line as to when going dark or disclosure by amendment is necessary. On the timetable spectrum, you may have some companies who take the most conservative approach and disclose the possibility of a sale when they decide to put themselves on the market. Continuing on the spectrum is suspension of sales or disclosure at the signing of the LOI (even if nonbinding), the signing of the definitive purchase agreement, or at the time when it becomes likely that all closing conditions will be met. From a business standpoint the parties will not want to reduce the value of the company by suspending or slowing sales. The buyer will likely resist having sales suspended, especially in an asset deal where it will not assume the liability of the seller for a sales violation. Factors for consideration include:

- whether the buyer is a financial sponsor or a strategic acquirer;
- whether key management will likely change;
- whether the buyer has a franchise system or other business that will compete with or sell supplies to franchises of the selling system;
- the level of risk of sales violation claims the parties are willing to take and which party bears the cost of a claim or a rescission right;
- the number of franchise sales that suspension or amendment will delay or affect;
- the location of the expected sale, e.g. whether in a non-registration state, a registration state, or a state with a general materiality component to required disclosures;
- the length of time expected after the signing of the LOI prior to the execution of a definitive agreement, and how difficult suspending sales will be from a business and competitive standpoint;

[15] *See e.g.,* MINN. STAT. § 80C.13, Suao.2, which states "No person may offer of sell a franchise in this state by means of any written or oral communication which includes an untrue statement of a material fact or which omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."; *see, also,* California Franchise Investment Law, CAL. CORP. CODE §§ 31202.
[16] Chernow & Modell, *supra* note 4, at 30.
[17] Another alternative is to consider disclosing the pending sale outside the disclosure document, in a written notice to the franchisee. This would help prevent a later common law claim of material misrepresentation.

- the risk of creating an expectation with the prospect that the deal will close when it may not;

- the level of concern that deal communication will raise among existing franchisees and the impact disclosure may have on the franchisee relationships and the activities of any franchise associations or councils;

- the buyer's desires with respect to suspending sales when considered against the purchase price and the desire to maintain a "hot" concept that is growing rapidly;

- the number of franchisees who need to renew during any "going dark" period to avoid expiration;

- when the company is prepared to make the transaction public and, if either the buyer or seller is a publically traded company, the requirements of securities laws and regulations regarding the disclosure of material, non-public information; and

- other factors related to the nature of the target company and deal specifics.

G. Goals of Each Party in Conducting Due Diligence

1. Buyer's Potential Goals. In conducting due diligence, the buyer will have certain key overriding goals as follows:

   - Identify any "red flags" and ascertain that the buyer wants to buy the target at an acceptable price based on the risk.

   - Assess whether the business enterprise value, as stated in the LOI's purchase price, needs downward adjustment based on information learned through the process.

   - Determine whether the seller should provide additional or different representations, warranties, covenants and indemnification coverage based on potential risks discovered.

   - Evaluate whether the buyer can achieve its business plan post-closing. For example, if the buyer wishes to expand, what white space is available. Or if the buyer wishes to buy back franchised units and operate more company-owned locations, do the relevant franchise agreements and applicable laws permit such purchases.

2. Seller's Potential Goals. During the due diligence process, especially if management will take a stake in the target after the closing, the seller will want to evaluate the buyer on a number of fronts, including as follows:

   - Determine whether the buyer is a good fit, is committed to closing the transaction, is financially capable of buying the target, has solid, organized management with integrity, will bring added value to the target, communicates well with the target's team, and is reasonable and fair in the negotiations.

- If the buyer will assume certain liabilities, the seller will seek assurance that the buyer can fulfill these obligations.

- Many sellers will keep a watchful eye on whether the buyer will retain, and how the buyer plans to treat, the target company's employees.

H. Buyer's Due Diligence Process[18]

1. Establishing Realistic Goals that are Deal-Specific. How much the buyer can achieve during the due diligence process will depend on many factors.[19] If the target is highly coveted with many potential suitors, the buyer may have to tread more lightly in what it requests as it "courts" the hot prospect. In recent years, sellers appear to have better bargaining power because of the increased demand for franchise system targets.

   If the buyer is a competitor of the seller, the seller may place significant limitations on access to information that would hurt the target competitively if the deal collapses. At the same time, a competing buyer may need to evaluate its own limitations in concluding the sale, such as whether its franchise agreement's exclusivity provisions will lead to territory exclusivity violations.

   In addition, the record keeping practices of the seller may lead to significant limitations on what is available for review. Also, the size of the franchise system and the buyer's due diligence budget will play a role in determining the scope of review, and the buyer may have to limit its document review to strategic sampling of the available documents.

2. Stages of Due Diligence. Presumably, the buyer's finance and legal teams have already helped the buyer review a shortlist of key issues (e.g., outstanding franchisee disputes, franchise sales activity, and royalty and other revenue source trends) before signing the LOI to determine whether the target franchise system satisfies the buyer's general criteria for a potential acquisition. This early information can help the buyer determine price and other key terms with the seller for the LOI. More detailed legal and financial due diligence can take place after the parties reach this preliminary commitment, though generally before negotiation of the purchase agreement.

3. Sending Out the Due Diligence Checklist. Legal counsel for the buyer should prepare a list of relevant documents to request from the seller.

[18] Substantial portions of this paper's Section H have been used or adapted from 2014 IFA materials; *see,* Knack, Brown, & Holland, *supra* note 2, at 5-14,17. Sandra Bodeau assisted in preparing early drafts of the paper cited.
[19] For a more detailed discussion of these factors, *see,* Knack, Brown, & Holland, *supra* note 2, at 1-2.

Exhibit A to this paper contains a sample due diligence checklist that buyers may work from in a franchise transaction.[20] This checklist focuses only on franchise-related documents and should be supplemented by items addressing general corporate matters as well as industry or system-specific matters. Because due diligence checklists typically are exhaustive and may overwhelm the seller, a buyer often will tailor the checklist to the specific transaction.

4. Preliminary Call with Seller. At approximately the same time as the delivery of the checklist, the buyer should schedule a call with the seller's team, which normally should include the buyer and seller's legal counsel. A conference call can be tremendously helpful in setting the tone of the process. Because the due diligence checklist can intimidate the seller, the buyer's counsel can explain its purpose, help set priorities within the long list, get an initial read on what the seller has and how it will respond, and find out the history of franchise compliance, recordkeeping and availability of information.

5. Assessing the Strength of the Franchise System's Intellectual Property.[21,22] The intellectual property of a franchise system — its marks, logos, proprietary software, domain names, trade dress, copyrights, and proprietary manuals and other trade secrets — form the foundation of the franchise system. Assessing the vulnerability of those assets is a key aspect of a comprehensive due diligence plan. Each intellectual property asset should be evaluated in terms of its inherent strength, its protectability and its value to the franchise system. This assessment should take into account the current environment in which each asset exists, as well as the future environment in which it may operate, e.g. international.

(a) Service Marks and Trademarks.[23] The service marks and trademarks (including logos) that identify a franchise system obviously are critical assets of the target franchise system. The buyer must closely examine the primary marks to assess their distinctiveness and overall strength. To adequately determine the strength of the seller's marks, the buyer should analyze several factors.[24] First, are there questions regarding the seller's ownership of its trademarks or other issues relating to their legal validity? Are the primary marks distinctive or have third parties registered similar marks in the same or related classes? To the extent the seller relies on a primary mark that is not distinctive to identify a franchise system, the buyer of such a system will likely face more challenges in protecting the mark and avoiding confusion in the marketplace. Has the seller registered the primary marks in the form and classes of goods and services in which they

[20] The Exhibit A checklist is reproduced from Knack, Brown, & Holland, *supra* note 2, at Exhibit A.
[21] Sandra Bodeau, John Brower & Gaylen Knack, *Acquiring the Franchise System: Due Diligence Tactics to Assess Value,* FRANCHISING WORLD, October 2013 at 29.
[22] Knack, Brown, & Holland, *supra* note 2, at 5.
[23] *Id.* at 5-6.
[24] Bodeau, Brower, & Knack, *supra* note 21, at 29-30.

are used in the franchise system? To what extent do third parties have prior rights of use in key geographic areas? The seller should have a solid base of information on any prior third party use of each key mark. Second, has the seller effectively protected and policed its trademarks both within the franchise system and from potential infringing use by third parties? In addition, to the extent the target franchise system has been or potentially may be exported to other countries, has the seller established a sound strategy for international protection of its primary marks and sought registration of those marks in key foreign markets?

Finally, the buyer should determine whether the seller registered and maintained control over key domain names related to the franchise system domestically and in foreign markets where the seller currently conducts activity or may plan to do so in the future.

(b) Proprietary Software.[25] Proprietary software and other system-specific intellectual property can distinguish a system from its competitors so long as the seller preserves clear ownership of, and has appropriately protected, the property. A number of franchise systems employ the use of proprietary software. To the extent proprietary software is employed in the target franchise system, it can provide the system with a competitive edge in the marketplace and improve franchisee operational performance. While proprietary software often serves as a valuable asset to the franchise system, the buyer should review certain attributes of the proprietary software to determine the actual value of that asset. First, the buyer will need to determine whether the seller or an affiliate owns the software or if ownership rights reside with a third party, possibly a software developer. If the seller or an affiliate owns the software, will that asset be transferred to the buyer at closing? To the extent a third party owns the proprietary software, what rights does the seller have to continue using and licensing the use of the software and what obligations must the seller satisfy to continue using the software (e.g., sale of a minimum number of software licenses)? How does the software license agreement address future updates and maintenance and who shoulders the burden of those expenses? Can the third party owner license the same or similar software to others, including the seller's competitors? These inquiries will assist the buyer in determining the value of any proprietary software used in the target system.

(c) Operations Manuals, Confidential Information and Other IP Assets.[26] The operations manual can serve as a key asset of a franchise system or as an indicator of underlying problems in a troubled franchise system. The operations manual should be regularly updated and reflect existing system standards and procedures. The buyer should evaluate the content of the operations manual to ensure that it is drafted to help shield the seller from potential liability. The buyer also should determine whether the seller

[25] Knack, Brown, & Holland, *supra* note 2, at 6-7.
[26] *Id.* at 7.

maintains other valuable IP that can increase the long-term value of the franchise system. The buyer should assess the importance of secret recipes, customer and supplier lists and any other confidential information and steps taken by the seller to protect the confidentiality of that information. Similar assessments should be conducted regarding other potentially valuable IP, such as copyrights, patents and the seller's website.

6. Analyzing the Strength of the Franchise (and Related) Agreements.[27] The value of a franchise system depends largely on the quality of the franchise agreements that document the relationship and the royalty stream.[28] Careful review of the existing franchise agreements will help the buyer measure the worth of royalty stream, and validate that the buyer can rely on the stream in its projections.

The buyer should review how many versions of the seller's franchise agreement exist, how they differ, which units they cover and when they expire. For most companies, lining up the versions by year will work best because a franchisor usually makes contract changes when it annually updates its FDD. The buyer should request a summary of the number of franchisees operating under each version of the franchise agreements, especially versions with lower fees, longer terms, larger territory grants and other material terms the seller later changed.

The buyer should review whether the franchise agreements give the seller flexibility in responding to dynamic changes in the marketplace. For example, can the franchisor require that franchisees add a new product line, install a drive-thru, comply with an Internet sales program, change restaurant seating availability by the adding a bar, etc.? If not, the buyer may face restrictions in implementing changes in the system going forward. As discussed below, the scope of rights granted to franchisees and outdated technology provisions tend to be two provisions that can restrict future system changes.

A thorough and useful contract review will summarize significant changes that have occurred over the years in royalty fees, marketing fees, technology and other fees, territorial rights and other key areas.[29]

(a) Assignability of Franchise and Other Key Agreements.[30] Before advancing far into a review of the target franchise system's franchise agreements, if the deal is an asset sale (rather that a stock sale or merger), the buyer must ensure that the franchise agreements, as well as other significant agreements, can be assigned upon sale of the system. Buyers generally find that the system's franchise agreements include provisions

[27] *Id.* at 7.
[28] Bodeau, Brower, & Knack, *supra* note 21, at 29.
[29] *Id.* at 29.
[30] Knack, Brown, & Holland, *supra* note 2, at 8.

permitting the seller to assign its interests in the agreements without the consent of the franchisees. The buyer will need to confirm that each version of the seller's franchise agreements includes these provisions and that the seller has not modified these provisions for select (often early stage or large multi-unit) franchisees. The buyer also should review key vendor contracts, leases and other significant contracts to determine what, if any, third-party consents must be obtained as part of the acquisition of the target system. To the extent a third party consent is necessary, the buyer will need to discuss with the seller any challenges in obtaining third-party consents and who will be responsible — buyer or seller — in obtaining such consents. The number of such consents required may also impact the length of the interim period between the signing of the purchase agreement and closing, to allow a reasonable opportunity for such consents to be obtained.

(b) Scope of Grant/Reservation of Rights.[31] The buyer should determine the exact nature of the license granted in the franchise agreement. How broad are the rights granted and what rights have been reserved by the seller? Has the seller consistently defined the rights granted to franchisees and rights reserved to the seller or do earlier versions of the franchise agreement grant franchisees broader or different rights? The buyer should determine whether the seller has reserved rights as to potential future markets such as internet sales, captive markets and national accounts. Rules should be established, either in the franchise agreement or the operations manual, regarding the franchisor's rights to sell to customers in a franchisee's territory and a franchisee's right to sell in another franchisee's territory. Finally, did the disclosures in the FDD accurately reflect the rights granted to each franchisee? Surprisingly, inconsistencies between the franchise agreement and the FDD can also arise and can blur rights granted to franchisees.

(c) Addressing Territory Conflicts.[32] To the extent the buyer owns similar or competing franchise systems, or may do so in the future, it will need to assess whether the rights granted to the seller's franchisees may conflict with the current or future rights of franchisees in the buyer's existing franchise systems. Do the targeted franchise system's franchise agreements specifically permit the seller to operate or franchise other or competing brands within the franchisee's territory? If the targeted system's franchise agreements do not specifically reserve this right to the seller, the buyer will need to assess the ability to proceed with the transaction and the reaction of the targeted system's franchisees. Even if the targeted system's franchise agreements specifically permit the seller to operate or franchise competing brands within the franchisee's territory, the buyer will need to determine the possible reaction of the seller's franchisees as well as that of the buyer's existing franchisees.

[31] *Id.* at 8.
[32] *Id.* at 8.

(d) Flexibility to Modify the System.[33] The buyer should analyze whether the franchise agreements and the operations manual are adaptable and give the seller flexibility in responding to dynamic changes in the marketplace. Can the seller update system technology, add new product lines, change suppliers, create value programs or add services that could not have been anticipated when the franchise was first sold?[34]

(e) Necessity/Ability to Re-Brand the System or Individual Units. Each of the seller's franchise agreements should also be reviewed for any ability to change the primary mark under which the system is operated, i.e., the ability to re-brand the system. In some cases, the buyer may want to fold some or all of the seller's units into an existing, competing system that the buyer already operates, and so a change in name, marks and trade dress may be necessary. Other times, the target system may have become somewhat "tired" and in need of a refresh in order to boost future sales and profitability. In either such event, the buyer will want to know whether it will be able to mandate such changes post-closing, or whether it is instead in for a series of protracted negotiations with its future franchisees. Many newer franchise agreements provide such flexibility to the franchisor, but many older forms of agreement do not, thereby adding potentially significant costs to the buyer's desired integration and expansion plans.

(f) Number of Negotiated Changes; Special Deals and Atypical Provisions.[35] The buyer must evaluate whether the seller has followed a uniform contract program. In the interest of growing the system and completing sales, the seller may have granted numerous concessions and made side offers favorable to the franchisee. The buyer will need to search for and catalog these negotiated deals and consider the implications of administering a non-uniform system.[36] Did the seller comply with franchise sales laws in negotiating changes to the standard-form franchise agreement? For example, negotiated changes to franchise agreements involving California franchisees or franchises located in California require compliance with unique negotiated change rules under the California Franchise Investment Law.[37] The buyer should also consider the implication of negotiated changes from a long-term perspective. When renewal time arrives, how successful can the buyer expect to be with these "one-off' deals in imposing a standardized agreement as a condition to renewal of the franchise? The buyer also will need to identify any unusual provisions that are atypical in franchise programs, which may create a material risk to the buyer as the new owner. For example, if a franchisee can easily terminate the franchise agreement without cause or get a royalty reduction if certain sales levels are not achieved, the seller may face the loss of all or a portion of its revenue stream for that contract. The buyer should factor

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[33] *Id.* at 8-9.
[34] Bodeau, Brower, & Knack, *supra* note 21, at 29.
[35] Knack, Brown, & Holland, *supra* note 2, at 9-10.
[36] Bodeau, Brower, & Knack, *supra* note 21, at 30.
[37] California Franchise Investment Law, CAL. CORP. CODE §§ 31110, *et. seq.*

this risk into the purchase agreement with a price reduction, hold-back or an indemnity.

(g) Existence of Promises or Oral Agreements Outside of the Written Contract. The buyer should not limit its review to specific provisions of the target system's franchise agreements in determining the seller's rights. It should also consider what expectations have been created by communications with the franchisee community - whether those communications take place one-to-one, with a select group of franchisees, or with a franchisee council. What safeguards, such as closing acknowledgments, has the seller implemented to limit franchisee claims that are based on representations outside the franchise agreement?

(h) Enforcement Practices of Franchisor. Have the seller's practices led to lower franchise standards? If the franchise agreement calls for the achievement of minimum sales, has the seller enforced such provisions?[38] In situations where the seller has not enforced franchise agreement provisions, has it instituted a "new day" program (i.e. "We've let you slide in the past, but now we're getting serious about compliance and will hold you accountable to our standards going forward") and with what success and ongoing implications to the enforceability of standards?

(i) Reviewing the Operations Manual. The buyer should carefully review the operations manual, including the frequency and manner in which it has been updated. The seller should have a standard method for implementing system changes through the operations manual and for notifying franchisees of each change to the operations manual as it occurs. A thorough review of the operations manual, however, goes far beyond understanding modifications of system standards. An operations manual should assist a franchisor in limiting liability resulting from activities occurring at the franchisee unit level. An operations manual that is not carefully drafted can result in potential joint employer or vicarious liability for a franchisor due to the level of control exercised or available to the franchisor.[39] The buyer should review the operations manual for common mistakes, such as directives intended for company-owned units or excessive and detailed direction on employment or safety-related unit standards.

7. Gauging Compliance with Franchise Sales and Relationship Laws/Practices.[40] Franchisors must comply with franchise and business opportunity laws regulating the offer and sale of franchises, as well as the franchise relationship. Failure to comply with these laws can lead to, among other things, costly regulatory actions, legal claims by franchisees or challenges to the future enforcement of franchise agreements. These claims or actions often arise months or years following the sale of the

[38] *Id.* at 30.
[39] *See* Section G, subparagraphs 8-9.
[40] Knack, Brown, & Holland, *supra* note 2, at 10.

system and a buyer who steps into the shoes of the seller under franchise agreements often is left facing such claims or actions. For this reason, the buyer must review the target system's compliance with franchise sales laws and franchise relationship laws.

(a) Franchise Disclosure Document.[41] The buyer often will need to examine (preferably for at least 5 years) the FDD prepared by the seller for compliance with applicable federal and state franchise disclosure requirements. Key areas addressed in the FDD that deserve focus include the following:

(i) Consistent Disclosure of Franchise Agreement Provisions.[42] The FTC Rule and state law requires a franchisor to disclose, in an FDD, information about the franchisor, the franchise system and terms of the franchisor's franchise agreement. As previously discussed, the buyer should determine whether there are inconsistencies between the FDD and the terms of the franchise agreements. Although this may seem an unlikely mistake, the failure to align provisions does occur. For example, the franchise agreement may state that the seller can increase fees up to a capped percentage or amount, but the FDD may use language that does not track uniformly with the franchise agreement, creating an ambiguity as to what fees can be charged. As another example, the franchise agreement may permit the seller to offer a competing brand under a different trademark, while the FDD may state that the seller will not open or franchise another outlet within the franchisee's territory, leaving it questionable as to what is permitted or prohibited. The integration provision in the franchise agreement will likely state that the provision is not intended to change any representation in the FDD, leaving the buyer with the task of dealing with this ambiguity.

(ii) Litigation. The disclosure of litigation in Item 3 of the FDD can be a material item for prospective franchisees and the failure to make appropriate disclosures could lead to future claims. For additional reasons, however, litigation - including any action subject to dispute resolution - deserves special attention when considering whether to acquire a franchise system. The buyer will need to understand what litigation exists and how it will be treated in negotiating the purchase agreement. The buyer also must determine whether existing or past regulatory actions or litigation may lead to similar claims in the future. In addition, the buyer should investigate the industry in which the system operates for recent litigation trends. For example, if the FTC or a state attorney general has investigated a type of practice or product used in the seller's industry, other states may jump on board in pursing copycat investigations or third parties may initiate class action or multiparty claims, often at great expense to the seller.

[41] *Id.* at 10-11.
[42] *Id.* at 10.

(iii) Financial Performance Representations.[43] Financial performance representations (FPRs) merit detailed scrutiny as well.[44] To the extent the seller has included an FPR in its FDD, the buyer will want assurance that the seller has strictly complied with FTC and applicable state franchise law standards for disclosure and that sales force activities have been consistent with Item 19 disclosures. Within the parameters of what is allowable for an FPR in Item 19, the buyer needs to understand that the seller has flexibility in selecting the categories of information to disclose in Item 19 and the manner of the presentation to make it look favorable. For this reason, the buyer should require the seller to provide detail to demonstrate that it has a reasonable basis for an FPR, together with written substantiation of the data to back up its representations. This substantiating data separately may assist the buyer in understanding unit level sales and profitability (see Section D.4 on financial considerations). The buyer's task in reviewing the seller's sales practices where no Item 19 FPR exists is more challenging. The buyer will need to take steps to determine whether the seller and its sales force have made any FPRs during the franchise sales process. The buyer should obtain assurances from the seller and review any supporting documentation (such as closing acknowledgments) to verify, to the extent possible, the seller's compliance.

(b) Franchise Sales Compliance. The buyer will need to determine if the seller has taken a disciplined approach to its franchise sales practices and ongoing franchisee administration. The number of franchise files reviewed by the buyer in the due diligence process will depend, in part, on the size of the franchise system, the buyer's budget, the time pressures of the deal and cooperation of the seller. When reviewing the FDD, the buyer should analyze a number of issues to help flush out typical franchise compliance violations. Was a receipt signed by the franchisee or a key individual of the franchisee entity? Does the date of the franchise agreement, when compared to the date of the signed receipt and other correspondence, confirm compliance with FTC and individual state disclosure waiting periods? To the extent the sale involved one or more franchise registration states, did the seller have current registrations or exemptions in those states? Was the then-current version of FDD provided? In particular, if the FDD was renewed after the date of the franchisee's receipt, was the updated FDD provided and the waiting periods observed?

Further inquiries should reveal poor or improper franchise sales or poor recordkeeping. For example, was the franchise agreement properly signed by the party acting as the franchisee? Did all required owners of a franchisee entity sign the guaranty? Was each ancillary agreement and any state specific addendum signed and dated? Were the exhibits completed properly? Franchisors frequently forget to complete the territory description upon signing the franchise agreement and may leave the description blank or state "TBD" (to be determined). The buyer should request copies of state

[43] Knack, Brown, & Holland, *supra* note 2, at 11.
[44] Bodeau, Brower, & Knack, *supra* note 21, at 30.

franchise registration orders, comment letters and related correspondence for prior years to help the buyer determine if sales were made properly.

The buyer should review any advertising materials that the seller uses to identify prospects and sell franchises to assess their proper registration and determine whether the materials included any information that was inconsistent with the FDD or franchise agreement, especially financial performance representation.

8. Joint Employer Concerns. A key issue that is receiving a great deal of attention in the general media, and throughout the franchise community, is the potential that franchisors may be treated as "joint employers" with respect to the franchisees' employees. The joint employer issue arises most frequently in the context of the Fair Labor Standards Act, the Family Medical Leave Act, the National Labor Relations Act, or Title VII of the Civil Rights Act. An exhaustive summary of the rapidly evolving legal considerations with respect to each of these issues is beyond the scope of this paper. However, as a general rule, franchisors can be at risk for a joint employer determination if through contract language or operational reality the franchisor directly or indirectly controls, or has the right to control, the franchisee’s employment-related decision-making. The buyer's due diligence review should assess the level of control (or advice) the franchisor actually, or potentially, can exercise over these employment-related issues. This would include a review of the franchise agreements and the franchisor's operation manuals to see what rights the franchisor has in this area. For example, sometimes a franchisor has adapted manuals from its company-owned operations and have failed to remove provisions regarding the hiring or firing of employees, or their day-to-day supervision. This can provide a pathway to joint employer liability claims. If control provisions are found, it increases the risk that the franchisor could be determined to be a joint employer with the franchisees.

9. Vicarious Liability Risk. An issue related to joint employer liability is that franchisors may be vicariously liable for the actions of their franchisees. With respect to vicarious liability, the operative inquiry is whether the franchisor exercises enough control over the franchisee's daily operations, especially the operations related to the alleged harm, that it should be held liable for the acts of the franchisee or its employees. Controlling the use of the trademark and those aspects of the franchisee's business that encompass "the brand" is generally permissible and should not result in vicarious liability. However, if the franchisor exerts control that goes beyond brand protection, the risk of liability increases. The buyer's due diligence review of the franchise agreement, relationship and operations manuals is warranted to ferret out the potential for vicarious liability claims.

10. Understanding Purchasing and Supply Chain Issues.[45] Depending on the franchise system involved, purchasing and supply chain issues may play an

[45] Knack, Brown, & Holland, *supra* note 2, at 17.

incidental or significant role in assessing the value of the system. For nearly all franchise systems, the buyer will need to conduct due diligence as to purchasing-related issues. What key goods or services must each franchisee acquire and how has the seller structured acquisition of, and control over the purchase of, these goods or services? For franchisees in certain franchise systems, purchasing focuses simply on goods and services necessary to conduct the franchised business. For franchisees in retail and many food-based systems, however, the supply chain becomes a much more central aspect of the franchise system. What role does the seller or its affiliates play in the supply chain? In many franchise systems, the seller (or its affiliates) may supply goods or services directly to franchisees. In those situations, to what extent does the seller profit from sales of these goods or services and is the seller's pricing structure competitive with that of third parties? In other franchise systems, the seller may impose restrictions on the type of goods/services or the vendors from whom the franchisees must purchase. The buyer should review these restrictions to ensure they are consistent with antitrust regulations and satisfy system-wide objectives.

In conducting due diligence involving purchasing and supply chain issues, the buyer will need to review franchise agreement provisions and operational standards established to monitor or control franchisee purchases and the system supply chain. The buyer also must examine agreements and relationships with key third party vendors to determine the nature and strength of those vendor relationships. Are these relationships properly documented or more informal in nature? Do they result in favorable pricing to franchisees in comparison to alternative vendors? How much control do key vendors have with respect to the system and what options does the seller have to change vendors? What rebates or commissions does the seller receive from third party vendors? Finally, has the seller properly disclosed in the FDD (Item 8) its role in the supply chain and revenues it or an affiliate receives from franchisee purchases of products and services?

11. Talking to Stakeholders. Rather than simply taking the seller’s word (as supported by its internal records) that its relationships with key stakeholders are stable, buyers sometimes wish to investigate those relationships by communicating with those stakeholders directly. Understandably, sellers are typically loathe to allow buyers the opportunity to interview franchisees, landlords, employees or suppliers, particularly before they have a reasonable degree of certainty that the deal will go through. One approach that buyers often use is to impose a requirement that the seller have its franchisees and landlords execute and return estoppel certificates, pursuant to which the signer certifies that it has complied with the franchise or lease agreement, as applicable, that it is not aware of any claims or possible claims that the franchisor may have against it, and that it has no claims against the franchisor. Whether or not these certificates have any legal force opposite the franchisees or landlords who sign them may vary from

jurisdiction to jurisdiction, however some buyers (i.e., those with a high degree of bargaining power in the sale transaction) are able to insert closing conditions into their purchase agreement requiring that a certain (high) threshold of certificates be returned before they will be required to proceed with the transaction.

12. Cross-Border Issues. As mentioned above, it is essential to engage local legal and tax advisors early in the deal process whenever the transaction involves a target or party in another jurisdiction. Local counsel can provide key assistance with structuring the transaction, conducting and interpreting the results of due diligence, and negotiating and drafting the definitive purchase agreement. For example, since franchise laws differ across jurisdictions, the buyer's investigation into the seller's compliance must be tailored, to a certain degree, to account for those differences – local counsel can help by telling the buyer and their domestic counsel what additional questions to ask. Similarly, the representations and warranties in the purchase agreement should be customized to take into account any more onerous compliance provisions that a foreign target must be expected to have met.

    Aside from franchise-specific assistance, local counsel may be needed to conduct security and other searches on the seller and its assets and to file notices or apply for relief under applicable antitrust, foreign investment review, and other local statutes. Again, any issues in such areas are best discovered as early as possible in the process, and so local counsel should be consulted before significant steps are taken and money is spent in advancing the proposed transaction.

I. Purchase Agreement Negotiations: How the Due Diligence Process can Impact the Transaction

As the deal progresses, the parties will work toward signing a "definitive agreement", which means a negotiated purchase agreement, within a stated time period, or the buyer will lose exclusivity. The purchase agreement is usually negotiated concurrently with preliminary due diligence. Who prepares the first draft? If the deal follows an auction process with multiple potential buyers—meaning the seller has bargaining power—the seller's legal counsel will prepare the first draft, and expect the buyer to work within this draft as negotiation proceed. Absent an auction process, we typically see the buyer's counsel control the first draft. The negotiations will focus on representations related to the business, as well as the covenants of the parties. In addition, the indemnification provisions, including the determination of any "dollar one" liabilities and other liabilities subject to a basket, and any cap on liabilities, will be negotiated. The results of the due diligence will feed into the negotiations, as the buyer will seek more favorable terms and more risk reducing provisions if the buyer's investigations reveal red flags.

1. Franchise Representations and Warranties. At the heart of any acquisition of a franchise system are the franchise-related representations and warranties (referred to as "representations" hereafter). The representations in the purchase agreement and the disclosures made by the seller in

response to them are a major source of information about the target company.[46] The representations should address and confirm the areas of due diligence discussed above. The buyer's goal in establishing these representations is to create a benchmark of key information and statements upon which the buyer can rely in buying the system. The consequence of a breach of the representations to the seller is that the seller will pay any buyer losses associated with the breaches, subject to certain conditions, by indemnification.

2. Sample Franchise Representations. A detailed review of typical representations is beyond the scope of this M&A Basics paper. Generally, however, the representations follow the key due diligence review areas in the buyer's due diligence process. A sample of possible franchise issues representations is attached to this paper as Exhibit B. As you will see in the sample, through the language of the representations and the items the Seller puts on the disclosure schedules, the buyer will want to:

- Assure that it has all of the franchise agreements, including any material amendment, whether oral or written.
- Confirm that the franchise agreements are valid, binding and enforceable as written.
- Review a schedule of pending or possible defaults, i.e. defaults which, with the passage of time or the giving of notice, would result in defaults.
- Confirm that all advertising and other funds have been administered properly.
- Obtain a full disclosure of pending or threatened franchise-related claims or governmental actions, including any vicarious or joint employer liability claims.
- Identify all forms of the FDD used for sales and assure that they were prepared and delivered in accordance with franchise laws. Consider adding a more specific financial performance representation, if the franchisee has an Item 19, e.g. that franchise seller has made FPR's outside Item 19.
- Identify the jurisdictions in which the franchisor is or has been registered or claimed exemption of its franchise.
- Assure compliance with all franchise laws, including franchisee relationship laws, and that no financial performance representations have been made in connection with an offer or sale, other than those incorporated into the FDD.

[46] Bodeau, Brower, & Knack, *supra* note 21, at 31.

- Check for issues related to territory grants.

- Determine whether the franchise has used brokers. If brokers have been used, additional representations should be made as to the franchise brokers' compliance with franchise laws. Any fee arrangements and amount owed to brokers should be scheduled.

- Identify rebates and contracts related to them and confirm that disclosures have been properly made about them in the FDD.

- Determine that there are no franchise-related options applicable to the franchise agreements or business.

- Assure that former franchisees have not been allowed to compete.

- Confirm that the franchisor has enforced the franchise agreements.

- Assure that there are no grounds for joint employer liability.

- Verify that insurance provisions have been complied with and that the franchisee has in each case named the franchisor as an additional insured on the franchisee's policy.

3. <u>Reductions to Price; Minimizing Risk with Seller Indemnifications, Holdbacks and Escrows; Covenants</u>. Based on the findings of the buyer's due diligence, including what the Seller reports on the disclosure schedules for its representations, and particularly with respect to discoveries that rise to the level of a "red flag", the buyer will seek to reduce purchase price, or use the red flags to justify any special indemnity treatment for high risk areas. Strategies regarding indemnifications with respect to red flag areas of concern will include using a lower basket (deductible) above which the seller must pay any buyer losses, or going to "dollar one" liability (no deductible) for specific losses related to franchise issues. In addition, the additions of covenants can protect the buyer, such as conditions requiring the key employees will continue with the business and that relationships with major suppliers will not be disrupted.[47]

   Finally, the buyer will seek ways to assure the seller can "make good" on its indemnities through holdbacks to the purchase price or, alternatively, the escrowing of funds to enhance buyer security.

4. <u>Keeping A Hand In – A Note on Roll-Over Equity, Earn-Outs and Post-Closing Employment/Consulting Agreements</u>. A relatively common occurrence with owner-operated businesses (which many franchise systems still are) is the desire of one or both parties to the sale to have the founder/principal stay on for a period of time following closing. Financial buyers may see the owner's participation as a key part of the ongoing

[47] *Id.* at 31.

success of the business and the owner may want to continue to participate in the growth of the business. In those instances, the owner will invest or roll-over/retain equity securities in the business and stay on. The negotiation and documentation of the governing documents of the business and ancillary agreements post-transaction are beyond the scope of this paper but will be an additional significant point of negotiation. The parties may view such participation as a temporary measure, to help ensure a smooth transition to new ownership, or it may be regarded as a more permanent arrangement, often where the founder/principal's own image and personality are closely tied to the brand's image and thus to the goodwill of the business. In such circumstances, an employment or consulting agreement is typically entered into between the buyer and the founder/principal for the desired transitional or other period. Such agreements should set out in detail the founder/principal's obligations as well as how the individual will be supervised, and by whom. In some cases, the compensation to be paid under these arrangements is tied to the performance of the franchisor company post-closing and can represent a significant portion of the overall consideration paid by the buyer to the founder/principal on the sale. These agreements may also supplement an earn-out clause in the purchase agreement – in such circumstances the term of the employment/consulting agreement usually coincides with the term of the earn-out. Needless to say, whenever such an arrangement is contemplated, the purchaser must ensure that it has sufficient visibility into, and checks and balances surrounding, the operating results (and the *reporting* of those results) that form the basis of the earn-out calculation and/or the founder/principal's compensation as an employee or consultant.

J. Conclusion

As the above overview of franchise mergers and acquisitions illustrates, the transfer of a franchise system has a unique set of financial and legal considerations. Sellers should prepare carefully in advance for a sale and will benefit from consultation with an M & A advisor. Buyers should understand that franchising poses distinctive opportunities and concerns and prepare themselves for the due diligence process.

EXHIBIT A[48]

SAMPLE FRANCHISE DUE DILIGENCE CHECKLIST

(NAME OF POTENTIAL FRANCHISOR SELLER)

Date:

For purposes of this document, the term "Company" collectively refers to _____________________ **[FRANCHISOR SELLER]** and all of its affiliates, parent companies, subsidiaries and any predecessors that have sold franchises during the past 10 years.

The term "franchisee" is intended to refer to Company's domestic and foreign franchisees, area franchisees, area developers, area representatives, subfranchisors, master franchisees, and licensees, as applicable. In addition, the term "subfranchisee" is intended to refer to the domestic and foreign subfranchisees and sublicensees, as applicable, of Company's franchisees.

The term "Disclosure Document" refers to and includes any franchise or business opportunity disclosure document (including Uniform Franchise Offering Circulars or UFOCs, and Franchise Disclosure Documents or FDDs) prepared by or for Company for use in: (i)the United States, including any of its states, jurisdictions, districts, territories or possessions; (ii) Canada, including any of its provinces, jurisdictions, territories or possessions; (iii) , **[LIST ANY OTHER COUNTRIES IN WHICH COMPANY MAY BE SPECIFICALLY INVOLVED]** including any of its states, jurisdictions, districts, autonomous regions, territories or possessions; or (vi) any other foreign country or jurisdiction.

Please provide to us the information described below. **[Identify format in which all requested information is to be received.]**

Section A. Disclosure Documents and Registration/Notice Filings

1. All Disclosure Documents for the past five years approved, used, or pending in any state, province, jurisdiction, district, autonomous region, territory or possession of the United States (including Puerto Rico), Canada, **[LIST ANY OTHER COUNTRIES IN WHICH COMPANY MAY BE SPECIFICALLY INVOLVED]** or any other foreign country. Provide a clean copy of each different version of each Disclosure Document, as well as blacklined copies showing changes between the different versions of each Disclosure Document. Also provide an electronic clean copy of each different version of each Disclosure Document in Microsoft Word format.

1. All files relating to franchise registration/notice filings, exemption filings and business opportunity notice filings made by or on behalf of Company during the past five

[48] This checklist is reproduced from Knack, Brown & Holland, *supra*, Note 2.

years, including all comment letters, approvals and other correspondence with applicable franchise regulators and governmental agencies.

2. All franchise registration applications (including initial, amendment or renewal applications) pending, or in the process of being prepared for filing.

3. A list of all states having franchise registration/notice laws or business opportunity laws where no required registrations or notices of sale are effective or currently in process.

4. A chart indicating all applicable effective dates, amendment dates, expiration dates and renewal dates for all required franchise registration/notice filings, exemption filings and business opportunity notice filings in each jurisdiction in which Company has offered or sold franchises since 20_.

5. A copy of all questionnaires provided to counsel to assist in preparation and updating of Disclosure Documents during the past five years.

6. A copy of all advertising and marketing materials used by Company to promote and sell franchises during the past five years, and all related registration filings submitted by or on behalf of Company to franchise regulators or governmental agencies during the same period.

7. A copy of all sales representative disclosure forms submitted by or on behalf of Company to franchise regulators and governmental agencies during the past five years.

8. A copy of all correspondence with the Federal Trade Commission ("FTC"), state franchise regulators and governmental agencies about franchise or business opportunity sales, consumer marketing activities, or franchisee comments or complaints.

Section B. <u>Franchise Agreements and Other Agreements</u>

9. Executed copies of all U.S. and foreign franchise agreements, master franchise agreements, development agreements, option agreements, area franchise agreements, area representative agreements, license agreements, subfranchise agreements, sublicense agreements and like agreements currently in effect that Company or its franchisees, as applicable, have entered into with franchisees or subfranchisees (collectively the "Franchise Agreements"). For each Franchise Agreement, include a copy of: (i) all addenda, exhibits and ancillary documents pertaining to that Franchise Agreement; (ii) the signed and dated receipt for the Disclosure Document, if any, associated with that Franchise Agreement; and (iii) any

10. other material in Company's files evidencing compliance with all applicable waiting periods and disclosure procedures with respect to any Franchise Agreements signed during the past five years.

11. A list of any franchisees or subfranchisees that executed non-standard forms of Franchise Agreements or that negotiated material changes to their Franchise Agreements (whether prior or subsequent to execution of the Franchise Agreements), together with a brief summary of all terms that are materially different from the terms contained within the standard form of Franchise Agreement utilized at that time. Limit this request to current franchisees and subfranchisees, and current and former franchisees and subfranchisees whose Franchise Agreements expired or were terminated within the past five years.

12. A list of any franchisees or subfranchisees that have been granted an option, right of first refusal or other similar right to establish one or more additional franchises.

13. A clean copy of each different form of each Franchise Agreement Company has used during the past 10 years, as well as blacklined copies showing changes between each different form of each Franchise Agreement. Also provide an electronic clean copy of each different form of each Franchise Agreement in Microsoft Word format.

14. Executed copies of any lease or sublease Company has signed or guaranteed on behalf of any franchisee or subfranchisee, and in the case of any subleases, an executed copy of the underlying lease. Limit this request to current franchisees and subfranchisees, and current and former franchisees and subfranchisees whose Franchise Agreements expired or were terminated within the past five years.

15. Executed copies of any agreements Company has signed for any Company-owned franchises, licenses or locations.

Section C. <u>Franchisee Matters/Franchise Sales Matters</u>

1. A list of all current franchisees and subfranchisees. For each such franchisee/subfranchisee, provide: (i) its name, address and telephone number; (ii) the effective date of each of its current Franchise Agreements; (iii) the location or locations it has been granted the right establish, and/or the territory it has been given the right to develop, under each current Franchise Agreement; (vi) the name and address of its guarantors, if any, for each Franchise Agreement; and (v) the respective exclusive territory, if any, granted to it under each current Franchise Agreement.

2. A list of all current and former franchisees and subfranchisees who had the term of their Franchise Agreements end as the result of expiration, termination or

non-renewal during the past five years. For each such current or former franchisee/subfranchisee, provide: (i) its name and last known address and phone number; (ii) the effective date of each of its prior Franchise Agreements; (iii) the location or locations it had been granted the right establish, and/or the territory it had been given the right to develop, under each of its prior Franchise Agreements; and (iv) the date and reason the term of each of its prior Franchise Agreements ended.

3. A list of prospective franchisees and subfranchisees (including name, address and telephone number) who have been approached or contacted about becoming a franchisee/subfranchisee. Indicate which of these prospective franchisees or subfranchisees, if any, Company or its franchisee, as applicable, expects will sign Franchise Agreements during the next 90 days. Provide copies of all agreements, letters of intent or similar expressions of interest, binding or nonbinding, with prospective franchisees or subfranchisees.

4. Access to Company's franchise files, including those containing: (i) Disclosure Documents and registration, notice and exemption filings; (ii) executed Franchise Agreements; (iii) correspondence between Company and former, current and prospective franchisees and subfranchisees; and (iv) inspection reports, internal compliance reports, and checklists for all franchisees and subfranchisees.

5. All correspondence, notices, agreements, consents and similar material related to any transfer proposed by a franchisee or subfranchisee during the past five years, as well as a description of any pending or proposed sales of existing franchises or subfranchises by franchisees or subfranchisees, and Company's rights of first refusal to purchase such franchises or subfranchises, if any.

6. A list of all franchisees and subfranchisees currently in default of their Franchise Agreements, indicating the cause, the date of the default, the date and type of notice sent to the franchisee or subfranchisee, if any, the cure date, whether any cure plan has been agreed upon, and Company's assessment of the probability of cure. We may request the full franchise file on any listed franchisee or subfranchisee.

7. All termination or nonrenewal notices to franchisees or subfranchisees, either pending or implemented in the past five years, together with a basic summary of the status or outcome.

8. A list of any current or former franchisee or subfranchisee who is currently violating, or who has violated during the past five years, any post-term noncompete provision contained in its expired or terminated Franchise Agreement.

9. A list of any prospective or current franchisee or subfranchisee who has been promised a waiver or reduction of any of the fees described in the current form Franchise Agreements.

10. Describe any policy relating to delays by franchisees or subfranchisees in starting or completing pre-opening activities beyond the performance dates in the Franchise Agreements.

11. State whether franchisees are required to obtain additional insured endorsements in favor of Company for franchisee insurance policies, and describe procedures for monitoring compliance.

12. A copy of the bylaws, minutes and other documents relating to any franchisee advisory council or other representative body and any franchisee association,

including any documents that create obligations on the part of Company to obtain franchisee approval of standards or policy changes.

13. A description of all financing arrangements offered by Company to franchisees or subfranchisees, amounts outstanding under such arrangements, amounts past due or in default and reserves established for doubtful accounts under such arrangements. Include copies of loan proposals, loan commitments, reports and correspondence relating to this activity. Also, include sample copies all notes, financing documents, UCC's, and disclosures, if any, required by law in connection with such financing.

14. A description of all instances where Company has consented to a collateral assignment of any Franchise Agreement to secure any franchisee or subfranchisee loan obligations.

15. A list of all contingent liabilities of Company relating to its franchisees or any guarantees of franchisee obligations.

16. All material system-wide communications with franchisees or franchisee groups since 20_.

17. A copy of Company's current franchise application form, as well as any other forms of franchise application Company has use over the past five years.

18. Copies of all form letters, notices and memoranda *(i.e.,* form default notices, form termination letters, and form transfer and consent to transfer agreements).

19. A list of all brokers or sales agents used by Company to sell franchises in the past five years, and copies of any agreements Company entered into with them.

20. A list of any franchise consultants used by Company in the past five years, and copies of any agreements Company entered into with them.

21. A list of all franchise sales shows, events and commitments including the date, a description of the event, the persons scheduled to attend and the financial commitment.

Section D. <u>Disputes, Litigation and Regulators</u>

1. All orders, directives, or inquiries received from the FTC or any state or foreign franchising, business opportunities, or other regulatory authority, related to the franchise system. All correspondence with any federal, state or foreign regulator pertaining to the franchise system including, franchisee or subfranchisee comments or complaints or alleged violations of applicable law.

2. Describe in detail the current status or results of, as applicable, all pending, threatened and concluded litigation, arbitration or mediation proceedings brought against Company, or any of its officers, directors or employees, during the past 10 years (even if not considered material for purposes of inclusion in the Disclosure Documents), which

involve or relate to franchisees or subfranchisees, or the franchise system. Provide a copy of all pleadings and notices in these cases. Provide a list of all vicarious liability claims and cases, indicating which claims are uninsured or underinsured, describing the nature of the claims. Disclose any policy relating to suits against franchisees or subfranchisees, including any policy about cases that should not be filed or defended. Describe Company's collection policy for delinquent fees from franchisees and subfranchisees. Provide copies of pleading files for all Company-initiated litigation, arbitration and mediation proceedings brought against franchisees or subfranchisees during the past five years.

3. Copies of all notices or correspondence from third parties within the past five years alleging violations by Company of the FTC Franchise Rule, any state or foreign franchise disclosure, registration or relationship, any federal, state or foreign deceptive trade practices act (or comparable laws), any federal, state or foreign business opportunities law or any other federal, state or foreign law specifically regulating franchises, business opportunities or similar arrangements.

4. A description of all litigation in the past five years involving or affecting any of Company's intellectual property rights.

5. Copies of all correspondence threatening litigation against Company within the past five years.

6. Copies of all termination, settlement, release, or estoppel agreements with current or former franchisees executed within the past five years.

Section E. Supply and Distribution

1. Copies of all agreements, if any, between Company and/or Company's affiliates, parent companies or subsidiaries relating to the manufacture, supply and/or distribution of products and services to franchisees or subfranchisees.

2. Copies of all manufacturing, supply and distribution agreements, if any, between Company and any manufacturers, suppliers or distributors of products and services to franchisees or subfranchisees.

3. Copies of all manufacturing, supply and distribution agreements, if any, between Company and franchisees or subfranchisees.

4. A list of all manufacturers, suppliers and distributors designated by Company as an approved source, or as the only or one of the only approved sources, from whom franchisees or subfranchisees may or must purchase products and services. Identify any manufacturer, supplier or distributor who falls within the definition of "Company."

5. Describe any commissions, rebates, discounts, or other consideration Company receives from third-party manufacturers, suppliers and/or distributors as the result of the sale of products and services to franchisees. Provide the specific dollar amount Company received from third-party manufacturers, suppliers and distributors for each of the past three fiscal years. Provide the specific dollar amount Company received

as the result of its direct sale of products and services to franchisees and subfranchisees for each of the past three fiscal years.

6. Copies of all documents concerning Company's approval or disapproval of manufacturers, suppliers and distributors since 20_, including all related correspondence.

Section F. Advertising (Marketing) Fund

1. A description of the national advertising fund Company administers, as well as any other local, regional, national or international advertising programs Company administers or controls to which franchisees or subfranchisees contribute. Include copies of all relevant articles, bylaws, or other governing documents.

2. A description of how contributions to any local, regional, national and international advertising programs Company administers or controls have been spent from the beginning of 20_ to the present. Include copies of financial statements for the past three fiscal years, and an accounting of advertising fees Company has collected in 20

3. List of franchisees and subfranchisees who are more than 60 days behind in advertising fee payments.

Section G. Franchise System

1. Provide a clean copy of all current (i) manuals distributed to franchisees, and (ii) internal policy manuals or other materials prescribing policies relating to franchise sales and administration. In addition, provide any different versions of these manuals Company has used over the past five years, with a description of the changes between the different versions.

2. A description of all training programs provided to franchisees or subfranchisees during the past three years, including copies of all written materials provided to franchisees and subfranchisees, and instructions from Company to the training staff. Provide a schedule of all training activities for the next 12 months, including classes at home office and training programs in the field and at franchised locations.

3. Copies of all quality assurance reports written by Company pertaining to franchisees and subfranchisees during the past three calendar years including the current year.

4. Describe any proprietary component of the franchise system that is licensed to Company by a third party or otherwise not owned and controlled exclusively by Company.

5. Printouts of all content currently published by Company on any internet or intranet or other computer network accessible by current or prospective franchisees or subfranchisees, or the general public.

6. A copy of all written policies and public statements, press releases, announcements by any officer, director or representative of Company that affect the

enforcement or interpretation of any of the Franchise Agreements, including termination rights, calculation of quantitative measures and metrics, impact/encroachment policies, and quality assurance/standards policies.

7. Provide a copy of all audit reports generated during the last 3 years from audits of franchisees and subfranchisees and any related correspondence, billing, collection and contract modification activity relating to audits.

8. Copies or descriptions of all earnings claims/financial performance representations, including supplemental earnings claims/financial performance representations, made or provided to prospective franchisees or subfranchisees (both within or outside of the Disclosure Documents), and all related substantiating data.

9. Instructions to franchise sales staff or franchise brokers regarding the making of earnings claims/financial performance representations to prospective franchisees.

10. Description of any required computer hardware or software.

Section H. <u>Intellectual Property</u>

1. Identify, describe and give the status of any and all U.S. and foreign intellectual property (collectively "Intellectual Property") owned, licensed or used by Company, including but not limited to patents, patent applications and any and all other patent rights, trademarks, trade names, service marks, trade dress, brand names, logos, other trade designations (including unregistered names and marks), trademark applications, trademark registrations, service mark applications, service mark registrations, copyrights, copyright applications, inventions, inventors' notes, moral rights, formulations, processes, methods, Internet domain names, Internet websites, URLs, trade secrets, software, computer programs, computer source codes, know-how, customer information, supplier information, proprietary development information, and drawings and designs.

2. Provide copies of all (i) agreements, including without limitation all licensing agreements (other than franchise agreements), assignment agreements, security agreements, maintenance agreements, confidentiality agreements (including those with members, managers, officers, directors, employees, and agents of Company or other entities) advertising agreements, marketing agreements, and development, manufacturing, distribution, dealer, sales agency, sales representative, or other like agreements, (ii) applications, (iii) registrations, (iv) correspondence and (v) other documents relating to the ownership, use, or exploitation of any Intellectual Property.

3. A description of any royalty arrangements involving the Intellectual Property, together with a statement of royalties paid out or received.

4. A list of all known pre-existing uses of the Intellectual Property (particularly trademarks and service marks), and to the extent possible, identify the user(s). Additionally, provide a list of areas within the U.S. and any foreign country where Company is prohibited from using its Intellectual Property (particularly trademarks and service marks).

5. A description of all infringement actions, oppositions, proceedings, or challenges to ownership, (whether pending or threatened, verbal or written) filed by or against Company, in the U.S. or internationally, with respect to any Intellectual Property or other right belonging to Company, and copies of all executed settlement agreements and related documents, and other material agreements, correspondence and documents, concerning any such infringement actions, oppositions, proceedings, or challenges.

6. List all software owned or licensed by Company and, for each item of software, describe whether it is "off the shelf" software readily available for purchase or license, or software specifically developed for Company by employees of Company or by outside parties. If any software development occurred, provide copies of applicable agreements relating to that development.

7. A list of all copyrighted works material to the franchise system for which no application to register has been filed. Any works owned by third parties should be separately identified.

8. Copies of Company's current policies, guidelines, and actual practices with respect to the protection of its Intellectual Property.

9. A description, along with copies of all related documentation, regarding what actions, if any, have been taken to protect Company's Intellectual Property in each of countries in which it has, directly or indirectly, conducted business.

10. A summary description of all litigation in the past five years involving or affecting any of Company's Intellectual Property rights.

11. Describe any proprietary component of the franchise system that is licensed to Company by a third party or otherwise not owned and controlled exclusively by Company.

EXHIBIT B

SAMPLE FRANCHISE REPRESENTATIONS AND WARRANTIES

The Company hereby represents and warrants to Purchaser, both as the Effective Date of this Agreement and the Closing Date, as follows:

Section [ ]. Franchise Matters:

1. Franchise System. Other than the Franchise System, neither the Company nor Owner has owned or operated any franchise system.

2. Franchise Agreements. Schedule [ ] of the Disclosure Schedule sets forth a list of all Franchise Agreements that are currently in effect between the Company and any Franchisee. The Company has made available to Purchaser accurate and complete copies of each Franchise Agreement. The list of Franchise Agreements accurately includes (i) the name of the Franchisee, (ii) the business address of each franchised location operated by such Franchisee, (iii) the effective and expiration dates, (iv) the number of remaining renewals, and (v) a description of any material waivers, alterations, amendments or other modifications of any Franchise Agreement (including regarding any fees, costs, expenses, defaults or obligations of a Franchisee) since the execution of such Franchise Agreement to which the Company, or any of its agents, have agreed to, entered into, or acquiesced.

3. Violations. Except as set forth in Schedule [ ] of the Disclosure Schedule, neither the Company or, to the Knowledge of the Company, any other party thereto, is in, or, has received written notice of any, violation of, threatened violation of, or default under (including any condition that with the passage of time or the giving of notice would cause such a violation or default under) any Franchise Agreement. Each Franchise Agreement is a valid and binding agreement of the Company, is in full force and effect (except to the extent such Franchise Agreement terminates or expires after the date hereof in accordance with its terms), and is enforceable against the Company, and, is valid, binding and enforceable against each Franchisee and not subject to any claim of, or right to, termination or rescission by any Franchisee or to the Knowledge of the Company, any third party thereto, in accordance with its terms, except as enforcement may be limited by applicable bankruptcy, insolvency, reorganization, moratorium or similar laws affecting creditors' rights generally and by general principles of equity (regardless of whether considered in a proceeding in equity or at law).

4. Options. No Franchisee or other Person has any enforceable right of first refusal, option or other right or arrangement to sign any Franchise Agreement or acquire any Franchise.

5. Franchisee Funds. All funds or cooperatives administered by or paid to the Company on behalf of any Franchisees, including funds that Franchisees contributed for advertising and promotion (i) have been administered and used in accordance with all Franchise Laws, all descriptions in the FDDs, and all Franchise Agreements, and (ii) the Company has in all material respects properly accounted for all payments made by each Franchisee with respect to any such fund or cooperative. There are no loans owed to or

owing from any such funds or cooperatives. To the Knowledge of the Company, there are no claims that any of the expenditures from any such funds or cooperatives have been improperly collected, accounted for, maintained, used or applied. Schedule [ ] of the Disclosure Schedule contains a listing of all presently established advertising fund or cooperative regarding the Franchises, which schedule also identifies whether each such fund or cooperative is presently operating.

6. Disputes. Either the FDDs or Schedule [ ] of the Disclosure Schedule contain a summary of all (i) Franchise-related or Franchisee-related arbitrations, litigation, class proceedings, material complaints or disputes, including claims that the Company is vicariously or jointly liable with any Franchisee, since , (ii) "litigation" required for disclosure under the FTC Rule or NASAA Commentary since the Reference Date, and (iii) other Legal Proceedings which were or are pending or, to the Knowledge of the Company, threatened since from any Franchisee, association purporting to represent a group of Franchisees, or Governmental Authority.

7. Forms of FDDs. Schedule [ ] of the Disclosure Schedule sets forth a list of all forms of FDDs that the Company has used to offer or sell Franchises at any time since _______ and the time period of effectiveness of each such FDD form. The Company has made available to Purchaser accurate and complete copies of each such form of FDD. All FDDs that the Company has used to offer or sell franchises at any time since ______ have contained all information required by the FTC Rule, NASAA Commentary, and other Franchise Laws and have otherwise been prepared and delivered to prospective Franchisees in compliance with the Franchise Laws, and no such FDD contains any statement which is false or misleading with respect to any material fact, or omits to state any material fact required to be stated therein or necessary in order to make the statements made therein not false or misleading in light of the circumstances under which they are made. The Company has made available to Purchaser correct and complete copies of all material correspondence with state and federal authorities concerning compliance with Franchise Laws.

8. Forms of Franchise Agreements. Schedule [ ] of the Disclosure Schedule sets forth a list of all forms or versions of Franchise Agreements for the Franchise System used since _____ and the time period of effectiveness of each such Franchise Agreement form.

9. Financial Performance. Since _______, no "Financial Performance Representation" (as defined in the FTC Rule) has ever been made to any Franchisee or prospective franchisee by the Company, or an officer, general partner, limited partner, salesperson, or Representative of the Company, except Financial Performance Representations which have been incorporated properly into the applicable FDD.

10. Jurisdictions. Schedule [ ] of the Disclosure Schedule sets forth a list of the jurisdictions in which the Company is currently registered or authorized to offer and sell Franchises, or is exempt from such registration, under a Franchise Law. There are no stop orders or other proceedings in effect or threatened that would prohibit or impede the Company's ability to offer or sell Franchises or enter into Franchise Agreements immediately following the Closing Date, except for any amendment filings and changes to

the FDD (if any) that might be required to describe the transactions contemplated by this Agreement.

11. Franchise Laws. The Company is, and since _____ has been, in compliance with all Franchise Laws and has not offered or sold any Franchise in violation of any Franchise Law (including any violation for failure to file on a timely basis all required amendments and renewals of the registrations and exemptions under the Franchise Laws and any violation for failure to file franchise advertisements). With respect to the relations of the Company with existing and former Franchisees, and all terminations, non-renewals, and transfers of Franchises since _____, the Company has complied with all the proper cause for default, default notice, time to cure, and actual termination requirements of any Franchise Agreement required by any Franchise Law.

12. Territories. No Franchisee has been granted protected or exclusive territory rights, a designated area, or an option, right of first refusal or other arrangement regarding additional territory rights, except as set forth in the Franchise Agreements. No Franchisee's protected or exclusive territory rights or designated area are violated in any way by another Franchisee's protected or exclusive territory rights or designated area

13. Sales Agents. The Company has not used any independent sales agents, sales brokers and referral sources to assist with the sale of Franchises.

14. Rebates; Products. Except as set forth on Schedule [ ] of the Disclosure Schedule, since _____, the Company has not entered into any Contract whereby the Company or any Affiliate receives rebates, allowances, discounts or other payments or remuneration of any kind (collectively, "Rebates") from suppliers or other third parties selling products or services, directly or indirectly, to Franchisees. Neither the Company nor any of its Affiliates has made any commitment, promise or pledge (oral or written) to share with Franchisees any Rebates. The Company has not received any revenue or other consideration, directly or indirectly, as a result of Franchisees' required purchases or leases of products or services.

15. Councils. Except as set forth on Schedule [ ] of the Disclosure Schedule, to the Knowledge of the Company, no franchise association or organization is acting as a representative of any group of five or more Franchisees. Any franchise council or advisory group (whether independently formed or sponsored by the Company) presently in place is advisory in nature and is disclosed on Schedule H.

16. Consents. Neither the execution of this Agreement nor the consummation of the transactions contemplated hereby: (i) will require the consent or approval by any Franchisee, council, association, or other third party, or (ii) will result in a violation of or a default under, or give rise to a right of termination, modification, cancellation, rescission or acceleration of any obligation or loss of material benefits under, any Franchise Agreement.

17. Non-Competes. Since _____, the Company has not waived enforcement of any non-compete restriction under any Franchise Agreement, and, to the Knowledge of the Company, no current or former Franchisee is currently in violation of any non-compete

covenant under any Franchise Agreement to which the current or former Franchisee is or was a party.

18. Enforcement. The Company has consistently enforced the terms of the Franchise Agreements, including enforcement of all required operating standards set forth in the operations manuals of the Company.

19. Franchisee Employees. The Company has not issued policies relating to, or otherwise exercised control over, any Franchisee's relationship with its employees, including hiring, firing, disciplining, compensation, benefits, supervision, and scheduling. The Company has not been alleged to be, and has not received, any formal or informal complaint, allegation or notice of inquiry or investigation from Franchisee, any employee of a Franchisee, third party or government agency, that the Company is or may be, joint employers with or subject to joint employment liability with, any Franchisee. To the Knowledge of the Company, no allegation has been made since _____ that any Franchisee or any of Franchisee's employees have been or are employees of the Company, or are or have been improperly classified as independent contractors in accordance with applicable Laws. To the Knowledge of the Company, no Franchisee is a party to or bound by any written or oral collective bargaining agreement or any other Contract with any labor union or other labor organization, and no union organizing or decertification activities are underway or threatened with respect to the employees of any of the Franchisees, and no such activities have occurred since _____.

20. Insurance. Each Franchisee has provided evidence to the Company that it has complied with the insurance requirements of the Franchise Agreement. The Company has been named as an additional insured on each Franchisee's insurance policy as required by the Franchise Agreement.