

INTRODUCTION TO PRACTICAL PROBLEMS AND ISSUES ASSOCIATED WITH BUYING OR SELLING A FRANCHISE COMPANY

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I. INTRODUCTION TO FRANCHISE ACQUISITIONS

A. OVERVIEW

As franchise systems have matured in the last couple of decades, there has been a significant increase in the number of franchise companies that have changed hands. These transactions often represent opportunities for sellers to cash out of their investments at significant profits, and for buyers to take these companies to another level. However, there are a litany of issues and potential problems associated with an acquisition of a franchise company, many of which are not found in the purchase and sale of other businesses. This chapter provides a general overview of some of the special considerations and issues to address when purchasing or selling a franchise company. It focuses on the unique issues in connection with mergers and acquisitions of franchise companies, including issues relating to franchise-specific laws, potential causes of action available to franchisees, key provisions to examine when reviewing franchise agreements, franchise disclosure issues with respect to the transaction, and drafting considerations.

Many of the challenges that apply to selling a business of any nature also apply to a franchise acquisition, but a number of nuances are unique

to the acquisition of a franchise company. All too often, attorneys (and others) in franchise acquisitions lack a “real” understanding of the nature and complexities of a franchise business, and treat the transaction just as they would any other acquisition. This can result in problems that could likely have been avoided if they were properly addressed at the outset. Proper planning and understanding of franchising’s unique challenges can help the process proceed more smoothly and lessen some of the inherent risks.

Buyers must be aware of the differences between having franchisees and having company-owned operations, as well as the laws that regulate franchising. Restrictions inherent in the franchise business model may not be consistent with the growth plans of the buyer. For example, a buyer planning to expand the system by quickly replacing underperforming franchisees needs to understand the impediments in doing so, both in terms of the franchise agreements and the laws that regulate termination in a number of states. Similarly, a buyer with a sales background outside the franchise arena will have to adapt to the concept of being required to deliver a franchise disclosure document to prospective franchisees and waiting two weeks before closing a sale. Furthermore, these buyers, who often have business plans and financing covenants requiring significant growth, may not appreciate the concerns that existing franchisees have about how the transaction will impact their business.

B. MOTIVATIONS OF BUYERS

Generally, there appear to be four types of buyers for franchise systems. First, there is the entrepreneur that can represent the next generation in the life cycle of a business system. Second, there is the buyer looking to use the franchise system as a distribution network for its products and services. Third, there is the competitor seeking to obtain additional market share through the economies of scale in acquiring a direct competitor. Fourth, there is the buyer who already operates franchise systems, often in industries or market segments different from that of the target franchisor. Each of these buyers faces different issues in an acquisition and presents different challenges to a seller.

Manufacturing and distribution companies have acquired franchise systems as an attractive way to exploit an alternative channel of distribution or to enhance their own distribution facilities and marketing expertise. They may see the acquisition of an established franchisor as facilitating entry into an alternative channel of distribution at a lower cost than developing a new franchise concept, building franchise sales and support infrastructure, and assembling an experienced management team. These buyers were particularly aggressive in the 1980s. An example was in the real estate industry, where buyers did not necessarily appreciate that

franchisees are independent business people who may have significant discretion in determining which products to purchase and promote. Sears bought Coldwell Banker to help it sell appliances and insurance products to new home buyers (through its insurance subsidiary, Allstate) but the Coldwell Banker franchise agreements did not require agents of the real estate broker to recommend insurance products to their customers, let alone a particular brand of insurance. Control Data Corporation acquired Electronic Realty Associates hoping to sell business computers to franchisees, but could not force anyone to buy the Control Data brand of computer when there were competitive brands available. Thus, while franchise systems can provide great synergy for companies with synergistic products and services, if these buyers are inexperienced in franchising, they can be disappointed and frustrated when they find there are both practical and legal limits on their ability to sell their products and services to franchisees and customers of their franchisees.

Strategic buyers who operate competitive franchise systems often have radical plans to change the franchisor's concept. They may intend to integrate the target's franchise system into their own, or vice versa. They need to take into account not only the free will of franchisees who may have views that are inconsistent with theirs, but the very real emotional difficulties franchisees may have when they find "their" system is suddenly being acquired by a company they competed against for years. Likewise, culture shock can occur when a system is sold by an individual or small company that operated as an entrepreneur able to make on-the-spot decisions, to a larger "conglomerate," with various layers of management and a bureaucracy that responds much slower.

A prudent buyer should also anticipate the public reaction to the acquisition, which might affect the business's future, particularly when the buyer intends to make significant changes to the system. In today's world of social media, many brands go to great lengths to establish followers, and many of these followers can become as parochial about the brand as the owner of the brand. A national company acquiring a regional brand will often discover negative public reaction because the system was a "favorite son" in the seller's region, and the loyal customer base is reluctant to patronize "just another" national brand.

Franchisors often choose to expand by acquiring competitors, not only as a means of expansion, but as a way to "eliminate" the competition. Buyers may view the acquisition of a franchised business that it is already familiar with and that it can integrate into the existing system as the easiest way to expand. Transactions that fit this mold include Cottman Transmission Systems, LLC acquiring AAMCO Transmissions, Inc., and America's Favorite Chicken Company (AFC Enterprises Inc.) acquiring Church's Chicken to supplement

its existing franchise system. A by-product of this model is the acquiring franchisor's vision for creating operational and marketing synergies between the two systems.

Some buyers may seek to revitalize faltering concepts by adding new products or services, while others may try to capture new customers for their proprietary products or distribution systems. Pepsico, for example, acquired Pizza Hut, KFC, and Taco Bell, in part to secure a market in the fast food industry for its soft drink products, before it spun them off to an independent company.

A recent trend has been venture capitalists and private equity firms creating a diversified or complementary portfolio of franchised (and even non-franchised) businesses. Private equity groups can provide funds for expansion, expertise, and sophistication, efficiencies based on cost cutting, and the ability to take advantage of other relationships, thereby positioning the system for expansion and greater profitability. Roark Capital Group, which acquired such brands as Cinabon, Money Mailer, Massage Envy (after Sentinel Capital Partners had owned it for only 33 months), Arby's, and Corner Bakery (which was acquired with a view towards franchising, even though Corner Bakery had no franchises at the time of the acquisition), exemplifies this trend. Similarly, Falconhead Capital, LLC acquired Rita's Water Ice Franchise Company, LLC, Thompson Street Capital Partners sold its Express Oil Change & Service Center chain to Carousel Capital, and, in possibly the largest acquisition as of this writing, The Blackstone Group L.P. acquired Hilton Hotels Corporation for more than \$20 billion. In some cases, as with Hilton, the private equity group will then position the acquired company for an initial public offering.

C. MOTIVATION OF SELLERS

Diverse considerations and reasons motivate franchisors to sell.¹ A conglomerate may decide to shed a franchise subsidiary that fails to meet the parent's profit goals or is no longer compatible with the organization's industry profile. The founders of a regional franchise chain whose growth potential is stunted by lack of capital or management expertise may seize an opportunity to liquidate an investment or convert it into a public company's securities. Likewise, a buyer may seize a unique opportunity in hopes of bringing in substantial franchise experience, such as the case in which the Serruya family acquired a controlling interest

1. See Robert P. Henley, Kenneth P. Milner & Kenneth S. Kaplan, *The Form of Ownership of the Franchisor: Issues and Concerns*, 36TH ANNUAL A.B.A. FORUM ON FRANCHISING, TAB W-3 (2013), for a discussion of the various forms of ownership for entities acquiring a franchise company.

in Kahala Corp., owner of Cold Stone Creamery and other brands, at auction. Franchisors who face financial or regulatory challenges may be compelled to seek a merger or buyout. Alternatively, a sale can also be part of a succession or exit plan, or a desire of the owners to do something different or to simply cash out. The motivation can also be pure economics, the right price at the right time. If the buyer understands the seller's motivation, this information could be very useful in negotiating the transaction.

II. UNIQUE ASPECTS TO THE ACQUISITION OF A FRANCHISOR

Some of a franchise company's most important assets and liabilities differ from those of non-franchise companies.

A. NATURE OF A FRANCHISOR'S ASSETS

The most valuable assets of a franchise system are usually its intellectual property, supply relationships, customer goodwill, and its franchise agreements and relationships with franchisees. Many franchisors do not own real estate or equipment, and if they do not have company-owned operations, they may have very few tangible assets.

Although standard acquisition checklists used in a non-franchise acquisition are still valuable, attorneys should supplement them to reflect the additional unique assets and liabilities of a franchise company. Intellectual property is often a franchise system's key asset. Because franchisors operate in dozens of industries, it is not practical to compile a single checklist of all the intellectual property found in franchise systems; however, the following assets are likely to be relevant to most transactions:

- trademarks and service marks;
- copyrights and copyrightable assets, including unique software, manuals and training materials, prototype blueprints, and advertising;
- patents;
- licenses and contractual rights, including agreements with suppliers, national accounts, and franchisees;
- domain names;
- trade secrets;
- Internet agreements; and
- customer information (franchisees, and customers of franchisees).

B. NATURE OF A FRANCHISOR'S LIABILITIES

On the liability side, franchise agreements impose obligations that may not be reflected on a balance sheet. Further, the franchise regulatory environment poses risks and liabilities that other businesses do not encounter. These liabilities are not considered liabilities under generally accepted accounting principles. For example, there are the obligations franchisors undertake in long-term agreements with franchisees, which may not all have been entered at the same time and may contain differing provisions. The possibility of violations of the laws and regulations that govern franchise sales and relationships with franchisees may pose significant potential liabilities.² Beyond legal liabilities, the franchisor's relationship with its franchisees, key suppliers, national accounts, and franchisee associations must be analyzed carefully to determine the true value of the business.

The presence of a franchisee community differentiates franchising from most other businesses. Franchisees often band together, either informally or formally through groups such as franchisee associations, and these groups can carry significant legal and practical power to influence the terms of an acquisition, as well as its post-closing success. For example, a potential lawsuit by an independent franchisee association of The Great American Chocolate Cookie Company delayed the franchisor's merger with Mrs. Fields Cookies. The association and its members feared that the merger would adversely affect the public's perception of the quality of The Great American brand and they threatened to enjoin the transaction.³

To analyze the franchisees' potential impact on the deal, the buyer should assess the franchisees' contractual leverage, which can sometimes be gleaned from the franchise agreement and Franchise Disclosure Document (discussed further in Section II.C). If possible, the buyer should also seek direct feedback from a representative sampling of the franchisees. There are, however, competing tensions between the buyer and seller over the input current franchisees will be allowed to have during the negotiation of an acquisition. The franchisor may be wary of permitting contact with franchisees or a franchisee association until the sale's consummation appears likely. In many circumstances, the franchisor's

2. See Rupert M. Barkoff, Gina D. Bishop & Leonard D. Vines, *Damage Control for Violations of Registration and Disclosure Obligations*, 24 FRANCHISE L.J. 191 (2005); Dale Cantone, Halima Madjid & Leonard D. Vines, *Best Practices for State Franchise Registration*, 32ND ANNUAL A.B.A. FORUM ON FRANCHISING, TAB (2009); Thomas M. Pitegoff, *Franchise Relationship Laws: A Minefield for Franchisors*, 45 BUS. LAW. 289 (1989).

3. Rupert M. Barkoff & Rochelle B. Spandorf, *Close Encounters: Franchise Associations and Councils*, 26TH ANNUAL A.B.A. FORUM ON FRANCHISING, TAB 1 LB/9, at 20 (2003).

concern is warranted. Opportunistic franchisees may decide they should have a share in the sale proceeds, perhaps to resolve disclosure and relationship issues that otherwise may not have been deemed material. Even to the extent the franchisee community would be supportive of the sale, a franchisor may be concerned about franchisee support for existing ownership, and overall morale, dissipating if the sale falls through. The franchisor may also be concerned that the franchisees will be in a position to exert pressure on the franchisor and hinder or thwart the transaction if the franchisees' demands are not met. In those circumstances, a review of minutes of the brand's franchisee association, or the association's website, if any, can be very insightful. A general Internet search may also uncover websites and "gripe sites" populated by franchisees and former franchisees. However, absent a franchisee association or direct contact with franchisees, a thorough review of the franchise files will likely be necessary to uncover correspondence involving common issues with franchisees.

Franchisees will likely have significant and legitimate concerns about any sale of the business. The ultimate success of the transaction could be jeopardized if the following questions cannot be answered satisfactorily:

- Will the buyer understand and be committed to franchising and providing service to franchisees?
- If the buyer is in a similar business, will it seek to expand either of the businesses in ways that would encroach upon the rights and territories of existing franchisees?⁴
- Will significant changes be made in procedures and operations that will be opposed or rejected by franchisees?
- Will the buyer require significant additional investment from franchisees and, if so, how have franchisees reacted to previous requests for new investment?
- Will there be significant management changes and will some of the franchisor's personnel who were highly regarded by franchisees leave the company?
- Will the historic culture shared by the franchisor and franchisee change?

The community of franchisees that operate units under a common brand can present other issues that need to be analyzed. One example is simply the effect

4. For additional commentary on the rights of franchisees, and of franchisors, when a system is acquired by a competitor, see Joel R. Buckberg, W. Garner & Jonathan C. Solish, *Legal Issues Arising from the Ownership of Competing Franchise Systems*, 22ND ANNUAL A.B.A. FORUM ON FRANCHISING, TAB 1 (1999). Kirk W. Reilly, Seth Stadfeld & Philip L. Wharton, *Litigation After Acquisition of a Competing Franchise System*, 29TH ANNUAL A.B.A. FORUM ON FRANCHISING, TAB W-6 (2006);

their operations have had on the goodwill of the business; are there markets in which the goodwill, and future expansion possibilities, have been tarnished by subpar operations of franchisees? As another example, while many companies issue gift cards, in a franchise business those gift cards are sold to franchisees who may add conditions, forfeitures, fees, and/or expiration dates to the gift cards.⁵ Such changes, and varying state laws dealing with gift card breakage and escheatment of gift card funds, affect the franchisor's ability to track its ongoing liability with respect to these gift cards. Similarly, when the franchisee sells products for which a franchisor (or its manufacturing affiliate) may have issued warranties, franchisee sales may not be as carefully tracked as sales by company-owned units.

C. FRANCHISE LAWS

1. DISCLOSURE REQUIREMENTS

A franchised business is unique in that before an agreement can be signed with a "customer," i.e., a franchisee, the franchisor must provide extensive disclosures in the form of a document referred to as a Franchise Disclosure Document (FDD). Federal law, state statutes, and common law fraud principles all govern these disclosures. Attorneys representing a client in the purchase or sale of a franchise system must understand the challenges posed by these and other unique aspects of the franchise business. The buyer of a franchise system should verify that franchisees received an accurate and complete disclosure document, that sales were offered only in those states where the franchisor was authorized to do so, and that the disclosure process required by law was followed. In addition, if any financial performance representations (formerly "earnings claims") were made, the buyer should be satisfied that they were made in compliance with the guidelines for disclosure in Item 19 of the FDD or in a supplemental document prepared in compliance with federal law. Of course, no franchisor is perfect and minor oversights or technical violations may not be cause for undue alarm.

The FTC Rule⁶ establishes disclosure requirements that apply throughout the United States. Section 5 of the Federal Trade Commission Act empowers the

5. State and federal laws and regulations (see, e.g., Regulation E, 12 C.F.R. § 205 et seq (1978) and now 12 C.F.R. pt 1005 (2012).) limit the expiration and fees associated with gift cards, and a franchisor must ensure that its franchisees' gift card sales comply with these laws and regulations. For an article summarizing gift card issues, see David M. Byers, Twyanda Lord & Bret Lowell, *Gift Cards and Loyalty Programs in Franchise Systems*, 33RD ANNUAL A.B.A. FORUM ON FRANCHISING, TAB W-7 (2010).

6. *Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures*, 16 C.F.R. § 436 (1978), reprinted in BUS. FRAN. GUIDE (CCH) ¶ 6090 et seq.

FTC to issue cease and desist orders against persons who violate its rules and to impose civil penalties of up to \$11,000 per violation.⁷ Moreover, although the courts have consistently held that the FTC Act does not create a private right of action and that private litigants may not sue directly under the FTC Rule,⁸ the FTC can take action for the violation,⁹ and courts in several jurisdictions have held that franchisees may attack franchise sales practices under state unfair or deceptive trade practices acts.¹⁰ The penalties for violating these state acts can, in some cases, include actual and punitive damages and rescission. Franchisees may also pursue private actions on grounds of common law fraud.¹¹ In addition, some of the state law exemptions on which franchisors rely are dependent upon compliance with the FTC Rule¹² and a buyer therefore should confirm whether the franchisor is, and has been, in compliance with the FTC Rule, and whether there are any existing orders or investigations pending with respect to such compliance.

Franchisors with publicly traded securities must also comply with the Securities Exchange Act's disclosure requirements. A change in control of a publicly held franchisor constitutes a material transaction that is likely subject to disclosure requirements under both franchise and securities regulations, and these dual disclosure requirements can cause practical problems for the franchisor in

7. 15 U.S.C. § 45 (2011).

8. See, e.g., *WW, LLC v. Coffee Beanery, Ltd.*, No 05-3360 2012 U.S. Dist. LEXIS 121347 (D. Md. Aug. 27, 2012); *Penn-Plax, Inc. v. L. Schultz, Inc.*, 988 F. Supp. 906 (D. Md. 1997); *Layton v. AAMCO Transmissions, Inc.*, 717 F. Supp. 368 (D. Md. 1989); *Days Inn of Am. Franchising, Inc. v. Windham*, 699 F. Supp. 1581 (N.D. Ga. 1988); *Oliveri v. McDonald's Corp.*, 678 F. Supp. 996 (E.D.N.Y. 1988); *Leonetti Furniture Mfg. Co. v. Sealy, Inc.*, No 90-380, 190 v Dist. LEXIS 20993 Bus. Franchise Guide (CCH) ¶ 9756 (D. Or. Oct. 16 1990).

9. This procedure is authorized under section 19(b) of the Federal Trade Commission Act (15 U.S.C. § 57b(b) (1980)). For an example of the way in which the FTC exercises this authority, see *Fed. Trade Comm'n v. Namer*, 781 F. Supp. 1136 (E.D. La. 1991).

10. *Brunswick Chrysler-Plymouth v. Mazda Motor of Am., Inc.*, No. 91-5144 1992 U.S. Dist. LEXIS 22790 (D.N.J. Feb. 21, 1992); *Bailey Emp. System, Inc. v. Hahn*, 545 F. Supp. 62 (D. Conn. 1982); *Akers v. Bonaifasi*, 629 F. Supp. 1212 (D. Tenn. 1985); *Texas Cookie Co. v. Hendricks & Peralta, Inc.*, 747 S.W.2d 873 (Tex. App. 1988); *Morgan v. Air Brook Limousine, Inc.*, 510 A.2d 1197 (N.J. Super. Ct. Law Div. 1986); see also Ala. Code § 8-19-5(20) (1981); D.C. Code Ann. §§ 28-3901 to -3908; Or. Rev. Stat. §§ 646.605-.652 (2003); Tenn. Code Ann. §§ 47-18-101 to -117 (2014); Tex. Rev. Civ. Stat. Ann. § 17.01 *et seq.* (2009). *Contra O'Brien v. Union Oil Co. of Cal.*, 669 F. Supp. 1562 (N.D. Ga. 1988); *Waldo v. N. Am. Van Lines, Inc.*, 669 F. Supp. 722 (W.D. Pa. 1987); *LeBlanc v. Belt Ctr., Inc.*, 509 So. 2d 134 (La. Ct. App. 1987); *Symes v. Bahama Joe's, Inc.*, No. 87-0903-2, 1988 WL 92462 Bus. Fran. Guide (CCH) ¶ 9192 (D. Mass. Aug. 21, 1988).

11. *Commercial Prop. Invs., Inc. v. Quality Inns Int'l, Inc.*, 938 F.2d 870 (8th Cir. 1991); *Moua v. Jani-King of Minn., Inc.*, 810 F. Supp. 2d 882 (D. Minn. 2011); *Noble v. C.E.D.O., Inc.*, 347 N.W.2d 734 (Minn. App. 1985); *Dowling v. NADW Mktg., Inc.*, 631 S.W.2d 726 (Tex. 1982); *Rodopoulos v. Sam Piki Enters., Inc.*, 570 So. 2d 661 Bus. Fran. Guide (CCH) ¶ 9741 (Ala. 1990).

12. See Fla. Stat. § 559.802 (2014); Iowa Code § 551A.4 (2014); Ky. Rev. Stat. Ann. § 367.807 (2008).

deciding when to disclose a pending change of control.¹³ Moreover, as discussed in greater detail in Section VI below, these disclosure and registration requirements also affect the sale itself.

2. REGISTRATION REQUIREMENTS

Fourteen states regulate the sale of franchises by requiring franchisors to register their franchise offering and delivering state-approved franchise disclosure documents to prospective franchisees.¹⁴ Oregon requires delivery of disclosure documents, but does not impose registration requirements.¹⁵ Connecticut,¹⁶ Florida, Kentucky, Nebraska, Texas, and Utah require the filing of a one-time or annual notice form in order to be exempt from their business opportunity laws.¹⁷

No governmental agency verifies the information contained in the FDD, and the FDD is not filed with the Federal Trade Commission. A franchisor risks liability if it sells franchises in any of the registration states without registering (or complying with the conditions for an exemption from registration), or if it makes false or misleading statements in its franchise disclosure document, or makes claims or promises to prospective franchisees that are inconsistent with the disclosure it has made in its FDD. Some state franchise statutes empower the franchise administrators to impose civil and criminal penalties on franchisors who offer unregistered franchises or who sell franchises in violation of statutory disclosure requirements and antifraud restrictions.¹⁸ Franchise administrators

13. Timing problems can grow even more complex if the buyer is also a public company because the buyer's disclosure preferences may conflict with the seller's disclosure obligations.

14. California (Cal. Corp. Code §§ 31000–31516) (2013); Hawaii (Haw. Rev. Stat. § 428E-1, *et seq.*) (2008); Illinois (1987 Ill. Laws Ch. 85-551) (2009); Indiana (Ind. Code § 23-2-2.5-1, *et seq.*) (2008); Maryland (Md. Ann. Code art. 56, §§ 14.201–233) (2010); Michigan (Mich. Comp. Laws §§ 445.1501–1545) (2008); Minnesota (Minn. Stat. §§ 80C.01.22) (2012); New York (N.Y. Gen. Bus. Law §§ 680–695) (1998); North Dakota (N.D. Cent. Code §§ 51-19-01-17) (2001); Rhode Island (R.I. Gen. Laws §§ 19-28-1-15) (2009); South Dakota (S.D. Codified Laws Ann. §§ 37-58-1 *et seq.*) (2008); Virginia (Va. Code Ann. §§ 13.1-557 to -574) (2009); Washington (Wash. Rev. Code §§ 19.100.010–.940) (2012); and Wisconsin (Wis. Stat. §§ 553.01–.78) (2008).

15. Oregon (Or. Rev. Stat. §§ 650.005–.085 (2013)).

16. The Connecticut requirement applies only if an exemption is claimed based on the obtainment, on or after October 1, 1996, of a federally registered trademark under which the franchisee will operate.

17. For a general overview of franchising and related topics, *see* R. Barkoff & A. Selden, *Fundamentals of Franchising*, A.B.A. FORUM ON FRANCHISING (3d ed. 2008).

18. Cal. Corp. Code §§ 31405, 31410, 31411 (2013); Haw. Rev. Stat. § 428E-(no subsection number assigned) (2008); 1987 Ill. Laws Ch. 85-551 §§ 24, 25 (815 ICCS 705) (2009); Ind. Code § 23-2-2.5-27 (2008); Md. Ann. Code art. 56, §14–228 (2010); Mich. Comp. Laws § 445.1538 (2008); Minn. Stat. § 80C.16 (2012); N.Y. Gen. Bus. Law § 690 (1998); N.D. Cent. Code § 51-19-14; R.I. Gen. Laws § 19-28-11 (2001); S.D. Codified Laws Ann.37–58–43 (2008); Va. Code Ann. §§ 13.1-569 to -570 (2009); Wash. Rev. Code § 19.100.210; Wis. Stat. § 553.52

may also revoke the registration of a culpable franchisor's offering or obtain injunctive relief against further violations.¹⁹ State administrators often communicate and share information, so a violation in one state may "taint" the franchisor and trigger a more comprehensive review of that franchisor's application. This exposure potentially involves both state actions and private actions by franchisees who are injured by a franchisor's misconduct.

The franchise laws of 15 states contain antifraud provisions that prohibit material misrepresentations in connection with the sale of a franchise, including material misstatements or omissions in franchise disclosure documents.²⁰ Some state franchise statutes also afford franchisees private rights of action against franchisors who violate the registration and disclosure requirements or antifraud constraints. The statutory remedies include contract rescission and monetary damages, which could be asserted against the buyer of the franchise company.²¹

The registration states provide various exemptions from the registration requirements. Exemptions range from large franchisor status, sales to existing franchisees, sophisticated investor transactions, fractional franchises, and others. Adding to the complexity of compliance is the fact that some of these exemptions are exemptions only from registration, while others are exemptions from both registration and disclosure. Moreover, the exemptions are not uniform from state to state, and exemptions available under the FTC Rule do not always

(2008). The Oregon statute, which is administered by the Director of the Department of Insurance and Finance, does not expressly empower the Director to impose civil or criminal sanctions, but preserves the state's right to seek these sanctions under other provisions of Oregon law. Or. Rev. Stat. § 650.085.

19. Cal. Corp. Code §§ 31400, 31402-03 (2013); Haw. Rev. Stat. § 428E (2008); 1987 Ill. Laws Ch. 85-551 § 22 (2009); Ind. Code §§ 23-2-2.5-14, -32, -34, -35 (2008); Md. Ann. Code art. 56, § 363 (2010); Mich. Comp. Laws § 445.1535 (2008); Minn. Stat. § 80C.12 (2012); N.Y. Gen. Bus. Law § 689 (1998); N.D. Cent. Code §§ 51-19-09, -13 (2008); Or. Rev. Stat. § 650.065 (2012); R.I. Gen. Laws §§ 19-28-5, -10 (2008); S.D. Codified Laws Ann. §§ 37-58-41, -48 (2008); Va. Code Ann. §§ 13.1-562, -568 (2004); Wash. Rev. Code §§ 19.100.120, .210 (2012); Wis. Stat. § 553.28 (2008).

20. Cal. Corp. Code §§ 31200-31202 (2013); Haw. Rev. Stat. § 428E-5 (2008); 1987 Ill. Laws Ch. 85-551 § 6 (2008); Ind. Code § 23-2-2.5-27 (2008); Md. Ann. Code art. 56, § 347 (2010); Mich. Comp. Laws §§ 445.1505, .1523 (2008); Minn. Stat. § 80C.13 (2012); N.Y. Gen. Bus. Law § 687 (1998); N.D. Cent. Code § 51-19-11 (2001); Or. Rev. Stat. § 650.020 (2013); R.I. Gen. Laws § 19-28-7 (2008); S.D. Codified Laws Ann. §§ 37-5B-24 to -26 (2008); Va. Code Ann. § 13.1-563 (2009); Wash. Rev. Code § 19.100.170 (2012); Wis. Stat. § 553.41 (2008).

21. Cal. Corp. Code §§ 31300-02 (2013); Haw. Rev. Stat. § 428E-9 (2008); 1987 Ill. Laws Ch. 85-551 § 26 (2009); Md. Ann. Code art. 56, § 365 (2010); Mich. Comp. Laws § 445.1531 (2008); Minn. Stat. § 80C.17 (2012); N.Y. Gen. Bus. Law § 691 (1998); N.D. Cent. Code § 51-19-12 (2001); Or. Rev. Stat. § 650.020 (2013); R.I. Gen. Laws § 19-28-9 (2009); S.D. Codified Laws Ann. § 37-5B-49 (2008); Va. Code Ann. § 13.1-571 (2009); Wash. Rev. Code § 19.100.190 (2012); Wis. Stat. § 553.51 (2008). The Indiana statute does not expressly provide for private actions, but indicates that successful private litigants may recover consequential damages, interest, and attorneys' fees. Ind. Code § 23-2-2.5-28 (2008).

mirror those provided under state law. Thus, determining the applicability and scope of an exemption requires careful analysis.

If the selling franchisor qualified for an exemption and the buyer wishes to preserve the exemption, the parties must exercise care in structuring the acquisition. When the exemption is based on the status of the franchisor, as opposed to the net worth or experience of the franchisee, the exemption will often disappear in an asset purchase arrangement because a different franchisor (the buyer) will assume responsibility for offering the franchise, but the buyer cannot claim the experience of the former franchisor's exemption criteria. Even in a transaction involving a stock sale, if the acquisition debt is placed at the franchise company level, the franchisor's net worth may disappear. Thus, thorough review of how the franchisor's offering was registered (or exempt) is necessary so that the buyer can structure or prepare accordingly.

3. RELATIONSHIP LAWS

In addition to liabilities that may arise from defects in the franchise sales process, franchisors potentially risk liability for actions that undermine a franchisee's investment, because 20 states²² and the District of Columbia regulate certain aspects of the franchise relationship.²³ These statutes, commonly known as "relationship laws," differ significantly in approach and in the activities they regulate, but they generally prohibit a franchisor from terminating, refusing to renew, or withholding consent to the transfer of a franchise except for good cause. Most of these laws also require the franchisor to provide notice or take other actions beyond the express obligations in

22. Arkansas (Ark. Code Ann. §§ 4-72-201-210 (1987)); California (Cal. Bus. & Prof. Code §§ 20000–20043) (2008); Connecticut (Conn. Gen. Stat. 23-2-2.7-1(7) §§ 42-133e to -133h) (2012); Delaware (Del. Code Ann. §§ 2551–2556) (2013); Hawaii (Haw. Rev. Stat. § 428E-6) (2007); Illinois (1987 Ill. Laws Ch. 85-551 §§ 18–20) (2013); Indiana (Ind. Code §§ 23-2-2.7-1-7) (2012); Iowa (Iowa Code §§ 523H.1–.17) (2012); Maryland (Md. Code Ann. §§ 11-1301 to -1311) (2012); Michigan (Mich. Comp. Laws § 445.1527) (2004); Minnesota (Minn. Stat. § 80C.14) (2012); Mississippi (Miss. Code Ann. §§ 75-24-51 to -61) (2010); Missouri (Mo. Rev. Stat. §§ 470.400–410, 420) (2012); Nebraska (Neb. Rev. Stat. §§ 87-401 to -410) (2012); New Jersey (N.J. Rev. Stat. §§ 56:10-1 *et seq.*) (2011); Virginia (Va. Code Ann. § 13.1-574) (2014); Washington (Wash. Rev. Code §§ 19.100.180, .190) (2012); Wisconsin (Wis. Stat. §§ 135.01–07) (2011); D.C. Code Ann. §§ 29-1201 to -1208 (2003). Puerto Rico and the Virgin Islands have enacted comparable legislation. P.R. Laws Ann. tit. 10, §§ 278–278d (2012); V.I. Code Ann. tit. 12A, §§ 130–139 (2002); Practices Act (15 U.S.C. § 2801).

23. Many states separately regulate the franchise relationship in particular industries, such as motor vehicles, petroleum products, alcoholic beverages, and farm implements. Consideration of these special industry laws is beyond the scope of this book. The federal government also regulates certain aspects of automobile dealerships and petroleum product distributorships under the Automobile Dealer Franchise Act (15 U.S.C. §§ 1221–1225 (2012)), and the Petroleum Marketing Practices Act (15 U.S.C.A. §§ 280 *et seq.* (2012)).

the applicable franchise agreement. For example, the franchisor may have to give advance notice of termination or nonrenewal for periods ranging from 30 to 180 days and/or allow franchisees to cure defaults within prescribed periods. Some states also impose inventory and equipment repurchase requirements, even on franchisors who properly exercise termination and nonrenewal rights. Civil penalties, actual and punitive damages, and injunctive relief for franchise law violations are also available under some state statutes. And in several states, the franchise administrators may impose civil penalties on noncomplying franchisors.²⁴

Several state relationship laws prohibit franchisors from discriminating among franchisees,²⁵ such as varying their charges for franchise fees, royalties, merchandise, and services, unless the variances reasonably relate to differences in time, franchisee qualifications, or other defined circumstances. Some of these statutes also regulate provisions that can be contained in the franchise agreement, such as waivers and releases, and governing law and venue provisions.²⁶

The possibility of existing liabilities for breach of the state relationship laws should be taken into account by an educated buyer. The extent to which these laws will have an adverse effect on the acquiring buyer's future business plans must also be considered.

III. INFORMATION ACCESS—BEYOND THE TYPICAL DUE DILIGENCE

One of the critical components of a franchise acquisition is accessing information about the existing franchisees. Future expansion or contraction of the business will in large part be dictated by the franchisor's existing franchisees. Are they interested in expanding and, if they are not, how will they react to significant expansion in their markets (assuming they do not have exclusive territories)? Will they provide validation to future franchisees? Are they themselves in financial difficulty and likely to contract in the future?

24. For an excellent review and summary of these statutes, *see* Pitegoff, *supra* note 2.

25. Hawaii (Haw. Rev. Stat. § 428E-6) (2007); Illinois (1987 Ill. Laws Ch. 85-551 § 18) (2013); Indiana (Ind. Code § 23-2-2.7-2) (2012); Minnesota (Minn. R. 2860.4400B) (2004); and Washington (Wash. Rev. Code § 19.100.180) (2013).

26. *See, e.g.*, Arkansas Franchise Practices Act, Ark. Code Ann. § 4-72-206 (1987); Hawaii Franchise Investment Law, Haw. Code R. § 482E-6 (2007); Nebraska Franchise Practices Act, Neb. Rev. Stat. § 87-406 (2012); Tennessee Franchise Terminations, Nonrenewals or Modifications Law, TENN. CODE ANN. § 47-25-1510 (2013).

The obvious starting place in learning about the existing franchisee population is to talk with them. However, as discussed earlier, many franchisors will be reluctant to allow would-be buyers to speak to their franchisees. In a small system, it may be practical to review each of the franchisor's franchise agreements²⁷ and each franchisee's file, but in a larger system, it will be impractical to review more than a representative sampling. The sampling, however, should be of multiple agreements and files of each type of franchisee (i.e., single unit, multi-unit, area developer, and master franchisee (sub-franchisor)) to make certain that the buyer has reviewed a good cross section of the franchisees. In addition, larger systems often have franchisee associations (franchise advisory councils and/or independent franchisee associations), and a careful review of the minutes of those meetings, and correspondence between the franchisor and the association(s), will often provide great insight into the issues that need further review.

If the buyer is a public company, other issues to consider include disclosure of the contemplated sale, potential disruption to the franchise system through inspections or interviews by third parties, responding to franchisees when they learn that the franchise system is for sale, and the impact on future sales once word of a possible sale spreads. Franchisees are clearly a critical component of the system's success, so the manner in which they are brought into the due diligence investigation must be handled with care.

A major due diligence consideration is access to information regarding the franchisor's revenue streams and liabilities. Typically, a franchisor generates most of its revenues from franchise fees, royalties, and, in some cases, sales of merchandise and services to franchisees. Are those revenues recurring, as would be the case if the vast majority are from royalties and ongoing product and service purchases? Or, are the revenues predominantly non-recurring, such as initial franchise fees and equipment purchases? For recurring revenues, a review of the accounts receivable aging, and the files of the most delinquent franchisees, will provide insight into the likelihood that a franchisor's existing revenue streams can be maintained, let alone increased, and whether there are liabilities that will surface when collection efforts are instituted against those franchisees.

27. For purposes of this chapter, when we refer to a "franchise agreement," we are referring to what may also be called a license agreement. The term franchise agreement used in this chapter refers to the agreement that is required to be in the franchisor's Franchise Disclosure Document as required by the Federal Trade Commission (FTC) Rule. See 16 C.F.R. Part 436 (2014) (FTC Rule). The franchise agreement may be required not only by the FTC Rule, but also by the states that have additional registration requirements pursuant to their applicable state laws. However, another due diligence aspect is to determine if the business is compliant with the FTC Rule and state requirements and, if not, what it will take to make it compliant.

No matter how the parties structure the acquisition, various franchise laws may prevent the buyer of a franchise company from avoiding all risks arising from the franchisor's pre-acquisition liabilities. For example, in an asset purchase, a well-drafted liability exclusion clause whereby the buyer expressly rejects responsibility for the franchisor's liabilities may provide protection from certain types of liabilities and claims; however, state law governing transferee liability may limit such protection. In addition, a buyer cannot completely avoid the risk that a franchisee will assert rescission or equitable defenses following the assignment of the franchise agreement.

A franchise acquisition agreement, like any other business acquisition agreement, should clearly identify which liabilities, if any, are to be assumed by the buyer. In *Schwartz v. Pillsbury, Inc.*,²⁸ a franchisee of Häagen-Dazs brought suit based on false representations concerning financial representations, seeking to impose successor liability on the buyer, Pillsbury. The court rejected the franchisee's claim that Pillsbury expressly or impliedly assumed Häagen-Dazs's liabilities to franchisees arising out of tort claims because the acquisition agreement expressly limited Pillsbury's obligations to the "leases, agreements, contracts, plans and commitments" listed in the balance sheet, and "all other agreements and contracts entered into in the ordinary course of business at any time prior to the Closing." The court also found that the mere fact that the sale of franchises was the core of Häagen-Dazs's business did not transform Häagen-Dazs's alleged fraud on the franchisees into an agreement, plan, commitment, or contract made in the ordinary course of business, for which Pillsbury assumed liability. Further, the court rejected the franchisee's claim that Pillsbury's acquisition of Häagen-Dazs amounted to a de facto merger under California law, because the acquisition was an arm's-length cash transaction whereby Pillsbury bought Häagen-Dazs's assets and assumed certain contractual liabilities, but the franchisor's shareholders did not become shareholders of the buyer or any of its subsidiaries.

Indemnification and risk allocation provisions can provide compensation to a buyer to reimburse it for liability to franchisees, but they will not insulate the buyer from franchisee claims, nor will they provide redress for the fallout from such claims, including lost revenues from closed units. It is, therefore, imperative for buyers to identify and quantify the franchisor's actual, contingent, and potential liabilities to franchisees. Otherwise, buyers may not be able to adequately negotiate appropriate indemnities, escrows, deferred payments, and similar safeguards to prepare for possible post-sale liabilities.

28. 969 F.2d 840 (9th Cir. 1992).

To make an informed judgment about a franchisor's liabilities to its franchisees, a buyer can access a variety of information. Often, a buyer can glean pertinent information from publicly available documents such as the franchisor's state-registered FDD²⁹ and if the franchisor is a reporting company, its Securities Exchange Act reports. In addition, an analysis of communications with any franchisee association, a review of previous litigation files (for common or systemic issues), and a review of the files of the largest franchisees (by number of units, size of territory, and revenue/royalties generated), are important.

In a thorough due diligence investigation, the buyer should also interview the franchisor's sales personnel and its contract administration staff. The buyer must be aware, however, that such activity can create an environment in which rumors flourish. Unless the franchisor is prepared to quell rumors by sharing information about the pending sale, morale and loyalty may be adversely affected. Selective disclosure may spawn illegal trading in a company's securities, so if either party's securities are publicly traded, a contemporaneous press release may become imperative. If the parties issue a public announcement and the buyer later withdraws from the negotiations, the franchisor may suffer unnecessary and irreparable damage to its reputation among numerous influential groups, including middle management, franchisees, suppliers, bankers, investors, and other potential buyers. Therefore, a publicly held franchisor may consider withholding permission for the buyer to interview its staff (and franchisees) until the buyer makes a legal or financial commitment to proceed with the acquisition.

In the end, because of their competing motivations, tensions invariably develop between a buyer's need to evaluate a target franchisor's actual and contingent liabilities and the franchisor's need to protect confidential information until the buyer makes a legal or financial commitment to complete the sale. These tensions create special drafting and procedural challenges, so counsel for both parties must analyze all of those due diligence considerations to prepare their clients for completing the process.

Finally, in addition to focusing on the specific franchise laws and nuances described above, the buyer may also need to consider other "hot topics," such as gift card and gift card escheatment,³⁰ state tax issues in connection with royalty

29. Some states have websites that report franchisor filings, such as California and Minnesota. *See, e.g., California Electronic Access to Securities and Franchise Information, California Department of Business Oversight* <http://www.dbo.ca.gov/CalEASI/CalEASI.asp>; *Commerce Actions and Regulatory Documents Search, MINNESOTA DEPARTMENT OF COMMERCE* <https://www.cards.commerce.state.mn.us/CARDS>.

30. *See supra* note 5.

and other franchise payments,³¹ and possible treatment of franchisees as employees of the franchisor.³² These were hot topics at the time of publication of this book and, at that time, the law was in flux on these issues. It is likely, however, that any issues that could generate revenue to governments will continue to evolve as governments look for alternative avenues for increasing revenue.

IV. RIGHTS OF, AND DUTIES TO, FRANCHISEES

As discussed above, the existence of a community of franchisees differentiates a franchise system from other types of businesses. Franchisees not only have an investment in their business that can be dramatically affected by a sale of the franchise system, but they may also have an emotional attachment to the status quo. The extent of the influence the community of franchisees will have on a transaction often depends on the degree to which franchisees have acted in the past as a unified group, and the culture of the franchise system in terms of communications with franchisees.³³ Getting the franchisees to buy in to and accept the new owner can pose challenges and should be handled diplomatically and with respect for the concerns of the franchisees. Therefore, those involved in the sale of a franchise system should be aware of the types of claims that might be brought or threatened by franchisees to challenge a sale of the franchisor. Even if lawsuits are not brought before closing, understanding the franchisees' concerns and allaying their fears may well be critical to having a smooth ownership transition. Some of the more common claims that could arise as a result of an acquisition are discussed below.

A. BREACH OF CONTRACT

1. RESTRICTIONS ON TRANSFER

The merits of a franchisee's legal rights to challenge a proposed transaction will depend in large part on the specific terms of the franchise agreements. Most well-drafted agreements give the franchisor the broad right to sell its assets, merge, reorganize, and sell the equity of the franchise company, without consent

31. *See, e.g.,* KFC Corp. v. Wagstaff Minn., Inc., 2012 U.S. Dist. LEXIS 372 (D. Minn. Jan. 3, 2012).

32. *Awuah v. Coverall N. Am., Inc.*, 707 F. Supp. 2d 80 (D. Mass. 2010).

33. Apart from any legal claims franchisees may have, buyers and sellers need to consider the reaction franchisees will have to a transaction, as those reactions will most certainly affect the future of the business.

or approval by franchisee and without compensating them.³⁴ Such provisions must be carefully reviewed, as should state statutes, some of which require the franchisor to make reasonable provision for the performance of its obligations by the transferee.³⁵ Ambiguous or weak language in a franchise agreement with respect to the franchisor's right to transfer could give franchisees the ability to at least conduct discovery on whether provision has been made for performance of the franchisor's obligations.

2. TERRITORIAL RESTRICTIONS

Territorial issues can also be a fertile ground for breach of contract claims. In some cases, the territorial provisions of the franchise agreements could be breached if the acquiring company or an affiliate operates a competing business. In *Auto-Chlor System of Minnesota, Inc. v. JohnsonDiversey*,³⁶ the plaintiff dealers sued their manufacturer, alleging that the exclusive territory provisions of their contracts were violated by the acquisition of a competitor that sold products virtually identical to those sold by the complaining dealers and breached the exclusive territory provisions of their contracts. The court sided with the defendant because the territorial restrictions were specific to products sold under the manufacturer's registered trademarks. However, in *G.I. McDougal, Inc. v. Mail Boxes Etc., Inc.*,³⁷ the court rejected the franchisor's motion for summary judgment on a similar infringement argument. In that case, Mail Boxes Etc. franchisees complained that the acquiring company's operation of UPS drop boxes, counters, and mailing locations by the acquiring company, within their territories, violated the exclusivity provisions of their franchise agreements. The franchise agreement at issue was broader and prohibited the establishment of a business selling similar products or services under a different trade name within the territory granted to franchisees. As a result, the court concluded there was a triable issue as to whether the new owner of Mail Boxes Etc. was operating or licensing similar products or services in violation of the exclusivity provisions in the franchise agreements.³⁸

34. See e.g., *Wardley Corp. v. Meredith Corp.*, 93 Fed. Appx. 183, Bus. Fran. Guide (CCH) ¶ 12,764 (10th Cir. 2004).

35. See e.g., Iowa Code § 523H.5(6) (2012); Mich. Comp. Laws § 445.1527(i) (2004).

36. 328 F. Supp. 2d 980 (D. Minn. 2004).

37. No. B196029, 2008 Cal. App. Unpub. LEXIS 4275 (Ct. App. May 23, 2008) (unpublished and uncitable).

38. For a more detailed discussion of the issue of exclusivity provisions, see the further discussion *infra* Section IV.D.

B. COMMON LAW FRAUD

Perhaps the most common claim alleged by existing franchisees in connection with a proposed sale of the franchise system is that the failure of the franchisor to disclose its plans constitutes common law fraud. Fraud is always difficult to prove, but perhaps more so in the franchise context, because the plaintiff generally must show there was a duty to disclose.³⁹ For prospective franchisees, the duty may arise out of the disclosure laws. Existing franchisees need to show the duty arose out of either a fiduciary or special relationship requiring a higher level of trust or confidence than would be found under ordinary contract case circumstances. Although the elements of a fiduciary relationship can vary from state to state, the majority of the courts that have considered the question in the context of the franchisor/franchisee relationships have found that the court does not impose fiduciary duties on the franchisor absent unique facts showing undue reliance by the franchisee upon its franchisor.⁴⁰

C. BREACH OF IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING

Franchisees have also used the implied covenant of good faith and fair dealing as a basis for seeking damages arising out of the sale of a system.⁴¹ Most of the reported cases have resulted in successful defenses by franchisors, but these claims may survive summary judgment. For example, in *A.J. Temple Marble & Tile, Inc. v. Union Carbide Marble Care, Inc.*,⁴² the plaintiffs argued that a sale would violate the implied covenant of good faith because the buyer had no experience as a franchisor in the marble business. The court denied summary judgment, even though the franchise agreement allowed assignment to a third party.

Although franchisees often take the position that the franchisor cannot take actions that undermine the fundamental rights under the franchise agreement, numerous cases have held that the implied covenant of good faith and fair dealing cannot override the clear, express written terms of the agreement and the covenant cannot be used to contradict the terms of the agreement. As one court explained, “courts have utilized the good faith duty as an interpretive duty to determine the parties’ justifiable expectations in the context of a breach of

39. See *Konold v. Baskin-Robbins, Inc.*, No. 95-1251, 1996 U.S. App. LEXIS 15309 (10th Cir. June 25, 1996); *Hardee’s v. Hardee’s Food Sys.*, 31 F.3d 573 (7th Cir. 1994); *Lightning Lube, Inc. v. Witco Corp.*, 4 F.3d 1153, Bus. Fran. Guide (CCH) ¶ 10,279 (3d Cir. 1993).

40. See *O’Neal v. Burger Chef Sys., Inc.*, 860 F.2d 1341 (6th Cir. 1988); *Vaughn v. General Foods Corp.*, 797 F.2d 1403 (7th Cir. 1986).

41. See, e.g., *Clark v. America’s Favorite Chicken Co.*, 110 F.3d 295 (5th Cir. 1997).

42. 618 N.Y.S.2d 155, Bus. Fran. Guide (CCH) ¶ 10,523 (Sup. Ct. N.Y. County 1994).

contract action, but that duty is not divorced from the specific clauses of the contract and cannot be used to override express contractual terms.”⁴³

D. TORTIOUS INTERFERENCE WITH CONTRACT

When the acquiring company is a competitor, the buyer should be alert for possible claims of tortious interference. For example, if franchisees or prospective franchisees are negotiating leases for new sites, and the franchisor shares this information with a competitive sister system, that system’s subsequent efforts to negotiate a lease for that site could lead to a claim of tortious interference.

The tortious interference issue can also arise when two systems are merged after acquisition. In 2005 Hyatt Corporation purchased the AmeriSuites hotel chain. Hyatt rebranded qualifying AmeriSuites hotels to the “Hyatt Place” brand and stopped operating and promoting the AmeriSuites brand, diverting support and resources to Hyatt Place. Prior to its acquisition by Hyatt, AmeriSuites had a franchise agreement with Epoch-Florida Capital Hotel Partners (Florida Capital), which operated a hotel that was not rebranded as Hyatt Place. Florida Capital sued Hyatt for, among other things, tortious interference with its business relationship with AmeriSuites. The court held that even though it was now a parent corporation, Hyatt may “never tortiously interfered with the preexisting business relationship and contract of its recently acquired subsidiary.” The court further stated that, even if Hyatt established a privilege to interfere with the Florida Capital franchise agreement, as the parent corporation of AmeriSuites, that privilege was not absolute and could be overcome because of Florida Capital’s showing that Hyatt willfully, oppressively, and maliciously interfered with a pre-existing franchise agreement.⁴⁴

E. VIOLATION OF ANTITRUST LAWS

Antitrust laws can be impacted when competitors merge. The Clayton Act prohibits mergers where the effect is to “substantially lessen competition or tend

43. *Northview Motors, Inc. v. Chrysler Motors Corp.*, 227 F.3d 78, 91 (3d Cir. 2000); *see also* *Donaldson v. Informatica Corp.*, 420 F. App’x 204 (3d Cir. 2011); *Low Carbon Processors, LLC v. Kennametal, Inc.*, 693 F. Supp. 2d 191 (N.D.N.Y. 2010); *Tango Transp., LLC v. Transp. Int’l Pool, L.L.C.*, No. 08-559, 2010 U.S. Dist. LEXIS 135669 (W.D. La. Dec. 22, 2010).

44. *Hyatt Corp. v. Epoch-Florida Capital Hotel Partners, Ltd.*, No. 6:07-cv-1260-orl-KRS, 2008 U.S. Dist. LEXIS 12693 (M.D. Fla. Feb. 20, 2008). *See also* *KMS Rest. Corp. v. Wendy’s Int’l, Inc.*, 194 F. App’x 591 (11th Cir. Fla. 2006); *Gossard v. Adia Servs., Inc.*, 723 So. 2d 182 (Fla. 1998) (holding that Florida law recognizes a claim for tortious interference against a corporation which purchases, as a subsidiary corporation, a corporation which has a preexisting obligation not to compete against its franchise, and subsequently purchases another subsidiary which is in direct competition with the franchisee).

to create a monopoly.”⁴⁵ While the Federal Trade Commission will often have the opportunity to review proposed mergers under the Hart-Scott-Rodino Act,⁴⁶ neither the lack of a Hart-Scott-Rodino filing requirement nor the FTC’s approval precludes a private right of action. In addition, even when the impact of a merger is not sufficient to run afoul of the Clayton Act, liability could arise under state antitrust Baby FTC Acts. Franchisees would not likely have standing to bring these actions, however, as the courts have consistently held that the cause of action lies with a competitor who would be harmed by the combination.⁴⁷

F. INTRA CHAIN COMPETITION

In some cases, a breach of contract claim may arise not out of the acquisition itself, but by the subsequent actions of the acquiring company. This is especially problematic when the new owner operates a competitive system and may have plans to integrate the system, or “borrow” personnel, systems, or resources from the acquiring brand to be utilized in the competing system.⁴⁸ In *Alaska Rent-A-Car v. Avis Budget Group*,⁴⁹ the Ninth Circuit Court of Appeals upheld a \$16 million judgment in favor a franchisee who alleged that Avis had breached a settlement agreement that arose out of the acquisition by Avis of a competing rental car company (Agency Rent-A-Car). The settlement agreement had provided some protections to Avis franchisees by not allowing use of the same personnel to sell and market both Avis and other brand cars. Subsequently, Avis purchased Budget and the plaintiff claimed that Avis breached the settlement agreement with its alleged combined Avis/Budget Operations.⁵⁰

45. 15 U.S.C. § 18 (1996).

46. *Id.* § 18(a).

47. *See, e.g.,* *Serpa Corp. v. McWane, Inc.*, 199 F.3d 6, 10–11 (1st Cir. 1999) (holding that distributors who argued that the consolidation of companies lessened competition and constituted an attempt to monopolize the plumbing supply products market “presumptively lack antitrust standing” because their “antitrust injury is too remote”).

48. *See generally* Paul J. Halasz & Aaron J. Stahl, *Managing Exclusivity Issues in a Multibranded Environment*, 31 *FRANCHISE L.J.* 95, 96–99 (2011); W. Michael Garner, Richard Greenstein & Mary McMonagle, *When Competitive Franchise Systems Merge: Opportunities & Pitfalls*, INT’L FRANCHISE ASS’N, 43RD ANNUAL LEGAL SYMPOSIUM (2014). *See also* *Hanson Hams, Inc. v. HBH Franchise Co.*, No. 03-61198-CIV-MARRA/SELTZER, 2004 U.S. Dist. LEXIS 29636 (S.D. Fla. Dec. 20, 2004) (finding no violation of Florida’s Deceptive and Unfair Trade Practices Act arising from franchisor’s post acquisition conduct based on defendant’s control of both competing systems and treating the two systems differently); *John Keenan Co. v. Norrell Corp.*, No. 99-1924, 2001 U.S. Dist. LEXIS 13250 (E.D. La. Aug. 20, 2001) (finding that franchisee failed to demonstrate elimination of any business advantage).

49. 738 F.3d 960, *Bus. Fran. Guide* (CCH) ¶ 15,024 (9th Cir. 2013).

50. This case demonstrates the need, as part of due diligence, to review all previous litigation and settlement agreements that could affect the acquisition and/or subsequent operations.

Even when there are no territorial restrictions that would prevent a franchisor from acquiring a competing brand, buyers should still consider the impact the acquisition may have on the franchisees' business, particularly where two chains operate in close proximity or target the same customers. As the brands develop, what will the acquiring company do when one brand develops a "best practice" that the acquiring company wants to implement in the other brand? If the promotions or best practices of Brand A are shared with franchisees of Brand B, and franchisees of Brand A lose customers to their Brand B competitors, franchisees of Brand A will not be happy. Likewise, if those ideas are not shared, franchisees of Brand B may feel like they are treated as second class citizens, and at a minimum, such feelings can seriously affect the system and its efforts to build the brand. They may, under the right circumstances, even give rise to claims of a lack of good faith and fair dealing in maximizing the assets available to franchisees of Brand B.

There could be a variety of provisions of the franchise and other agreements that could be breached by an acquisition, including best efforts clauses and confidentiality provisions. Thus, counsel for both parties should be cognizant of the provisions of the franchise agreements of the acquired party, as well as those of any acquiring party and its affiliates that operate in the same industry.

Franchisees who have faced competition as a result of the acquisition of a competitor have also asserted claims based on violations of state laws. For example, in *Precision Enterprises, Inc. v. Precision Tune, Inc.*⁵¹, a Precision Tune franchisee claimed that the offer of more favorable rates to franchisees of the newly-acquired competitor company violated the Washington Franchise Investment Protection Act ("WFIPA"). However, the court found no violation because the offer was based on a reasonable decision of the franchisor and could ultimately benefit all franchisees. Furthermore, the court held that the franchisor's refusal to allow the franchisee to relocate its franchise did not constitute a breach of good faith under the WFIPA. Another example of a state law claim arose in *Gossard v. Adia Services, Inc.*⁵²

G. LACK OF QUALIFICATIONS

The lack of qualifications of the buyer of the franchise system was raised in *Marc's Big Boy Corp. v. Marriott Corp., NL*.⁵³ In that case, a franchisee sought to enjoin

51. *Precision Enters., Inc. v. Precision Tune, Inc.*, Bus. Franchise Guide (CCH) ¶ 10,472 (W.D. Wash. Oct. 4, 1993).

52. 723 So. 2d 182 (Fla. 1998) (analyzing a franchisee's state-law claim for tortious interference by a franchisor for purchasing a competing corporation).

53. No. 87-C-1183, 1988 U.S. Dist. LEXIS 19514 Bus. Fran. Guide (CCH) ¶ 9100 (E.D. Wis. 1988).

the sale of the Big Boy system from Marriott to one of Marriott's largest Big Boy franchisees. Although the court did not find that the transferee lacked the qualifications to become the franchisor, it did conclude that a franchisee may have a legitimate interest in who controls the franchisor. While the franchisee was not able to block the sale, the fact that a court even considered the issue and envisioned a situation where a franchisee may have a legitimate interest in the transaction can be cause for concern.

V. THE FRANCHISE AGREEMENT AND FDD—GENERAL

It is vital that counsel review the franchisor's franchise agreements and disclosure documents, including both the current agreement and previous forms still in effect. Franchisors frequently update their documents to correct "mistakes" and oversights from one year to the next and to reflect changes in the law and court decisions, and some changes may impact provisions that impair the system's salability or restrict the franchisor's activities in ways that could impact the system's value.

Some of the key provisions that should be analyzed in the case of an acquisition are discussed below. A reference to corresponding items in the FDD appears in parenthesis at the end of each section.

A. TRANSFER AND ASSIGNMENT PROVISIONS

Provisions regarding transfer and assignment by the franchisor, as discussed in the previous section, are of particular importance. Does the franchisor have the unrestricted right to transfer its interest in the franchise agreements? If there are any restrictions, such as the agreement of the transferee to assume these obligations, they should be addressed in the purchase agreement for the transaction. (Item 17, FDD.)

B. TRADEMARKS

Most well-drafted franchise agreements allow the franchisor to change the trademark, and require franchisees to adopt any new names/marks the franchisor requires. However, not only should the agreements be reviewed to confirm these rights exist, but the buyer should be aware of any restrictions or costs imposed upon the franchisor in these agreements (such as the cost to replace signage) or in individually negotiated amendments thereto. This is obviously of concern when the buyer plans to merge two systems, but even when the brand will remain

independent, the buyer's marketing department may have plans for changes to the logo, if not the trademark itself, and the agreements should be reviewed to confirm these changes can be made, and whether the franchisor will be responsible for the costs incurred by franchisees. (Items 13, 17, FDD.)

C. SYSTEM CHANGES

Most franchise agreements contain broad language, allowing the franchisor to make changes in the system, most often through changes in operating manuals (which are referred to and incorporated into most franchise agreements). The buyer will want to confirm these provisions exist, that they have not been amended in any individually negotiated agreements, and that the franchisor bears no responsibilities for the costs incurred at the franchised units for implementation of changes. (Item 17, FDD.)

It is also important for the buyer to understand operating provisions in the franchise agreements that could impair the buyer's ability to develop and expand the system in the manner needed to generate the increased value typically expected in an acquisition. Particularly with "first generation" franchises who are still operating under their original franchise agreements, outdated or poorly drafted forms may still be in effect and contain provisions that will hinder the buyer's ability to maximize the potential of the franchise system. Some areas of inquiry include:

- Do franchisees have termination rights that could be triggered by a sale or can a franchisee terminate without cause, thus jeopardizing the revenue streams anticipated by the buyer? (Item 17, FDD.)
- Do the franchise agreements contain reasonable, enforceable non-compete provisions that would dissuade franchisees from seeking to exit the system, whether or not they have a right to do so (and are the agreements governed by the laws of states that enforce covenants not to compete)? (Item 17, FDD.)
- Does the franchisor have the right to control products and services distributed through the system? (Item 8, FDD.)
- What rights does the franchisor have to sell products through alternative means of distribution? (Item 12, FDD.)
- What do the franchise agreements say about the ownership and use of the customer information?

Even if the standard forms are favorable to the franchisor on all these issues, this is a situation where amendments to those forms need to be reviewed carefully, particularly amendments granted during the early years of operation of the franchise system that may remain in effect. Many new (and even mature) franchisors

may not have appreciated the reason their lawyers included provisions favorable to them on these issues, and they may have negotiated individual amendments that limit the power of the franchisor to engage in certain activities that are important for growth and could have an impact on the system's future operations.

D. TERRITORIAL RIGHTS AND ENCROACHMENT PROBLEMS

The provisions of the franchise agreements granting protected territories can be of particular importance and significant in a number of contexts. Many franchisors grant their franchisees a trade area in which the franchisor agrees not to operate or license anyone else to operate a competing outlet. When a competitor acquires a franchise system, the provisions of the acquiring company's agreements or the target company's agreements could put one or both of the franchise systems in default upon consummation of the acquisition. Even when the acquiring company is not a competitor, to the extent broad rights have been granted to franchisees in specific trade areas, they could limit the ability of the acquiring company to expand the system. Franchise agreements that grant "exclusive territories" can be particularly problematic because the term "exclusive" can be ambiguous, or worse, be interpreted to prohibit the franchisor from engaging in activities important to the buyer.

The first thing to consider in reviewing territory provisions is the extent to which certain activities are restricted. Franchise agreements often limit the franchisee's territorial protection, permit franchisors to distribute products and services through alternative distribution channels, and specifically reserve broad rights to the franchisor. In some cases, the restrictions apply only to outlets bearing the same trade name licensed to the franchisee, such as in the *Auto-Chlor System Minnesota, Inc. v. JohnsonDiversey* case,⁵⁴ discussed previously in Section IV.A.2. Such restrictions could impact the ability of an acquiring company to merge two franchise systems, but they would not affect the ability of competing companies to operate under different marks. If, however, the territory grant prohibits the franchisor from operating a competitive system under other names, these restrictions can be problematic, and may require individual negotiations with a number of overlapping franchisees.⁵⁵ An early resolution before the transaction is consummated can be less costly and less risky than a later one.

54. 328 F. Supp. 2d 980 (D. Minn. 2004). See discussion *supra* text accompanying note 36.

55. See *G.I. McDougal, Inc. v. Mailboxes Etc. Inc.*, No. B196029, 2008 Cal. App. Unpub. LEXIS 4275 (Ct. App. May 23, 2008), (unpublished and uncitable) discussed *supra* Section IV.A.2. See also *G.I. McDougal, Inc. v. Mail Boxes Etc., Inc.*, No. B226122, 2012 WL 90083 (Cal. App. 2d. Jan. 12, 2012) (unpublished and uncitable), in which the Court of Appeals found no breach of contract and no violation of the covenant of good faith because the

Even when there are no overlapping territories, the geographic scope of these provisions can still be important. If, for example, a single restaurant operator has a ten-mile exclusive territory in the center of a small town of 2,000 people, the restriction may be of little concern to the acquiring company, but the same restriction in Manhattan will significantly limit the franchisor's ability to expand in a major market. (Item 12, FDD.)

Although many provisions in franchise agreements may be fairly standard, territory provisions are often individually negotiated. Some franchise agreements do not grant any territorial protection whatsoever; however, special territorial rights, if any, may be included in an amendment to the franchise agreement. The franchisor's records of territory grants may not always be complete, and such amendments or other evidence of territorial protections warrant review.

E. ADVERTISING AND MARKETING PROGRAMS

Franchise system buyers should not overlook the selling franchisor's advertising and marketing programs. Some of the issues raised by these programs, such as contractual relationships with advertising companies, ownership of advertising materials, licensing of intellectual property used in advertising materials, and long-term media contracts that may already be in place, are no different from those found in the acquisition of a non-franchise company. However, unique among franchise system acquisitions is the existence of advertising and marketing programs to which all franchisees contribute.

Advertising provisions in franchise agreements typically require franchisees to spend a fixed amount or percentage of their sales on local advertising, and contribute a fixed amount or percentage of their sales to a central advertising fund. Among the issues that arise in connection with these marketing funds are:

- Who manages the funds?
- What input/control do franchisees have?
- Do all franchisees contribute equally or on the same basis?
- Are company-owned units obligated to contribute and, if so, how much?
- What requirements and limitations are there on the use of these funds?
- Are the funds required to be maintained in a trust or separate account?
- Are there unfunded liabilities of the fund, i.e., have greater amounts been collected than have been spent and, if so, is there sufficient cash being transferred

franchise agreement required the franchisee to sign the then-current form of agreement on renewal, even though it contained substantial changes.

to meet those obligations, or is this a liability the acquiring company will have to fund?

- Are a significant number of franchisees not making their required contributions and, if so, why?

An acquiring company must understand its obligations in the future, as well as whether the franchisor has been meeting its contractual commitments in the past. If it has not, regardless of what is stated in the purchase agreement, the acquiring company may ultimately have to address liabilities for past transgressions concerning these funds.

If the buyer is an existing franchisor, it may want to integrate the target company's marketing programs and funds with its own. If so, there are additional considerations: Do the franchise agreements of the two companies allow for such integration? If not, are there still common services that can be provided at a savings to both companies? If so, do the enabling clauses for these funds permit the funds to acquire services from the other brand? Limitations and restraints in these areas may impair a buyer's ability to maximize the cost savings or other benefits of the acquisition. (Item 11, FDD.)

F. DISPUTE RESOLUTION PROCEDURES

While some franchisors adopt dispute resolution procedures suggested by their attorneys, without significant input, these procedures may also be based on the franchisor's culture and resources. The buyer should try to understand this culture and the dispute resolution provisions that govern these contracts. Compulsory, non-binding mediation provisions, which are often included in franchise agreements to force the parties to meet before incurring significant legal fees in an adversarial proceeding, have been enforced.⁵⁶ Recent U.S. Supreme Court cases have also upheld arbitration clauses⁵⁷ and restrictions on the scope of arbitration or remedies available, such as restrictions on class action arbitrations.⁵⁸

56. *See, e.g.*, *Delamater v. Anytime Fitness, Inc.*, 722 F. Supp. 2d 1168 (E.D. Cal. 2010); *3-J Hospitality, LLC v. Big Time Design, Inc.*, No. 09-61077-CIV, 2009 WL 3586830 (S.D. Fla. Oct. 27, 2009); *Brosnan v. Dry Cleaning Station, Inc.*, No. C-08-02028 EDL, 2008 WL 2388392 (N.D. Cal. June 6, 2008).

57. *See, e.g.*, *14 Penn Plaza v. Pyett*, 556 U.S. 247 (2009) (holding that an arbitration clause in a collective bargaining agreement is enforceable); *Green Tree Fin. Corp. v. Randolph*, 531 U.S. 79 (2000) (holding that arbitration clauses are generally enforceable unless specifically precluded by statute).

58. *See, e.g.*, *AT&T Mobility LLC v. Concepcion*, 131 S. Ct. 1740 (2011) (holding that a waiver of class actions contained in arbitration clause is enforceable).

Some buyers, either because they lack experience in settling disputes outside of court or have had disappointing experiences in alternative dispute proceedings, may not be comfortable with these procedures. Conversely, those accustomed to alternative dispute resolution procedures may be frustrated if the franchisor has not embraced these alternatives and incorporated them into their franchise agreements. (Item 17, FDD.)

G. VENUE, JURISDICTION AND CHOICE OF LAW

Franchise agreements typically include venue provisions that stipulate where litigation, arbitration, or mediation proceedings will occur. Occasionally, the franchise agreement will provide for venue in the state in which the franchisee's business is located. Acquiring companies should be aware of these provisions, which can become problematic if a number of franchisees attempt to challenge the acquisition, each entitled to venue in a different state.

Most often, the franchise agreements provide that the specific state in which the franchisor's principal office was located at the time the franchise agreements were signed will be the venue for litigation or arbitration proceedings. While these clauses may have provided a "home field advantage" to the original franchisor, they could be problematic or inconvenient for an acquiring company located elsewhere, in a place that is inconvenient to the buyer. Some franchise agreements attempt to address this potential problem by providing that venue will be in the jurisdiction where the franchisor is located at the time the dispute results in the initiation of litigation.

Apart from venue clauses, most franchise agreements will provide a governing law provision that is tied to the state in which the franchisor was based at the time the agreement was signed. For an out of state company acquiring the franchise system, this will subject the buyer to laws with which it may not be familiar. While the buyer can obviously change this provision in any new franchise agreements that are issued, it will have to live with these provisions in existing agreements for the pendency of those agreements. (Item 17, FDD.)

H. AREA DEVELOPMENT AND SUBFRANCHISING RIGHTS

If a franchise system grants development rights, i.e., rights granted to one franchisee to develop multiple units in a given area, these development agreements (which are sometimes embedded in the "unit" franchise agreement or an addendum) must also be reviewed, as they frequently contain rights to develop units in a broader market. They may also include rights of first refusal that, at best, could delay or limit the acquiring company's ability to bring new franchisees into the system, and could be broad enough to apply to competing units offered

under any trademark. In some cases, these restrictions may only last as long as the franchisee is developing new units, but in other cases, they may continue as long as the franchisee maintains the minimum number of units required in the development agreement. Oftentimes, an area developer fails to meet its development schedule, and the franchisor may not have enforced its rights or formally terminated the agreement, thus giving rise to a possible waiver or estoppel claim. (Items 1, 5, 12, 22, FDD.)

If a franchisor has expanded through area representative agreements, master licensing, or subfranchising, territory grants can be even more complicated. In the area representative model (also sometimes referred to as a development agent or by other names), an area franchisee has paid the franchisor for the right to bring prospective franchisees to the franchisor. In those situations, the franchisor signs the franchisee agreements directly with these prospects, but it shares with the area representative the responsibility for providing initial and ongoing service to franchisees, and it shares fees with the area representative. In the subfranchise model, there is a similar sharing of responsibilities and fees, but the master franchisee enters into contracts directly with the “retail” or “unit” franchisee, or subfranchisee. When these arrangements exist, it is particularly important for the buyer to understand the limitations imposed on the franchisor under these agreements, the lost revenue opportunities, and the potential for liability as a result of the master franchisees’ acts and/or omissions. Moreover, in the case of the master franchise arrangement, where there is no privity of contract between the franchisor and the “retail” franchisee, the franchisor may have no ability to deal directly with the individual franchisees in the market. These arrangements will be of particular concern to strategic buyers looking to sell products and services to franchisees or to customers of the franchisees. (Items 1, 2, 5, 11, 12, 20, 22, FDD.)

VI. DISCLOSURE AND REGISTRATION ISSUES WITH RESPECT TO THE SALE OF THE SYSTEM

Disclosure and registration laws are intended to provide disclosure to prospective franchisees of important information concerning the franchise. Therefore, it is particularly important to determine whether and how the impending transaction should be disclosed under these laws if the franchisor intends to sell new franchises before the sale is closed. Disclosure guidelines do not specifically address disclosure obligations with respect to the pending sale of a franchise system. However, they do require disclosure of certain information about any

parent company of the franchisor.⁵⁹ Moreover, a number of state franchise disclosure laws include a requirement not to omit any material information from the disclosure document,⁶⁰ and several of these statutes address actual changes in a franchisor's ownership or management control as constituting a material event requiring disclosure.⁶¹ A failure to timely disclose the existence of a potential sale to a prospective franchisee could also lead to a claim of common law fraud for negligent misrepresentation.⁶²

Determining when to disclose a pending sale is not easy, and a franchisor considering the issue may find itself between the proverbial rock and a hard place. At first glance, it would seem that the conservative advice to provide to a franchisor is to be very open and disclose a potential sale as soon as it is considered, amending at each stage of the transaction to bring the disclosure current. The risk inherent in that position should be obvious. For one thing, it is human nature for people to fear change, and a premature disclosure could raise anxieties and affect existing relationships. Moreover, if a prospective franchisee invests in the franchise with the expectation that a sale beneficial to the system will be consummated, will it have a claim against the franchisor if the closing never occurs? Of course, the opposite is also true; if a prospective franchisee purchases a franchise without knowledge of a pending sale, and the sale proves not to be beneficial to franchisees, will the franchisee have a cause of action for nondisclosure? The question of when a pending sale must be disclosed is exacerbated if either the buyer or franchisor is a public company because there is potential liability under the securities laws for a premature disclosure of a contemplated transaction that does not come to fruition.

From a practical standpoint, most franchisors do not want their competitors learning about a potential sale before it is at least under contract, and perhaps even closed. Many franchisors also would prefer not to concern existing

59. 16 C.F.R. § 436.5(a) (2008).

60. *See, e.g.*, Minn. Stat. § 80C.13(1) (2012).

61. The franchise regulations of Hawaii, Maryland, Minnesota, and Wisconsin include a change in control of the franchisor and/or its management as examples of particular material changes. HI Dept. of Commerce and Consumer Affairs (2007), Tit. III, Bus. Registration § 16-37-1 (2012); Md. Regs. Tit. 02, § 02.02.08.01B(9) (2011); Minn. R. 2860.2400B; Wis. Admin. Code § SEC 31.01(2)(b) (2010).

62. *See, e.g.*, *McLachlan v. New York Life Ins. Co.*, 488 F.3d 624, 628 (5th Cir. 2007) (discussing claim for negligent misrepresentation under Louisiana law); *Pearson's Pharmacy, Inc. v. Express Scripts, Inc.*, 505 F. Supp. 2d 1272, 1275–76 (M.D. Ala. 2007) (discussing claim for fraud under Alabama law); *Manhattan Motor Cars, Inc. v. Automobili Lamborghini, S.p.A.*, 244 F.R.D. 204, 212–13 (S.D.N.Y. 2007) (discussing claims for fraud and negligent misrepresentation under New York law).

franchisees about a potential sale before the franchisor is prepared to address them.⁶³ Thus, absent a business or legal reason to disclose a pending transaction to prospective franchisees, many franchisors prefer to wait as long as possible before disclosing a potential sale.

Timing of disclosure was at issue in *Century Pacific, Inc. v. Hilton Hotels Corporation*,⁶⁴ in which two former Red Lion hotel franchisees brought suit against Hilton Hotels Corporation and the former owner of the Red Lion system, claiming that the failure to disclose the pending sale when they were signing their franchise agreements violated the New York Franchise Act and constituted common law fraud, negligent misrepresentation, and fraudulent omission.⁶⁵ In its franchise disclosure document, Hilton had actually stated that a potential sale was a possibility at the time and one of several alternatives under consideration. Hilton maintained that once the sale became a reasonable possibility, it made disclosure, but by that time, these franchisees had already signed their franchise agreements. The court agreed with Hilton's position that the original disclosure was sufficient, and dismissed the plaintiff's claims. The *Century Pacific* case is a good example of the balancing that a franchisor should do when a sale is being considered. The fact that a sale is being discussed with a potential buyer may be of interest to prospective franchisees, but as noted above, premature disclosure of the discussions could cause more harm to the acquiring business than the benefit provided to prospective franchisees, particularly when those discussions may not lead to a binding agreement, let alone an actual sale. In the *Century Pacific* case, the fact that the Red Lion system was being put up for sale was known in the hotel industry; however, that is not always the case.

Unfortunately, there is no bright line as to when a transaction must be disclosed and each transaction has unique characteristics. In some situations, once a letter of intent is signed, the buyer and franchisor begin working on transition issues, and the signing of definitive agreements, let alone the consummation of the closing, becomes a mere formality. In other situations, the signing of a binding letter of intent may be only the beginning of an extensive negotiating and due diligence process that may never lead to a closing. Thus, no hard and fast rule can be adopted for when a sale must be disclosed, and common sense and the particular circumstances should dictate. Similarly, when the buyer also sells franchises, these same considerations apply to its disclosure document. Among the considerations are (a) at what point the transaction is more likely than not

63. See discussion *supra* Section II.B.

64. 528 F. Supp. 2d 206 (S.D.N.Y. 2007).

65. *Id.* at 213.

to occur; and (b) what effect the transaction will have on the operation of the business and the disclosures currently contained in the franchise disclosure document. The closer and more likely the transaction is to becoming a reality, and the greater the effect of the transaction on prospective franchisees (whether of the buyer or seller), the sooner the possible transaction should be disclosed. Prospective franchisees who will be making a significant investment in the business will justifiably feel that a change in ownership is a material fact about which they should be made aware.⁶⁶

A franchisor can avoid potential liability in this area if it is willing to suspend franchise sales—i.e., “go dark”—until the parties are prepared to announce the transaction to the public. In many cases, however, suspension of franchise sales may not be practical from a business and competitive standpoint. It could conceivably be deemed a change in the ordinary course of operation of the business, which the purchase agreement likely prohibits. Further, if the suspension of sales causes a decline in the target company’s earnings, the buyer may be concerned enough to seek to renegotiate the purchase price. The suspension of sales also can have an impact on staff morale, particularly if the sales staff is compensated, in whole or in part, on a commission basis.

It is important to note, however, that there is no duty to disclose an impending transaction or to provide an updated FDD to existing franchisees. The FTC Compliance Guide⁶⁷ states that “(a) franchisor is not required to provide a disclosure document to a franchisee exercising a right under the franchise agreement to establish any new outlets (as opposed to selling outlets to others), nor to a franchisee who chooses to keep its existing outlet post-term either by extending its present franchise agreement or by entering into a new agreement, unless the new relationship is under terms and conditions materially different from the present agreement.” Nevertheless, if a franchisor is planning to sell the system it may be wise to either advise an existing franchisee who is planning to open another unit or suspend the sale until the acquisition is completed.

Suspending sales may, however, not be an option for franchise systems that have renewing franchisees who are required to sign updated franchise agreements containing materially different terms and conditions from their expiring

66. For additional analysis of disclosure obligations with respect to franchisor acquisitions, see Mark Kirsch, Scott Pressly & Patrick Walls, *A Seller’s Guide to Preparing to Sell the Franchise System*, INTERNATIONAL FRANCHISE ASSOCIATION’S 42ND ANNUAL LEGAL SYMPOSIUM ch. 3, at 23 (2009); and Joyce G. Mazero, Jan S. Gilbert & Roberta Lauer, *Pieces of the M&A Puzzle: Key Transaction Challenges for the Franchise Lawyer*, 28 FRANCHISE L.J. 79 (2008).

67. FEDERAL TRADE COMMISSION, FRANCHISE RULE COMPLIANCE GUIDE, 1, 19 (2008), available at <http://business.ftc.gov/documents/franchise-rule-compliance-guide>.

agreement. Likewise, if there are pending transfers of existing outlets, and the franchisor requires the transferee to sign each new form of agreement or is otherwise involved in the sale (beyond merely having approval rights or a right of first refusal), the transaction is subject to the franchise disclosure laws and the franchisor must deliver a current disclosure document.

VII. INITIAL DRAFTING AND DOCUMENT ISSUES

A. EXPLORATORY STAGE

The parties to a business combination usually begin their negotiations with informal discussions during which they explore each other's intentions and sincerity. In the context of a franchise acquisition, the parties can use this exploratory stage to create mechanisms for solving the practical problems discussed earlier. With counsel's assistance, they can, and should, establish procedural rules to safeguard the interests of both parties during the project's three principal phases: the period during which the buyer formulates a concrete purchase proposal, ending with the negotiation and execution of an agreement in principle or letter of intent; the more intensive diligence stage, which culminates with the signing of a definitive agreement; and the period between the signing of the definitive agreement and closing.

A certified public accountant should, of course, be involved in the early stages of any transaction. In large-scale transactions, an investment banker may be able to provide various services relating to mergers and acquisitions. An investment banker can also be valuable if a public offering is contemplated or if the acquiring company needs assistance in raising capital.

B. CONFIDENTIALITY AGREEMENT

Rules governing the initial phase can be expressed in a confidentiality agreement that identifies the documents, data, and other information the franchisor will make available to enable the buyer to formulate a preliminary acquisition proposal. A confidentiality or secrecy agreement should identify precisely the items that the franchisor will provide and indicate where, and under what circumstances, the franchisor will allow the buyer to examine those documents that it is unwilling to release from its custody. Although such agreements may seem innocuous and even-handed, there are subtle but important ramifications,

depending on whether they are drafted for the party receiving the information or for the party disclosing it.⁶⁸

Relevant documents the parties might identify in the confidentiality agreement include:

1. Sample forms of each franchise contract the franchisor has offered, including franchise, development, and subfranchise agreements.
2. A summary of franchise contract changes the franchisor has negotiated, perhaps limited to items of special importance, such as territorial protection, royalty rates, and marketing contributions, but without identifying specific franchisees or territories affected.
3. Sample forms of leases, promissory notes, security agreements, guaranties, and related contracts the franchisor uses if the franchisor leases real estate or personal property to its franchisees or provides them financing.
4. Lists of the states in which the franchisor has offered or sold franchises and in which its franchisees are currently operating.
5. Copies of registration orders, exemption notices, and other documentary evidence of the franchisor's authorization to offer franchises in particular states.
6. A copy of each franchise disclosure document the franchisor has used during the last five years,⁶⁹ including copies of any supplemental financial performance representations the franchisor has provided to prospective franchisees.

Copies of the brochures, application kits, media advertisements, and other materials the franchisor has used to advertise and promote its franchise program during the last five years.

68. See Glen W Young, *Ten Secrets About Secrecy Agreements*, 39 NO. 6 PRAC. LAW. 67 (1993), for a discussion of provisions in such agreements from the viewpoint of both the disclosing party and the recipient. It also includes suggested language to resolve differences and make for a mutually beneficial agreement.

69. A five-year review period is suggested because the statutes of limitations governing franchise sales will normally have run in less than five years. The limitations period may, however, be extended if, in the exercise of reasonable diligence, a franchisee could not have discovered a fraudulent misstatement or omission within the prescribed time. See *Carlock v. Pillsbury Co.*, 719 F. Supp. 791 (D. Minn. 1989) (stating that the statute of limitations does not begin to accrue until the aggrieved party discovers the facts constituting fraud); cf. *Mackey v. Judy's Foods, Inc.*, 654 F. Supp. 1465 (M.D. Tenn. 1987) (holding that statute of limitations did not toll because franchisees were put on notice of the franchisor's impending legal issues). If the buyer's diligent investigation uncovers situations in which franchisees might successfully argue for an extension of the limitations period, the buyer should extend its review beyond five years.

1. Copies of any stop orders, notices of investigations, and notices of other administrative actions the franchisor has received from state franchise administrators and the Federal Trade Commission.
2. Copies of the franchisor's federal and state trademark registrations.
3. If the franchisor (or its parent) is a reporting company, copies of recent forms 10-K, 10-Q, 8-K, and other reports it has filed with the Securities and Exchange Commission.
4. Financial statements for relevant periods.

The confidentiality agreement should obligate the buyer and its advisors to hold these documents and the information they contain in strict confidence and provide for the buyer to return the documents if the parties abandon the transaction. The agreement should also define diligence activities in which the buyer agrees not to engage before the parties sign an agreement in principle. For example, the agreement should expressly prohibit the buyer from making contact with the franchisor's franchisees, suppliers, and staff (except members of the franchisor's negotiating team). Further, it should restrict both parties from publicizing their negotiations before they sign an agreement in principle.

C. LETTER OF INTENT

When a buyer completes its initial review of the franchisor's operations and the parties reach tentative agreement on the transaction's structure and price, they typically sign a letter of intent (sometimes referred to as an agreement in principle). The letter of intent can vary from a simple statement of the intent and basic terms, to a very detailed term sheet.

The letter of intent will typically outline the terms of the transaction. It should also set forth the buyer's due diligence activities and guidelines for dealing with other practical problems, along with defining the scope of the buyer's investigation during the period preceding the definitive purchase agreement's execution.

Among other points, the letter of intent will often expand the list of documents the franchisor must make available and provide for confidential treatment of these documents. The additional documents might include (recognizing that in systems with thousands of franchisees, the buyer will not be reviewing all these documents):

1. All contracts the franchisor has signed with current and former franchisees, including amendments or addenda reflecting changes the franchisor has negotiated.
2. Notices of expiration or termination, assignment documents, any releases the franchisor gave or obtained, and any related correspondence with respect

to contracts that expired, were terminated, or were assigned to successor franchisees.

3. Acknowledgements of Receipt the franchisor received for franchise disclosure documents it delivered within the last five years.
4. A schedule of the territory assigned to each existing franchisee under a franchise, subfranchise, or development contract.
5. The documents governing the organization and administration of any advertising funds or advertising cooperatives the franchisor or its franchisees have created.
6. A description of the organization and activities of any franchisee association the franchisor's franchisees have organized and of any franchise advisory boards or councils the franchisor has created, and copies of minutes of that organization over the last five years.
7. Schedules that list and describe arbitration and litigation matters completed in the last five years, and similar actions currently pending or threatened against the franchisor, as well as disputes the franchisor considers likely to result in adversarial proceedings.
8. A schedule describing any violations of the various franchising statutes of which the franchisor has knowledge, based on the franchisor's contemporaneous review of its franchise files.
9. Contracts between the franchisor and key suppliers and vendors.
10. Policy manuals, including training manuals, marketing manuals, accounting manuals, operating manuals, and procedures and bulletins related to the operation of the system.

In most cases, the franchisor cannot practically copy its entire collection of franchise files and records and will need to provide the buyer direct access to these documents. Parties to large transactions typically make documents available in a "virtual data room" so that they can easily be accessed by the parties online. Further, the buyer may want an opportunity to discuss these documents and to explore other issues with members of the franchisor's staff. The letter of intent, therefore, should identify members of the franchisor's franchise sales, franchise services, operations, and marketing departments that the buyer may interview during its diligence review. If the franchisor prefers not to provide the buyer unrestricted access to its records and staff, the letter should also indicate when, where, and under what circumstances the franchisor will make these resources available to the buyer. The letter of intent should also reiterate the prohibition against the buyer's making contact with the franchisor's franchisees until (at least) the parties sign a definitive agreement.

If either the buyer or seller is a public company, the parties must consider their obligation to announce the proposed transaction to investors promptly after they sign the letter of intent. In addition, the franchisor must decide whether to amend its franchise disclosure document or to suspend franchise sales. If the franchisor elects to suspend sales, the letter of intent should address the consequences that this development will have on the franchisor's obligation to continue operating in the ordinary course of business pending execution of the definitive agreement.

Many letters of intent will also contemplate a "no solicitation" period of time, preventing the franchisor from shopping the transaction, or negotiating with others, while the definitive agreement is being negotiated. In return, the letter of intent may provide for a termination or break-up fee, perhaps in the form of an earnest money deposit that the franchisor will be entitled to retain as liquidated damages if the buyer opts not to proceed with a definitive agreement after the franchisor suspends franchise sales and/or other efforts to sell the business. Along with these provisions will typically be a time frame for initial due diligence, and for the drafting and execution of definitive agreements.

D. THE DEFINITIVE AGREEMENT

The definitive agreement should contain the final set of "rules" for the transaction, including how to deal with practical problems. Conditions to closing merit special consideration, particularly those relating to the franchisor's obligation to remedy franchise law violations and to the time and consequences of the buyer's contact with members of the franchisor's franchisee community.

During the buyer's diligence investigation, the franchisor may disclose, or the buyer may independently detect, defects in the franchisor's franchise sales compliance procedures or possible violations of the franchise relationship and antidiscrimination laws. Unless the parties feel comfortable dealing with these problems through an escrow, deferred payment, or indemnity arrangement, the definitive agreement should define remedial actions that the franchisor must undertake prior to closing.

The agreement should also state the parties' rights and obligations in the event the franchisor's remedial actions produce financially adverse consequences. For example, the parties might agree that the franchisor will make rescission or restitution offers to a select group or class of franchisees. If the number of franchisees who accept these offers exceeds the parties' expectations, the franchisor's financial condition or the stability of the franchise system might be eroded. The franchisor's interests will be jeopardized if the buyer can unconditionally

avoid its obligation to close under these circumstances. Conversely, the buyer's interests will not be served unless it can adjust price and payment terms. Similar concerns may arise in other areas, such as the franchisor's protection or its own intellectual property of system standards.

In approaching these issues, the parties should consider incorporating materiality standards into the definitive agreement. They can rely on these standards to establish a threshold for the franchisor's obligation to pursue remedial action in particular instances, to determine the extent of the buyer's right to renegotiate or terminate the transaction if adverse consequences result from the franchisor's remedial actions, and to define the franchisor's post-closing indemnity obligations.

The agreement might also require an increase in the buyer's earnest money deposit or break-up fee to protect the franchisor in case the buyer withdraws its offer after the franchisor initiates required remedial action. The amount to which the franchisor may be entitled might depend on the reasons for the buyer's decision not to proceed.

We previously discussed the risks of allowing a buyer to contact the franchisor's franchisees prior to consummation of the transaction.⁷⁰ Assuming such contacts are allowed, once the buyer begins communicating with the franchisor's franchisees, the franchisor will lose control over potentially adverse consequences of an aborted sale. Consequently, if such contacts are allowed, the definitive agreement should restrain the buyer from initiating contact with franchisees until the buyer provides assurance that it is prepared to consummate the acquisition, subject only to the franchisor's compliance with its pre-closing covenants and the buyer's reasonable satisfaction with franchisee reaction to the proposed change in control. This assurance has no bearing on the franchisor's obligation to comply with express closing conditions, the survival of its representations and warranties, or its post-closing indemnification obligations. It merely forecloses the buyer's reliance on issues that can be raised and dealt with prior to making direct contact with franchisees to justify a refusal to complete the acquisition.

There are a number of additional provisions that can be inserted to dissuade would-be buyers from abusing the right to contact existing franchisees. For example, the agreement can enumerate the points the buyer intends to discuss with the franchisor's franchisees and, within reason, specify the issues that must be resolved to the buyer's satisfaction before it will be bound to complete the acquisition. In addition, if the definitive agreement does not contain a covenant not to compete imposed on the buyer, the franchisor might negotiate to have such

70. See discussion *supra* Section II.B.

a provision triggered once the buyer begins contacting franchisees. Of course, such a provision would be problematic if the buyer already operates a competing system.

The buyer also deserves protection in relation to its contact with the franchisor's franchisees. For numerous reasons, franchisees may withhold information about legal and business conflicts with the franchisor, preferring to harbor these conflicts until they determine how the buyer will behave as their new franchisor. Ideally, a buyer would like to obtain estoppel certificates from a substantial percentage of franchisees, confirming that they have no legal or business complaints against the franchisor. However, as a practical matter, franchisees likely are not required to sign such certificates, and the franchisor will be reluctant to allow the buyer to request such certificates, particularly when there is no assurance that the sale will go through.

Further, buyer contact with the franchisor's franchisees may stimulate some franchisees to make an issue of previously ignored legal and business conflicts with the franchisor. It may also cause them to lose confidence in the franchisor's commitment to the franchise system or its performance capabilities. If the buyer abandons the acquisition after making contact with the franchisor's franchisees, the franchisor may encounter serious relationship problems with its franchisees. The definitive agreement, therefore, should insulate the buyer from liability to the franchisor on account of deterioration in the system's value if the buyer refuses to close for reasons the definitive agreement justifies.

VIII. CONCLUSION

None of the practical problems that attend the purchase or sale of a franchise company lack solutions. However, the process of crafting appropriate solutions demands substantial foresight, imagination, and experience. Lawyers who shepherd clients through the purchase or sale of a franchise company need to alert their clients to the need to proceed cautiously and to refrain from making commitments before considering and taking appropriate measures to address the issues discussed in this chapter and throughout this book.