FRANCHISE WHOLE BUSINESS SECURITIZATIONS: STRUCTURE, REGULATORY AND OPERATIONAL CONSIDERATIONS

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FRANCHISE WHOLE BUSINESS SECURITIZATIONS: STRUCTURE, REGULATORY AND OPERATIONAL CONSIDERATIONS

I. INTRODUCTION

Securitization is a financing structure whereby assets that produce predictable cash flows, such as loans, leases or other contractual arrangements, are pooled to create a security that can be sold to third party investors. The cash flows related to the pooled assets are used to pay principal and interest to the investors. The pool is modeled to be large and diverse enough that defaults or delinquencies on a portion of the assets will not affect payment of principal or interest on the security. Additionally, securitizations are structured to be ‘bankruptcy-remote’ from the parent entity. In the event of a bankruptcy of the parent, the pool of assets will not be included in the parent’s bankruptcy estate, giving investors additional comfort regarding the future cash flows of the security.

Securitization allows issuers to transform a group of assets that would be fairly illiquid on an individual basis into a highly rated, liquid security. Across many different industries and with respect to many types of assets, securitization can be an efficient way to raise capital.

A. Business Objectives

Since the financial crisis, whole business securitization (“WBS”) has become a popular source of financing in the franchise industry. In comparison to traditional bank and bond deals, WBS can offer access to credit at reduced interest rates, as well as attractive covenant packages and other bond terms. The management standard that is built into every WBS deal allows for flexibility in operations, with the goal being uninterrupted management autonomy before and after the closing of the transaction. The provisions of the documents can be tailored to accommodate a company’s larger corporate strategy, including the purchase, sale or development of brands, and any franchisee support programs in existence or in development. Additionally, WBS structures are generally portable in the event of a sale of the company, subject to certain restrictions.

While the WBS bond offering process is more involved than a traditional bond issuance, the benefit of fixed rates and reduced weighted average cost of capital can make this product a more attractive long-term financing decision than obtaining financing through the traditional bank and bond markets.

B. Why the Franchise Industry?

The collateral in traditional securitizations is generally loans—mortgage loans, auto loans, student loans or other consumer loans. Traditional securitization transactions isolate a pool of loans from a diverse set of obligors into a newly formed, bankruptcy-remote issuer. The pool of loans is the sole collateral backing the securitization bond issuance. The issuer sells notes to investors that will be repaid using the payments that are made on such loans by the loan obligors over time. Essentially, the securitization process monetizes the loan payments that the issuer expects over time into a large upfront payment from noteholders in the form of proceeds from the note issuance.
Failures of underwriting and diligence from residential mortgage-backed securities during the financial crisis aside, the theory behind securitization is that, statistically, if a pool of loans is sufficiently large and diverse (either by number of obligors, geographic location of obligor or other factors), the aggregate cash payments on such pool of loans should be fairly predictable over time. The underwriters that craft the pool of loans to be included in the issuer’s collateral model the cash flows such that defaults by a handful of obligors or defaults in one particular state should not affect the issuer’s ability to make payments of principal and interest to investors in the securitization notes.

Another driving force behind the securitization market is the benefits that come with isolating cash flow-generating assets into a newly formed, bankruptcy-remote special purpose vehicle. As discussed in depth later in the paper, isolating the pool of loans from the liabilities and obligations of the parent company that originated such loans means that the noteholders are isolated from the parent company’s risks as well. If the parent company goes bankrupt, the structuring is intended to prevent the pool of loans from being included in the parent company’s bankruptcy estate. As a result, the credit risk on just the pool of loans is less than the credit risk on the parent company, plus the pool of loans and, therefore, the securitization can receive better pricing on its debt than the company as a whole.

In the franchise industry, franchise agreements require the franchisees to pay to the franchisor a percentage of gross sales on a regular basis. Much like a pool of loans, franchisees are a large, diverse group of contractually bound obligors that create a predictable cash flow stream. By isolating these cash flows into a bankruptcy-remote entity, the parent company is able to obtain the favorable pricing that comes with a securitization structure with respect to any debt backed by such cash flow-generating assets.

C. Summary of Legal Considerations

1. Securities Laws

The issuance of securitization notes will be governed by the securities laws. While there are publicly registered securitization offerings, most WBS transactions opt to use the exemption under Rule 144A exempting it from the requirement to register the securities offering with the Securities and Exchange Commission (the “SEC”).\(^1\) Not registering with the SEC has the benefit of permitting a faster time to market than a publicly registered offering, but it also means that the notes can only be sold to sophisticated investors and cannot be sold to the general public. In a Rule 144A issuance, an issuer will use one or more banks as “initial purchaser(s)” of the WBS notes from the issuer. Each initial purchaser will then resell the notes to sophisticated investors called Qualified Institutional Buyers (“QIBs”). In order to be a QIB, an entity must meet certain restrictions, such as having a significant amount of assets. QIBs are generally financial institutions such as mutual funds, banks, insurance companies, hedge funds or other money managers. Because the U.S. securities laws aim to protect investors in the United States, the initial purchasers may also sell to investors who are not “U.S. persons” under Regulation S without having to register the offering with the SEC.

Rule 10b-5 of the Securities Exchange Act of 1934 protects WBS investors from fraud in connection with statements made (or omitted) by WBS issuers in connection with the purchase or sale of WBS notes. Under Rule 10b-5, issuers can be exposed to civil liability for making “any

\(^1\) 17 C.F.R. 230.144A (2017)
untrue statement of a material fact or . . . omit[ting] to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." This rule requires “scienter” by the issuer, which is generally understood to mean intentionality, knowledge or recklessness, in connection with the statement or omission. WBS issuers can help prove lack of scienter by providing adequate support for the information included in the offering documents and otherwise provided to investors. Market practice will dictate the process and procedures that need to be undertaken as part of an issuer’s due diligence defense, and will include involving experts, such as accountants, with respect to financial information provided to investors, and lawyers, with respect to drafting the disclosure about the company and the notes.

2. **Bankruptcy Laws**

As discussed above, WBS issuers are structured to be “bankruptcy-remote” from the parent company. The parent company will form new subsidiaries, usually in the form of Delaware limited liability companies, which will hold the WBS assets and issue the notes (collectively, the “Securitization Entities”). The parent company is not obligated on the WBS debt, nor does it guarantee the repayment of the notes. Covenants in the operating agreements of the Securitization Entities and the other transaction documents will require the Securitization Entities to interact with the parent on an arm’s-length basis and are intended keep the Securitization Entities separate from the bankruptcy estate of the parent company. Additionally, the operating agreements of the Securitization Entities will state that the entities have been formed solely for the purpose of entering into the WBS transaction. What was once an integrated company can be thought of, post-WBS restructuring, as two separate companies with the parent company and any non-Securitization Entity subsidiaries operating “above the bankruptcy line” and the Securitization Entities “below the line.”

The “separateness” provisions included in the operating agreements and transaction documents have been developed over time based on bankruptcy case law. In order to provide equality of distribution and equitable treatment of creditors, bankruptcy courts have broad discretion to exercise their equitable powers to “substantively consolidate” affiliated entities into a single entity for bankruptcy purposes. While rare, bankruptcy courts have consolidated the assets and liabilities of non-debtors and debtors.\(^2\) In the context of a bankruptcy filing by a parent company with a bankruptcy-remote subsidiary, the court will look at a number of factors regarding operation of the two entities and the relative fairness of separate versus consolidated treatment of the assets and liabilities of related entities.\(^3\) Such factors considered by the court

\(^2\) See, e.g., In re Bonham, 229 F.3d 750, 760–65 (9th Cir. 2000) (upholding bankruptcy court’s substantive consolidation of debtor and non-debtors involved in Ponzi scheme to assure that overcompensated initial investors share in losses suffered by subsequent investors); cited by Clark’s Crystal Springs Ranch, LLC v. Gugino, 548 B.R. 246, 252 (B.A.P. 9th Cir. 2016) (holding that the bankruptcy court has the authority to order substantive consolidation of a non-debtor entity with a debtor); In re S&G Fin. Servs. of S. Fla., Inc., 451 B.R. 573, 582 (Bankr. S.D. Fla. 2011) (holding that “it is well within this Court’s equitable powers to allow substantive consolidation of entities under appropriate circumstances, whether or not all of those entities are debtors in bankruptcy”); In re Creditors Serv. Corp., 195 B.R. 680, 690–91 (Bankr. S.D. Ohio 1996) (substantive consolidation warranted where there was a “complex web of transactions” among parties, evidence of fraudulent concealment of debtor’s postpetition operations, entanglement of financial affairs of debtor and non-debtors, benefit of substantive consolidation far outweighed any detriment and no creditors objected).

\(^3\) See, e.g., In re Bonham, 229 F.3d at 766 (9th Cir. 2000); In re Reider, 31 F.3d 1102, 1106–07 (11th Cir. 1994); In re Giller, 962 F.2d 796, 799 (8th Cir. 1992); In re Augie/Restivo Baking Co., Ltd., 860 F.2d 515, 518 (2d Cir. 1988); In re Source Enters., Inc., 392 B.R. 541, 552–54 (S.D.N.Y. 2008); In re 599 Consumer Elecs., Inc., 392 B.R. 541, 552–54 (S.D.N.Y. 2008); In re Bauman, 535 B.R. 289, 295–96 (Bankr. C.D. Ill. 2015); In re E’Lite Eyewear Holding, Inc., No. 08–41374, 2009 WL 349832, at *2–3 (Bankr. E.D. Tex. Feb. 5, 2009); In re Verestar, Inc., 343 B.R. 444, 462–63
include whether the parent company has observed corporate and other organizational formalities, maintained separate books and records, and/or commingled assets and intercompany debts and guarantees.\(^4\) If a court determines that the parent company has failed to maintain “separateness”, it will likely consolidate the assets of the debtors and non-debtors.

For many issuers, one of the biggest conceptual adjustments following a WBS transaction is that the above the line entities and the Securitization Entities must keep records and operate as two separate companies. Poor or nonexistent record keeping of intercompany transactions and of purportedly separate assets (particularly cash and other liquid assets) and liabilities, whether by design or otherwise, is a common reason courts impose substantive consolidation. If the assets, liabilities and business affairs of the parent company and the Securitization Entities are so hopelessly entangled that segregation is prohibitively expensive or impossible, courts are more likely to grant substantive consolidation.\(^5\)

The expectations of and potential harm to creditors are also important to bankruptcy courts.\(^6\) “[The] Court must be convinced that a harm or prejudice to creditors will occur in the absence of substantive consolidation by weighing the equities favoring consolidation against the equities favoring the debtor remaining separate from the entities and the individual.”\(^7\) It is a general rule that, absent a compelling reason such as fraud, substantive consolidation may not reduce a creditor that is secured by specific, identifiable assets to the status of an unsecured creditor.\(^8\) Additionally, it is generally agreed that secured creditors’ specific, identifiable collateral should not be enhanced, absent unusual circumstances, as a result of substantive consolidation.\(^9\) WBS investors have purchased the notes based on the bankruptcy-remote structure and isolation of the specific cash-generating assets, and courts will generally respect this contractual arrangement.

3. **Franchise Laws**

As discussed more fully below, since the WBS transaction involves a franchise company, there are myriad of federal and state franchise laws which are implicated. As part of

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\(^7\) *In re Creditors Serv. Corp.*, 195 B.R. at 690 (citations omitted).


the WBS transaction, a new franchisor entity, one of several “below the line” Securitization Entities, will be formed to serve as the go-forward franchisor. All pre-closing franchise agreements will be assigned to it, and it will designate the Manager (an “above the line entity”) to fulfill those obligations. The new franchisor entity, a “below the line entity”, will be responsible for future franchise sales and agreements and, as a result, it must comply with all federal and state laws which govern the offer and sale of franchises and business opportunities.\(^{10}\) Since the Manager will engage in franchise sales on behalf of the new franchisor, it too must comply with state and federal franchise registration and disclosure laws.

II. STRUCTURE

A. Example Structure Chart

The chart below generally summarizes the steps that are taken to structure a WBS transaction. The key parties and documentation are more fully described later in this paper.

(1) Above the line entities contribute assets to wholly owned special-purpose subsidiaries (the “Securitization Entities”) in exchange for equity in the securitization.

(2) Securitization Entities grant a security interest in the assets to the trustee for the benefit of the noteholders.

(3) Securitization Entities issue notes backed by those assets and use the proceeds from the notes to make a distribution of excess proceeds to the parent for expenses and general corporate purposes.

(4) Cash flow from the assets is owned by the Securitization Entities and must be used to make payments on the notes and cover expenses.

(5) A parent entity, acting as manager, administers collections and manages the assets (i.e., perform certain marketing, franchising, IP, operational and reporting services) in exchange for a fee.

(6) Securitization Entities and their assets are “bankruptcy-remote” and isolated from the bankruptcy risk of above the line entities.

B. Description of the Transaction

1. Contributions

In anticipation of the WBS transaction, a number of bankruptcy-remote Securitization Entities are formed, normally as Delaware limited liability companies. The assets that will be contributed from the parent companies to the Securitization Entities include domestic and international franchise agreements, domestic and international development agreements and all intellectual property for the brand or brands. Intellectual property will include all trademarks, patents, copyrights and related license revenue and, depending on structuring discussions, may also include proprietary software, mobile apps and domain names.

In order to increase the amount of proceeds from the WBS issuance, additional revenue-generating assets can also be contributed, depending on the business. Additional assets can include company-owned stores, fee-owned real estate, lease revenue, promissory notes with

\(^{10}\) See Section VII, infra at p.17.
franchisees or proprietary product agreements. If a licensing arrangement with a third party contributes a large enough share of the annual revenue, such as a distribution arrangement for selling products in grocery stores, it may be beneficial for the parent company to assign such license agreement to the Securitization Entities, so that the securitization is in direct contractual privity with the third party paying the license fees.

Certain assets are not contributed to the Securitization Entities, either because they are associated with liabilities, present difficulties in assigning title or their assignment would cause adverse tax consequences. Employees, marketing funds, stored value card programs, inventory purchasing co-ops and assets located in international jurisdictions are normally not contributed to the Securitization Entities. Difficulties in contributing assets should be raised early in the structuring discussions and should be subject to diligence by the law firms involved in the transaction to make sure no last minute issues arise.

Title to the assets must be updated to reflect the new ownership, the requirements of which will depend on the asset type (i.e., real estate, trademarks). If a company has a large international intellectual property portfolio, the securitization covenants are flexible and will limit the requirements to update title to only the material jurisdictions. As discussed more specifically later in this paper, one of the Securitization Entities will need to become the new franchisor, since the franchise agreements have been contributed. In exchange for contributing the assets to the Securitization Entities, the parent company will receive an increase in the value of its equity ownership of the Securitization Entities.

The parent company will make certain representations and warranties about the assets being contributed to the Securitization Entities in the contribution agreements. If an asset violates these representations, the parent company will be required to indemnify the Securitization Entities for any losses. The formula for indemnification will vary depending on the type of asset.

2. **Indenture and Variable Funding Notes**

After the Securitization Entities have been formed and the assets contributed, the next step is to issue the debt. The WBS structure mirrors a typical capital structure and offers access to both term debt, pursuant to an Indenture and a revolving line of credit, in the form of “Variable Funding Notes.” The Variable Funding Notes will function like a typical revolving facility and will offer swingline and letter of credit subfacilities. The Variable Funding Notes can be used for capital expenditures, including on capital expenditures on assets that will be contributed to the securitization.

The Securitization Entities will grant a security interest in all of their assets as collateral for both the term and revolving debt. Because of the importance of cash flow to the securitization structure, the accounts into which franchisees pay will normally be required to be subject to account control agreements.

3. **Role of the Manager**

After the contributions, the company has been separated into two parts—the Securitization Entities own all of the cash-generating assets, and the parent companies hold the employees, any legacy liabilities, and any assets that were not contributed to the securitization. While a pool of loans will continue to generate cash payments with very little oversight, a franchise business requires management expertise to communicate with and support
franchisees, market the brand, and maintain and develop intellectual property related to the brand(s). In order to ensure that the assets contributed to the securitization continue to thrive, a parent company will act as “Manager.” Because the two parts of the company must maintain “separateness”, all dealings between them must be “at arm’s-length” and, as a result, the Manager will be paid a reasonable management fee in exchange for providing services to the Securitization Entities. The services provided will consist of all actions of the management team necessary to run the business prior to the securitization. The Manager will also have discretion to adjust the services it provides to the Securitization Entities over time to ensure the assets continue to generate revenue.

III. MAIN PARTIES

A. Relationships Among the Parties

The diagram below shows the key parties to a WBS transaction, as well as the agreements amongst the parties that make up the main transaction documents.
B. Securitization Entities

As shown in the diagram in Part III.A, there will generally be at least three Securitization Entities, in a structure similar to a traditional lending arrangement. The top entity in the chain will be the “SPV Guarantor,” which will be an empty entity holding nothing but the equity of its direct subsidiary, the “issuer.” The SPV Guarantor exists solely to pledge the equity in the issuer. In a foreclosure scenario, it is much easier for a trustee to foreclose on an equity interest and essentially “take the keys” to the entire chain of Securitization Entities, rather than attempt to foreclose on individual assets owned by the Securitization Entities. The direct subsidiary of the SPV Guarantor is the issuer, which is the entity that is the obligor on the WBS notes. The issuer also does not own any assets, except for the equity in its direct subsidiary or subsidiaries that will hold all of the assets. Because all franchise agreements have been contributed to the Securitization Entities, one of the asset-holding subsidiaries of the issuer must be the new franchisor, as further discussed in Part VII. There is no prohibition on the franchisor holding assets in addition to the franchise agreements, and in many cases the franchisor will hold the intellectual property as well. Depending on the assets included in the WBS transaction, the parent company may choose to form additional Securitization Entities as direct subsidiaries of the issuer to hold other assets, such as real estate or company-owned stores.

In order to achieve bankruptcy remote status, the operating agreements for each Securitization Entity will contain certain covenants, per the discussion in Part I.C.2. First, the operating agreements will state that the entities are being formed for the limited purpose of entering into the transaction documents for the securitization and issuing the debt. Second, they will set forth further limitations on the company’s activities so that it must act as an entity separate and at arm’s-length from the parent company. These separateness covenants will include prohibitions on commingling money with or guaranteeing the debts of any other entity. There are also requirements that each Securitization Entity hold itself out to the public as an entity separate from parent, maintain separate books and records, and maintain an arm’s-length relationship with the parent company.

As further protection against substantive consolidation risk, the organization documents (and other transaction documents) take steps to decrease the chance the Securitization Entities could be put into bankruptcy and therefore, resulting in the bankruptcy-remote structure being tested by a court. The organizational documents limit the entity’s purposes and the transaction documents prohibit additional debt in an attempt to limit the number of additional creditors of the Securitization Entities beyond the WBS notes. Limiting the creditors of the Securitization Entities limits the number of entities that can petition to put the Securitization Entities into bankruptcy. Similarly, the operating agreements will appoint two independent directors to the board of each Securitization Entity. The unanimous approval of the independent directors will be required to file for bankruptcy, consent to a bankruptcy filing, seek or consent to the appointment of a receiver, liquidator or bankruptcy trustee, consent to substantive consolidation and other material actions with respect to the existence of the entity. The presence of independent directors gives comfort to the WBS investors because it will theoretically make it harder for a parent company to put a Securitization Entity into bankruptcy if they must convince two independent directors to vote in favor of filing as well.

C. Manager and the Management Agreement

The primary responsibilities of the Manager will be to administer collections of cash from the assets owned by the Securitization Entities and to perform certain franchising, marketing, real estate, intellectual property and operational and reporting services on behalf of the
Securitization Entities with respect to such assets. In performing its obligations under the Management Agreement, which governs this relationship, the Manager will act as an independent contractor for the Securitization Entities. The Securitization Entities will grant the Manager a power of attorney so that the Manager may act as an agent of the Securitization Entities and engage in franchise sales activities, as broker, or receive payments on behalf of the Securitization Entities. The Manager is responsible for filing all documents necessary to register as a franchise broker, franchise seller or franchise sales agent as required by applicable state franchising authorities. The Manager may also enter into sub-managing arrangements with affiliates or third parties to assist in providing the foregoing services. For example, the Manager may have a foreign affiliate that provides support for certain international franchisees act as sub-manager.

As compensation for the performance of its obligations under the Management Agreement, the Manager will be entitled to receive a weekly management fee. The amount of the management fee will be calculated prior to the closing of the securitization with assistance from the bank structuring the transaction. Because the Manager is required to pay from its own funds all expenses it may incur in performing its obligations under the Management Agreement, including the salaries of all employees, the bank will review the company’s historical financials in depth to model the management fee.

The Management Agreement requires that the Manager service and administer the assets of the Securitization Entities in accordance with a “managing standard.” The managing standard is intended to protect the securitization assets, while at the same time not disrupting the company’s ongoing operations. The managing standard also provides for flexibility in operations going forward, due to changed circumstances, practices, technologies, strategies or implementation methods. The managing standard requires compliance with law and compliance with quality control standards with respect to intellectual property assets. The Manager has wide discretion over its actions; the Management Agreement gives the Manager full power and authority to take, or refrain from taking, any actions, and to do any and all things in connection with performing the managerial services that the Manager may deem necessary or desirable.

To ensure that the Manager does not have any conflicts of interest with respect to its management of the Securitization Entities, the Manager will agree not to engage in any business that, in the good faith determination of the Manager, is intended to compete against the franchised brands contributed to the Securitization Entities, to the extent such competitive business is not contributed or expected to be contributed to a Securitization Entity substantially contemporaneously with entering into or acquiring such competitive business. The concern is that, if the Manager develops a competing brand and does not contribute that brand to the Securitization Entities, the new brand may cannibalize the existing brand or the Manager may neglect the Securitization Entities in favor of the new brand, causing losses for the WBS investors. If the new brand or business poses a threat to the assets of the Securitization Entities, the WBS investors would want those profitable assets to be added to their collateral.

Further, to ensure that the Manager is not overburdened or distracted, the transaction documents will also place a limit on the amount of debt the Manager may incur “above the line,” subject to certain carve-outs. The proceeds of a WBS transaction will normally be used to refinance the parent company’s aggregate debt in full, so the above the line entities generally should not have a great need for new above the line debt. Additionally, as most of the revenue-generating assets have been contributed to the Securitization Entities, there may not be many assets left above the line to lend against.
Since there is a true arm’s-length relationship between the Securitization Entities and the Manager, it is possible for the Manager to be terminated. The Manager may be terminated for breaches of representations or warranties, if the Manager declares bankruptcy or upon certain other adverse events with respect to the Manager or the Securitization Entities. If the Manager is terminated, all rights, powers, duties, obligations and responsibilities of the Manager under the Management Agreement and the other transaction documents will be assumed by a successor Manager appointed by the “Servicer.” If no successor Manager has been appointed, the Back-Up Manager will serve as successor Manager and will work with the Servicer to implement the transition plan until a successor Manager (other than the Back-Up Manager) has been appointed.

D. Trustee and the Indenture Documents

Pursuant to the transaction documents, the Securitization Entities will grant a security interest in all of their assets to the Trustee, on behalf of all secured parties. The secured parties will include the WBS note holders and the Variable Funding Note holders. Upon an event of default, the Trustee will be able to take certain remedial actions on behalf of the note holders to extract value from the assets to pay principal and interest on the WBS notes. The Trustee will also engage in certain administrative actions during the life of the WBS notes, such as distributing weekly payments to the parties and to WBS investors.

E. Servicer and the Servicing Agreement

The primary responsibilities of the Servicer under the Servicing Agreement will be to monitor and review the reports and information provided to it by the Manager and the Back-Up Manager and to make certain decisions with respect to the assets of the Securitization Entities. Upon an event of default, the Servicer will assist the Trustee in certain actions with respect to the Securitization Entities’ assets, for the benefit of the WBS investors. Upon certain poor performance triggers being met, the Servicer will also assist the Back-Up Manager with the development and implementation of a transition plan in connection with a termination of the Manager.

F. Back-Up Manager and the Back-Up Management Agreement

Pursuant to the Back-Up Management Agreement, during the ordinary course of the transaction, the Back-Up Manager will provide consulting, monitoring and reporting services to the Servicer, the Manager, the Securitization Entities and the Trustee, such as reviewing the periodic reports and other materials received from the Manager or posted to the Trustee’s or the Manager’s website, discussing by telephone with the Manager’s management team the performance of the securitization, and conducting an annual on-site visit with the Securitization Entities and the Manager to review the performance of the Manager and the securitization.

If there are financial problems with the securitization and certain financial triggers have been met, the Back-Up Manager will take a more active role in the management of the Securitization Entities in anticipation of a potential termination of the Manager. The first steps will include performing an in-depth analysis of the Manager and its financial position and of the Securitization Entities and their assets covering, among other things, the key drivers of historical performance, the strategic business plan for the Securitization Entities and the causes of poor performance, including pricing, cost structure and leverage. Based on this analysis, the Back-Up Manager can take additional steps, including generating revised projections, identifying alternative suppliers and providers of services, obtaining appraisals and valuations of the assets.
and, with the assistance of the Servicer, developing a transition plan in the event of a termination of the Manager.

If the Manager is in fact terminated, the Back-Up Manager will serve as the successor Manager until a successor Manager has been appointed. Upon becoming the successor Manager, the Back-Up Manager will implement the transition plan, identify potential successor Managers and generally take over the management of the Securitization Entities in order to stabilize the condition of the Securitization Entities. In connection with its duties, the Back-Up Manager may engage in audits and inspections, restructure and/or re-negotiate transaction documents, make personnel decisions, hire consultants or liquidate assets.

IV. ADDITIONAL TRANSACTION DOCUMENTS

A. Indenture Documents

1. Priority of Payments

Payments of interest and, if applicable, principal on WBS notes will be paid pursuant to a priority of payments (often referred to as a “waterfall”) that is run each week. Starting with all revenue collected during the week, each step of the waterfall is paid in order. Each listed step of the waterfall must be paid in full before any money is allocated to the next step. Generally the first steps of the waterfall are payment of expenses to the service providers in the transaction, followed by payment of the management fee to the Manager and operating expenses, then interest followed by principal, and finally the remainder (if any) is available to the Securitization Entities to be distributed up to the parent company. Various reserve accounts are also built into the waterfall, and cash will be diverted to these steps upon certain financial triggers. Because the waterfall is run weekly, it is important for companies with WBS notes to be prepared to track cash closely.

2. Covenants and Events of Default

The covenants and events of default in WBS transactions are becoming increasingly similar to those in high-yield bonds. Depending on the available interest rates, companies will often switch from financing with high-yield bonds to a WBS transaction, and will want to integrate the covenant packages they have previously negotiated into their WBS deal. With certain structural deviations, this can very often be accomplished. One main difference is that, due to substantive consolidation concerns and bankruptcy-remote structuring, WBS transactions do not allow the Securitization Entities to incur additional debt or make guarantees, aside from issuing additional WBS notes or guaranteeing the obligations of other Securitization Entities, so the permitted indebtedness and permitted liens covenants are much more limited. The capital structure needs of the company should be discussed with the bank structuring the WBS transaction prior to the transaction to address any concerns.

3. Permitted Asset Dispositions

Similar to a traditional financing, there will be limits on dispositions of assets by the Securitization Entities. The proceeds of such dispositions, in excess of a certain threshold per year, will need to be reinvested in eligible assets within a certain time period or used to pay down debt. Special care should be taken to tailor the permitted asset disposition provisions if the company is engaging in refranchising or is brokering certain types of transactions on behalf of franchisees. The WBS market is amenable to bespoke asset disposition provisions, but it will
require forethought on behalf of the attorneys and business people involved in the transaction to appropriately provide for flexibility. Additionally, if the WBS transaction involves multiple brands, any plans to sell one or more of the brands should be discussed and addressed.

4. Additional Debt, Refinancings

Once the Securitization Entities have been formed, the assets contributed, the management arrangement set up and the first WBS notes issued, the WBS documents are set up to easily allow for additional WBS debt to be issued by the Securitization Entities, backed by the same assets. Depending on capital structure needs and the interest rates available at the time of issuance, WBS issuers may decide to issue different tranches of notes at various maturities. Each of these tranches can be refinanced as it comes due without upsetting any of the other tranches of notes, including the Variable Funding Notes.

B. License Agreements

After the intellectual property is contributed to the Securitization Entities, the licensing structure of the company will need to be adjusted. The Securitization Entity that owns the intellectual property (the “IP Holder”) will enter into one or more license agreements with above the line entities to ensure that the system is able to continue to operate seamlessly, but on an arm’s length basis as between the Securitization Entities and the parent company. The intellectual property owned by the Securitization Entities will consist of all intellectual property contributed on the closing date of the transaction, as well as all intellectual property created, developed, authored or acquired by or licensed to the IP Holder (the “Securitization IP”).

The IP Holder will grant a license of the Securitization IP to the Manager in order for the Manager to perform its duties under the Management Agreement. The Securitization Entities will also give the Manager a power of attorney in order to perform certain services with respect to the Securitization IP, such as filing, prosecuting and maintaining applications and registrations of the Securitization IP in the IP Holder’s name; monitoring and enforcing unauthorized use or other violations of the Securitization IP; and establishing fair market value royalty rates for any licenses or sublicenses of the Securitization IP required or permitted under the transaction document.

The IP Holder will also grant a license of the Securitization IP to the parent company in connection with (i) the corporate names and trade names of the above the line entities, (ii) if any company-owned stores are owned above the line, the operation of such company-owned stores, (iii) if a gift card program exists above the line, the operation of the gift card program, (iv) any other ancillary goods, products and services related to the Securitization IP, such as products sold in grocery stores and (v) to hold, on a temporary basis, any franchise agreements that are not immediately contributed. If the parent company is party to any licenses with third parties, for example for the manufacture or distribution of grocery store products, the scope of the grant to the parent company must be broad enough to accommodate these licenses. The third party licenses will be subject to diligence by the WBS transaction counsel, to ensure that the WBS transaction will not cause any defaults under such licenses.

Depending on the number of Securitization Entities and the assets held therein, there may need to be licenses put in place between Securitization Entities. For example, if the entity holding the Securitization IP is not the same as the new franchisor entity or the entity holding company-owned stores, such entities will need a license of the Securitization IP in order to operate.
C. Opinions of Counsel

In connection with the WBS issuance, the issuer’s counsel (including its special franchise counsel) will need to provide certain legal opinions to the Trustee, the Servicer, the Back-Up Servicer, the Variable Funding Note purchaser and any rating agencies. Traditionally, financings require opinions that the documents are enforceable against the parties and that a valid security interest has been created in the collateral. Securities issuances require an opinion that the notes will be considered debt for tax purposes. The law firm will also deliver a ‘negative assurance letter’ regarding material misstatements or omissions in the disclosure to investors. The rating agencies will also require opinions that there has been a “true sale” or other absolute transfer of the assets to the Securitization Entities, and that a bankruptcy court would not order the substantive consolidation of the Securitization Entities with the parent company. Such opinion is delivered in the form of a ‘reasoned opinion,’ which means that it will include references to case law and will walk through the analysis in detail.

Franchise counsel to the issuer is also required to provide a separate, reasoned opinion regarding the franchise documents, which include, primarily, the franchise agreements and disclosure documents, and the franchise specific provisions of the preliminary offering memorandum. In its opinion, franchise counsel will opine as to the accuracy of the franchise related provisions contained in the preliminary offering memorandum and the assignability of the franchise agreements. The franchise opinion will also describe, in summary fashion, the franchise laws that the new franchisor will be required to comply with, including, for example, the requirement to: (a) prepare franchise disclosure documents (each, “an FDD”) that comply with the disclosure mandates and requirements of the United States Federal Trade Commission and applicable state franchise and business opportunity laws; (b) apply for and maintain franchise registrations/filings, or exemptions from franchise registrations/filings, in the relevant franchise registration/filing states; (c) apply for and maintain exemptions from the business opportunity registration/filing requirements in the relevant business opportunity states; (d) if necessary, file advertising and other franchise solicitation materials in certain of the franchise registration states and, universally, cause such advertising and other franchise solicitation materials to comply in substance and form with all standards and conditions prescribed by applicable law; (e) file with all applicable state franchise registration authorities any franchise seller, franchise sales agent and franchise broker disclosure forms required by state franchise laws to be filed with such state franchise registration authorities; and (f) use and disseminate, in connection with its franchise offer and sales activities in the United States, and in compliance with the disclosure mandates and requirements of federal franchise laws applicable state franchise and business opportunity laws.

V. OFFERING MEMORANDUM

A. Key Components

1. Summary of the Offering

The offering memorandum is a document given to potential investors in the WBS notes, summarizing the assets, the Manager’s business, the parties and the transaction documents. Like all documents and oral statements given to investors, the statements made in the offering
memorandum are subject to the securities laws discussed in Part I.C.1, and so care must be taken with respect to the disclosure therein.

One of the first sections included in the offering memorandum is a description of the offering, which gives a short introduction to the parties and assets and focuses on the terms of the notes being issued, such as maturity, interest and principal payments, prepayment and financial covenants. There will be sections later in the offering memorandum summarizing the transaction documents that will expand upon the information contained in the summary.

2. Description of the Business

The Manager and the historical operating history of the company as a whole are material to the WBS investors. The company will provide a description of its business to be included in the offering memorandum, which will look similar to the type of disclosure provided in Form 10-K. The Manager will also provide information in the offering memorandum about its executives and their backgrounds. The company will need to provide factual backup for all statements and numbers contained in these sections to the accountants and lawyers working on the transaction, in accordance with market practice regarding securities law liability.

3. Required Financial Disclosures

Pursuant to Rule 144A(d)(4), an issuer in an offering exempt from registration pursuant to Rule 144A is only required to provide the "most recent balance sheet and profit and loss and retained earnings statements, and similar financial statements for such part of the two preceding fiscal years as the issuer has been in operation (the financial statements should be audited to the extent reasonably available)." However, since the issuer in a securitization transaction is likely a newly formed entity, historical financial statements would not be available. Market practice has evolved such that WBS issuers instead provide other financial information to comply with this rule, including (i) historical financial statements of the parent company, (ii) securitized net cash flow information, derived from the parent company financial statements and showing the cash flows that would be generated by the Securitization Entities and (iii) pro forma financial information, to the extent available or informative.

Generally, three years of audited long-form financial statements of the parent company are included, as well as the most recent unaudited interim quarterly long-form financial statements. The parent company’s financial information will be summarized within the offering memorandum, and the long-form financial statements will be attached to the back as an appendix. SEC rules will also determine, based on certain factors of the parent company, when the financial statements “go stale” and are, therefore, no longer considered reasonably current enough to be included in the offering memorandum. Often, “staleness” of financial statements will drive the timeline of an offering.

The bank structuring the transaction will assist in preparing the securitized net cash flow information, which is a table deriving the financial information of the Securitization Entities from the financial information of the parent company. Generally, the information is presented as the revenue of the parent company, less any assets not contributed to the securitization (if material), adjusted for any intercompany payments (i.e., the management fee) between the

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11 See supra. at p. 2.
parent company and the Securitization Entity, and less any securitization-related expenses (i.e., the servicing fee).

Additionally, financial and other information about the Securitization Entities, such as systemwide sales, store count, average unit volume and royalty rates, will be presented. The capitalization of the company before and after the securitization will also be included.

4. Risk Factors

Another important section for securities law liability purposes is the risk factors section. This section will spell out, in layman’s terms, any and all material risks to repayment on the WBS notes. This will include general risks to the business, risks related to the specific assets held by the Securitization Entities, risks related to the terms of the WBS notes and any other specific legal risks, such as substantive consolidation in bankruptcy. Risk factors should be discussed with the attorneys to make sure that no material risks are unintentionally omitted from this section.

B. Franchise Specific Provisions

1. Description of the Franchise Arrangements

The offering memorandum will include a detailed discussion of the franchisor’s historic franchise operations, as well as a description of the current franchise arrangements in the pipeline (both domestic and international) and the existing related agreements that will be sold and/or contributed to the new franchisor upon the closing of the WBS transaction. This section of the offering memorandum is intended to provide a high-level overview of the franchise system and its structure. In particular, it will describe the franchise offering and nature of the franchised business (i.e., fast-casual or full service restaurant; fitness center; or convenience store), the number of franchised outlets and company-owned outlets as of a date certain prior to the transaction, the existence of any franchisee advisory councils, and the types of agreements that franchisees operate under – such as standard single-unit franchise agreements, multi-unit area development agreements, and master franchise agreements.

This section of the offering memorandum will also include, for each type of franchise arrangement (e.g., unit franchise agreements, area development) a comprehensive summary of the franchisor’s rights and obligations under the various agreements. Generally focusing on the franchisor’s current form (which will presumably not change materially post closing of the WBS), the company will describe the material aspects of the agreement, including, for example: rights granted to a franchisee and those reserved by the franchisor; the initial term and any renewal term, including conditions for renewal; initial and ongoing fees, including primarily the initial fees, ongoing royalty, and advertising contributions; services provided by the franchisor, including assistance with site selection, training and supply chain; the territory; franchisee’s operational requirements; required products, services and supplies; indemnification obligations and insurance requirements; required technology/computer system; restrictive covenants; transfer; default and termination; remodeling obligations, if any; restrictions on competition, both in-term and post-termination; transfer restrictions and material conditions to transfer; a summary of the default and termination provisions; a discussion of advisory councils and coops, if any; and, personal guaranties.

If the company engages in multi-unit franchising, the offering memorandum will also include a general description of the parties’ rights and obligations under those agreements,
including, for example: development fees; territories, duties of the franchisor, which may include the obligation to accept or reject a proposed site; transfer restrictions, events of default and termination, and personal guarantees and covenants.

2. **Legal Aspects of the Franchise Arrangements**

In this section of the offering memorandum, the company will provide a summary of the legal and regulatory framework governing franchising in the United States, and internationally, if the company is engaged in the sale of franchises outside of the United States. The company will provide a detailed description of the following three distinct bodies of law that govern the offer and sale of franchises and certain aspects of a franchisor's relationship with its franchisees:

   (i) United States federal and state franchise laws, rules and regulations requiring disclosure, and in certain states, registration or filing before offering or selling franchises;

   (ii) "business opportunity" laws; and

   (iii) state franchise "relationship" laws.

The description in this section of the offering memorandum will include a fairly comprehensive discussion of the FTC’s franchise rule\(^\text{13}\) (the “FTC Rule”) which requires pre-sale disclosure to prospective franchisees of certain information regarding the franchisor and franchise system in a franchise disclosure document (“FDD”). It will also address the 15 states that have laws that require franchisors to register and provide to prospective franchisees a FDD before offering or selling a franchise or any interest in a franchise\(^\text{14}\).

In addition, this section of the offering memorandum will include a summary of franchise relationship laws and outline certain practices that are prohibited under these laws. Examples of prohibited practices or limitations on the franchisor’s rights include one or more of the following:

   (i) termination or failure to renew a franchise without good cause;

   (ii) interference with the right of free association among franchise owners;

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\(^{13}\) Disclosure Requirements and Prohibitions Concerning Franchising, 16 C.F.R. §436.

\(^{14}\) California Franchise Investment Law, CAL. CORP. CODE § 31000 et seq.; Hawaii Franchise Investment Law, HAW. REV. STAT. § 482-E1 et seq.; Illinois Franchise Disclosure Act, ILL. COMP. STAT. § 705/1 et seq.; IND. CODE § 23-2-2.5-1 et seq.; Maryland Franchise Registration and Disclosure Law, Md. CODE ANN., BUS. REG. § 14-201 et seq.; Michigan Franchise Investment Law, MICH. COMP. LAWS § 445.1501 et seq. (2011); MINN. STAT. § 80C.01 et seq.; N.Y. GEN. BUS. LAW § 680 et seq.; North Dakota Franchise Investment Law, N.D. CENT. CODE § 51-19-01 et seq.; Oregon Franchise Transactions Law, OR. REV. STAT. § 650.005 et seq.; Rhode Island Franchise and Distributorship Investment Regulations Act, R.I. GEN. LAWS § 19-28.1-1 et seq.; South Dakota Franchises for Brand-Name Goods and Services Law, S.D. CODIFIED LAWS § 37-5B-1 et seq.; Virginia Retail Franchising Act, VA. CODE ANN. § 13.1-557 et seq.; Washington Franchise Protection Act, WASH. REV. CODE § 19.100.010 et seq.; Wisconsin Franchise Investment Law, WIS. STAT. § 553.01 et seq. 14 of these states (all but Oregon), known as “franchise registration states”, generally require a formal filing or registration, including the prior submission of the franchisor's FDD (except for Michigan), before the offer of a franchise may be made in the state (except for Hawaii and Wisconsin, which allow franchise "offer", but not sales activity, before a formal filing or registration has been completed so long as no sale ultimately is accomplished absent timely dissemination of the franchisor's registered FDD).
(iii) disapproval the transfer of a franchise without good cause;

(iv) discrimination among similarly situated franchisees regarding charges, royalties and other fees; and

(v) encroachment.

VI. FRANCHISE DUE DILIGENCE (SCOPE)

Franchise counsel in a WBS plays a critical role in the diligence process. The purpose of franchise diligence in a WBS transaction is similar to the diligence performed in connection with the sale of a franchised business – to confirm that the revenue stream (typically royalties) will remain intact post-closing so that the investors and rating agencies can rely on the continuing revenue stream as collateral and for future proceeds of the business. Franchise counsel will rely on the results of its diligence to prepare its legal opinion and to describe the franchise arrangements in the offering memorandum.

Thus, franchise diligence will typically consist of a review of all extant unit franchise agreements, area development agreements and any other forms of agreements pursuant to which the franchisor licenses third parties the right to use its marks and system. This review is conducted for two primary reasons. First, counsel must confirm that the agreements are legally binding and enforceable and, most importantly, are assignable as part of the WBS transaction.

Second, it is also common for franchise counsel in a WBS transaction to review certain franchise relationship issues to determine whether there is risk that the company will be required to rescind any franchise agreements or that there will be litigation which could impact the revenue stream and the viability of the franchise system.

VII. POST-CLOSING FRANCHISE REGULATORY CONSIDERATIONS

A. Domestic

1. Franchise Regulatory Issues

As noted above, if the WBS transaction involves a franchise company, there are a myriad of federal and state franchise laws which are implicated. As part of the WBS transaction, a new franchisor entity will be formed to serve as the go-forward franchisor. All pre-closing franchise agreements will be assigned to it and it will designate the Manager (an “above the line entity”) to fulfill those obligations. The new franchisor entity, a “below the line entity”, will be responsible for future franchise sales and as a result, it must comply with all federal and state laws which govern the offer and sale of franchises and business opportunities. Since the Manager will engage in franchise sales on behalf of the new franchisor, it too must comply with state and federal franchise registration and disclosure laws.

The new franchisor’s regulatory obligations must be addressed early on in the WBS transaction to ensure that the transaction is structured properly so that, post closing, the company will be able to commence new franchise sales and renewals immediately upon closing.
a. **Impact on Exemptions**

Most of the fifteen franchise registration states exempt from the typical registration (and, in some cases, the disclosure) requirements, transactions involving certain experienced parties.\(^{15}\) The availability of an exemption facilitates, expedites and avoids the need for a franchisor's compliance with franchise registration and in some cases disclosure requirements. The exemptions available under state franchise registration laws vary by state but commonly, although not universally, include a large franchisor exemption (the "Large Franchisor Exemption"), which is often utilized by franchise systems that become the subject to WBS transactions.\(^{16}\) Virtually all of these states require some type of filing for a franchisor to claim the Large Franchisor Exemption.

The Large Franchisor Exemption generally is available when (i) the franchisor (and/or, depending on the corporate structure, its parent company) maintains a certain minimum net worth based on its most recent consolidated audited financial statements; and (ii) the franchisor (and/or, depending on the corporate structure, its parent company – and in certain cases, its predecessor) possesses certain franchising and/or operating experience involving a minimum number of units over a certain period of time. The minimum net worth requirement a franchisor must maintain in order to take advantage of the Large Franchisor Exemption is $5 million, $10 million or $15 million, depending on the state. In addition to the minimum net worth requirement, many franchise registration states with a Large Franchisor Exemption require the subject franchisor to have a specific minimum threshold of franchising experience in order to invoke the exemption. The minimum franchising and/or operating experience required of the franchisor (or its parent company, or, in certain cases, its predecessor) to invoke the Large Franchisor Exemption generally is 25 franchisees or one or more company-owned outlets in operation for at least five years before the exemption is claimed. Many of the states, by statute or as a matter of franchise regulator discretion, allow franchisors to "tack on", combine or rely on the experience of parent and/or other affiliated entities to reach the minimum required franchising and/or operating experience if there is continuity in franchisor management.

If not structured properly, a WBS transaction can render a Large Franchisor Exemption invalid, and the new franchisor may no longer be able to rely on the exemption of registration and/or filing requirements. If after the close of the WBS transaction the new franchisor fails to satisfy the minimum required net worth set forth above, but possesses significant net worth according to its own recent consolidated audited financial statements (typically in excess of $1 million) and is owned by a parent company that does satisfy the minimum required net worth level set forth above, the new franchisor may rely on the parent company's consolidated audited financial statements and net worth to claim the Large Franchisor Exemption, provided that the parent company absolutely and unconditionally guarantees the new franchisor's duties and obligations under the franchise agreements if the franchisor is unable to do so.

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\(^{15}\) For purposes of this paper, we focus our discussion on the large franchisor exemption within the context of a WBS transaction. For a detailed discussion of registration and disclosure exemptions and exclusions available to franchisors, see Leslie D. Curran and Beata Krakus, *Exemptions and Exclusions Under Federal and State Franchise Registration and Disclosure Law* (American Bar Association 2017).

\(^{16}\) The nine states whose franchise registration laws include a Large Franchisor Exemption (although the specific statutory exemption language varies among them) are: California, Illinois, Indiana, Maryland, New York, North Dakota, Rhode Island, Virginia and Washington. (CAL. CORP. CODE § 31101(c); ILL. ADMIN. CODE tit. 14, § 200.202(e)(3); IND. CODE § 23-2-2.5-3(c); MD. CODE REGS. § 02.02.08.10(D); N.Y. GEN. BUS. LAW § 684(2)(c); N.D. CENT. CODE § 51-19-04(1)(c); R.I. GEN. LAWS §19-28.1-6(1)(iii); 21 VA. ADMIN. CODE § 5-110-75(4); and WASH. REV. CODE § 19.100.030(4)(a).
Under the state franchise registration and disclosure statutes, a new franchisor is required to make an initial franchise registration filing in all states (where it intends to offer and sell franchises), requiring either a full application or a notice filing or to seek new exemption filings. As part of the WBS, the new franchisor will typically seek registrations or exemptions from registration immediately prior to or shortly after the closing date. This could result in the new franchisor’s temporary inability to offer new franchises, enter into renewal agreements or approve transfers in states where the Large Franchisor Exemption is not available or not granted and registration is required and not effective on receipt.

b. Role of the Manager as a Franchise Broker

As discussed below, the Manager may be required to register as a franchise broker or sales agent or file as a franchise seller in various states post-closing. Due to the Manager’s role in providing services to franchisees, it is possible that one or more state franchise law administrators could impose additional filing requirements on the Manager or require changes to the FDD to properly disclose the relationship between the Franchisor and the manager.

Upon closing of the WBS transaction, the Manager will serve as the franchisor’s principal franchise broker and, as such, may be required to register in certain states (together with the franchisor’s other brokers) prior to engaging in franchise sales. The new franchisor should also be aware of the registration of franchise brokers and sales agents. A "franchise broker" or "franchise sales agent" is an independent contractor retained by the franchisor for the purpose of helping secure prospective franchisees, and franchise brokers and sales agents are required to be registered in New York and Washington. If the new franchisor qualifies for an exemption from New York’s franchise law, it is unlikely that the Manager or any other brokers and sales agents will be required to register in New York. In order to avoid any additional disruption to the franchise sales process, any broker and sales agent registrations and filings should be submitted to the applicable state as soon as possible after the closing of the WBS transaction.

1. Description of Transactions in the FDD

Several items within the FDD must be updated in order to reflect the new franchisor upon the closing of a WBS transaction. In addition to the obvious changes, such as referencing the new franchisor on the cover page and in Item 1, the FDD must also disclose details (both in Item 1 and throughout the document) regarding the predecessor franchisor, any parents or affiliates of the new franchisor that were created as part of the WBS transaction, and the role of the Manager. Item 2 must be updated to reflect any new directors (including any independent Directors required to be appointed under the transaction documents), officers, and/or managers (who often are the same individuals in identical or similar positions, but identified as employees of the Manager as opposed to the franchisor), and the litigation and bankruptcy disclosures in Items 3 and 4, respectively, may need to be updated to include required disclosures if a parent company is guaranteeing the new franchisor’s financial performance in connection with a Large Franchisor Exemption. If the new franchisor, Manager, or another affiliate is a supplier of required products, the disclosures in Items 7 and 8 may need to be updated. In Item 11, the role of the Manager should again be addressed, as applicable, with respect to the assistance provided to franchisees. After all, while the franchisor is responsible for providing services to the franchisee under the franchise agreement, it will delegate those responsibilities to the

17 13 NYCRR 200.1 (2017); WAC 460-82-200 (2017).
Manager. Depending on the ownership structure of the franchise system's relevant intellectual property prior to the WBS transaction, Items 13 and 14 may need to be updated accordingly. Specifically, if the intellectual property is held in a separate entity, the license agreement must be described in item 13. If the franchise system has company-owned outlets, Item 20 may need to include disclosures clarifying the post-closing ownership of such outlets. Finally, and as discussed further below, Item 21 will need to be updated to make reference to the various financial statements that must be included as discussed more fully below.

2. Financial Statements

The post closing financial statements are perhaps the most important closing deliverables which could impact the franchisor's ability to continue franchise sales post closing of the WBS transaction. Pursuant to Section 436.5(u)(1)(v) of the FTC Rule\textsuperscript{18}, Item 21 of the FDD must include separate financial statements for the franchisor and "...any parent that commits to perform post-sale obligations for the franchisor [i.e., the services the Manager will provide] or guarantees the franchisor's obligations." Thus, upon the closing of a WBS transaction, the amended FDD will need to include financial statements for both the Manager and the new franchisor. As a newly formed entity, the new franchisor may phase-in the use of audited financial statements by providing the following: (i) an unaudited opening balance sheet for the first partial or full fiscal year selling franchises; (ii) for the second fiscal year selling franchises, an audited balance sheet opinion as of the end of the first partial or full fiscal year selling franchises; and (iii) for the third and subsequent fiscal years selling franchises, all required financial statements for the previous fiscal year, plus any previously disclosed audited statements that still must be disclosed in accordance with Section 436.5(u)(1)(i) and (ii) of the FTC Rule.\textsuperscript{19} The new franchisor should prepare the unaudited statements in a format that confirms as closely as possible to audited statements, and should prepare audited financial statements as soon as practicable.\textsuperscript{20}

3. Business Opportunity Filings

In addition to the registration and disclosure statutes described above, twenty-seven states have enacted "business opportunity" statutes.\textsuperscript{21} the majority of which prohibit the sale of

\textsuperscript{18} 16 C.F.R. §436.5(u)(1)(v).
\textsuperscript{19} Id. at 436.5(u)(2)(i)-(iii).
\textsuperscript{20} Id. at 436.5(u)(2)(iv).
business opportunities unless the seller gives potential purchasers a pre-sale disclosure document that has first been filed with a designated state agency (in addition to other applicable requirements). The disclosures required by state business opportunity laws differ from and are usually less onerous than those required by the FTC Rule and state franchise registration and disclosure statutes.

In many states, franchise offerings are explicitly excluded from business opportunity law coverage if the franchisor complies with the Franchise Rule or state franchise registration and disclosure laws, rules and regulations. In other states, however, franchise offerings are regulated under the business opportunity law, even if there is compliance with the Franchise Rule and state registration/disclosure requirements, if the franchisor makes certain representations in the course of selling a franchise. Many franchise offerings are also exempted or excluded from the definitional scope of the business opportunity laws if the franchisor is licensing a federally registered or state-registered trademark.

In most WBS transactions, the new franchisor will be exempt from all of the aforementioned business opportunity laws, as one or more of the following typically applies: (i) it intends to comply with the FTC Rule and state franchise registration and disclosure statutes; (ii) it licenses a federally registered trademark or service mark to the franchisees; (iii) it does not make any of the representations that trigger application of these statutes; and/or (iv) it will make exemption filings permitted under various state laws. In certain business opportunity states (e.g., Florida, Kentucky, Nebraska, Texas and Utah), the new franchisor must file a one-time exemption notice or annual exemption notices in order to qualify for the business opportunity law exemption.

B. International Considerations

If the company has international operations, it is imperative to retain local counsel to in each jurisdiction to confirm that there are no unique requirements that would prevent a franchisor from assigning the rights and obligations under the agreements to a newly formed franchisor. Similarly, counsel must confirm that the newly formed entity will be permitted to continue to offer and sell franchises in the jurisdiction immediately following closing of the WBS transaction. Often, the company may have international operations in one or more countries with unique requirements or conditions concerning the assignability of franchise agreements and/or the ability of a newly formed entity to offer and sell franchises.

VIII. PRE-AND POST-CLOSING ADMINISTRATION

The WBS transaction will result in substantial administrative changes which must be addressed both pre and post-closing. It is vitally important for the company to comply with all administrative requirements under the Securitization Documents. Failure to comply with these requirements could result in a default under the Transaction Documents and could also jeopardize the “bankruptcy remoteness” of one or more of the “below the line” entities.

A. Assignment of Agreements

1. Franchise and Development Agreements

As an initial matter, the franchisor must notify its franchisees that the franchise and development agreements have been assigned to one or more newly formed Securitization Entities. Most franchise agreements contain broad rights allowing the franchisor to assign its rights and responsibilities to any person or entity it deems appropriate. Therefore, the notification of the assignment is simply that – a notification – and should not require a franchisee’s consent. Because one or more new Securitization Entities will have been created for the franchise relationship, the franchisor must explain the assignment to such Securitization Entity (or entities). The franchisor can either assign both existing and new franchise agreements to a single Securitization Entity or it can assign them to two separate Securitization Entities. If the franchisor takes the latter approach, the franchisor must advise that all existing franchise agreements have been assigned to the Securitization Entity created for existing locations. Next, the franchisor must advise that all new franchise agreements (including all existing development agreements) have been assigned to the Securitization Entity created for future locations. Existing franchisees that continue to develop new locations will be parties to agreements with both new entities.

2. Leases

For franchise systems with company-operated locations, leases for the underlying real property must be assigned to yet another newly formed Securitization Entity prior to the closing date. A detailed analysis of all assignment clauses in the leases will be undertaken a sufficient period of time prior to the closing to determine which leases require mere notice to a landlord and which leases require actual consent. Obtaining landlord consents can be challenging and often involves a lengthy explanation of the transaction and execution of a new parent guaranty by the SPV Guarantor. Locations for which the landlords refuse to provide consent to assign the lease are withheld from securitization collateral (and maintained as an asset of the Parent or other relevant “above the line” entity) until the lease can be assigned with the landlord’s consent post-closing. If the lease is never assigned, the company-operated location is expected to remain outside of the securitization transaction and not included as collateral. The revenue generated by any company-operated location that remains outside the securitization will not be distributed into the waterfall in accordance with the priority of payments under the Indenture.

3. Assignments or Transfers of Other Business Items

Given that the company-owned locations will be operating under newly formed Securitization Entities, all business licenses, health permits, and other licenses (i.e. liquor) also need to be transferred, assigned, or obtained as new. Each state and many counties have different rules for transferring licenses or requiring new licenses. This likely will require the assistance of local counsel and associated administrative costs. In some instances, remodeling or other work may be necessary if the local jurisdiction treats the request for a transfer or new license from the assignee as a new applicant.
B. Notification and Delivery of Items Required Under Securitization Documents

1. Weekly Manager’s Certificate

The Manager is responsible for collecting and managing the cash and regular reporting to the Trustee and noteholders. The Manager prepares a Weekly Manager’s Certificate which is delivered to the Trustee every week within sufficient time for the Trustee to distribute the required priority of payments. The Weekly Manager’s Certificate specifies exactly which payments are to be made, and to whom, for the fees and expenses of the service providers, the operating expenses of the Securitization Entities, and interest payments on the notes. A sample cash management structure appears below:

Managing the Business Post-Closing: Cash Management

The Management Accounts are held in the names of the various Securitization Entities. These accounts are maintained for deposits of franchise royalties, revenue from company-operated locations, revenue from any other intellectual property assets, rental income, etc., pending deposit into the Concentration Account. Other Management Accounts may be maintained for specific purposes such as holding asset disposition and insurance proceeds. The Manager has access to the cash in the Concentration Account before it is deposited into the Collection Account. The amounts on deposit in the Concentration Account are swept weekly for deposit into the Collection Account, from which the Trustee makes weekly and quarterly payments to the servicing parties and the investors. Advertising account(s), if any, are separately maintained so as not to be swept into the Collection Account.

2. Quarterly Noteholders Report

A Quarterly Noteholders Report also is prepared by the Manager (and reviewed by the Back-Up Manager and Servicer). This report sets forth the interest and principal payments on the notes, disbursements from reserve accounts, if any, and amounts on deposit in the accounts. This report is delivered by the Manager to the Trustee a specified number of days
prior to Quarterly Payment Date to permit the Trustee to apply the funds in accordance with the report. Unlike the Weekly Manager’s Certificate, the Quarterly Noteholders Report is made available to Noteholders and Rating Agencies.

3. **Other Reporting Obligations**

The Manager also is responsible for providing a Quarterly Compliance Certificate to the Trustee within a specified number of days prior to each Quarterly Payment Date. This will contain an Officer’s Certificate disclosing whether any event of default or other specified event has occurred. Further, within a specified number of days after the end of each fiscal year, the Manager will provide the Trustee and other parties with a report of an independent auditor or the Back-Up Manager following the agreed upon form and procedures. Finally, quarterly unaudited and annual audited financial statements of the Manager and Securitization Entities are provided to the Trustee.

C. **Operation of the Franchised Business**

1. **Communication with the Franchisees**

In the notice to the franchisees of the assignments, the franchisees also must be advised to send their royalty payments to one or both new Securitization Entities. Payments for franchise agreements dated prior to the securitization date will go into one account and payments for franchise agreements entered into after the securitization date will go into another account.

The notification of the assignment letter also should explain the relationship between the newly formed Securitization Entities and the Manager. The franchisees should be advised that the Manager, pursuant to the Management Agreement, will now undertake all obligations under the existing and new franchise agreements. Franchisees should be further advised that there will be no noticeable change from their standpoint, and that the people with whom they have been transacting business will continue to provide the same services. A sample letter to the franchisees is attached hereto as Appendix A.

Post-securitization, the company must be mindful of which Securitization Entity is engaging in any particular communication or transaction. For instance, in issuing a notice to cure default, the letter should be issued from the newly formed Securitization Entity, as assignee of the underlying agreement. The notice may be sent by the Manager, but only in its capacity as manager for the new franchisor. Similarly, when entering into an amendment of a franchise agreement, the new franchisor entity must be used.

2. **Collections and Commingled Funds**

A franchisor must be very careful in the administration of funds. Prior to the closing, the franchisor must establish new bank accounts for the Securitization Entities in order to prevent the comingling of funds of the Parent (and other “above the line” entities) with funds of the Securitization Entities. All of the amounts payable by the franchisees under the franchise agreements (except national marketing funds) are expected to be deposited directly into new bank accounts for the Securitization Entities. If a payment is made into a wrong bank account, the franchisor has a limited period of time (typically 72 hours) to transfer the funds to the correct account before the monies are swept into the waterfall. Likewise, to the extent that franchisee payments to a National Marketing Fund were previously paid into the franchisor’s general bank...
accounts and subsequently dispersed to the National Marketing Fund, these payments must now be made directly into a separate account to keep them distinct from the cash collateral.

3. **Contributions of New Assets**

New assets acquired or created by the company must be contributed to the securitization collateral. If a franchisor licenses its trademarks for new uses to third-party manufacturers, those license agreements would be contributed as new collateral for the secured parties. Any royalty payments derived from the license agreements would be paid to the newly-formed, below the line, IP holder and those payments would flow through the waterfall. Similarly, if the franchisor creates a new line of business that does not impermissibly compete against the franchised brand, that new business would be contributed as an additional asset for the benefit of the WBS Investors. For instance, if a full-service restaurant franchisor created a complementary, fast-casual concept, that new concept would be a contributed new asset of the Securitization Entities. Similarly, if the franchisor owned proprietary software that it wanted to license to third parties, the license agreement and any payments therefrom would constitute a new contributed asset and revenue stream. After following the priority of payments discussed in Section IV, any remaining revenue would belong to the parent company.

4. **Permitted Asset Dispositions and Reinvestment**

Since all collateral was contributed to the Securitization Entities prior to the closing, the franchisor cannot simply sell off assets and retain or distribute the proceeds. Pursuant to the Indenture and the Management Agreement, upon the sale of an asset, the franchisor is required to either (i) deposit the proceeds into an Asset Disposition Account for reinvestment in other “Eligible Assets” or (ii) use the proceeds to pay down debt. “Eligible Assets” are defined as any real property or other asset useful to the Securitization Entities in the operation of the business or their other assets, including, without limitation, (x) capital assets, capital expenditures, renovations and improvements and (y) assets intended to generate revenue for the Securitization Entities. These provisions apply in whole business securitizations because if you sell or refinance assets, the WBS investors want you to reinvest it in the business or apply it to pay down the notes.

The refranchising of company-operated units is considered a permitted asset disposition and will not require separate consent. Upon receipt of the proceeds from the sale, the franchisor must decide whether to reinvest in other Eligible Assets within a specific deadline identified in the Indenture (typically one-year) or pay down debt. Another example of a permitted asset disposition is the sale of real estate, and a franchisor can use a sale-leaseback process to reinvest in company-operated units at relatively little cost. A franchisor can buy a parcel of land and simultaneously sell it with a long-term lease attached. The franchisor can then use the proceeds of the sale to help finance the construction of the new unit.

5. **Providing Franchisee Support**

The Manager employs all personnel of the franchisor and continues to provide support to the franchisees just as it did prior to the securitization. By contrast, the Securitization Entities have no employees of their own. Therefore, the Manager is responsible for providing all support. The Manager remains responsible for training, monitoring payments on franchise agreements to identify delinquencies and defaults, and interfacing directly with franchisees and other parties to franchise documents. One exception might be if a state or local jurisdiction requires a local
resident to be an employee or member of a Securitization Entity for the limited purpose of obtaining a liquor or other license.

6. Capital Expenditures

Any amounts received by the Securitization Entities upon the refranchising of company-operated locations or other permitted asset dispositions must be either reinvested into the business in the form of real property or other assets useful to the operation of the business within one year of receipt or will be applied to the prepayment of notes.

IX. Conclusion

WBS is an attractive means for franchisors seeking to raise capital on favorable terms secured by the royalty stream and other revenues generated from a franchise business. The process, however, is quite complex and will lead to material changes in the way that the franchisor and its affiliates conduct their business. Counsel – both in-house at franchise companies that have engaged (or are considering engaging) in such transaction and their outside franchise counsel – must be aware of the practical and legal implications of engaging in a WBS transaction.
APPENDIX A
SAMPLE NOTICE OF TRANSACTION AND ASSIGNMENT

Date

Franchisee Name
Franchisee Notice Address

Re: Notification of Assignment of Franchise and Related Agreements

Dear Franchisee,

This is to notify you that all existing franchise agreements, including the franchise agreement(s) you have signed with us as identified in Schedule A to this letter, were assigned to [Name of Securitization Entity I], a newly formed indirect subsidiary of Franchisor, effective as of [Closing Date] (the "Effective Date") as part of a restructuring of Franchisor and its affiliates. The restructuring occurred in connection with a securitized financing transaction that closed on or about the Effective Date. [Securitization Entity I] accepted the assignment and agreed to assume all of the obligations of Franchisor under these franchise agreements.

[As part of the restructuring, [Name of Securitization Entity II] was formed to enter into new franchise agreements with franchisees. All existing development agreements were assigned to [Securitization Entity II], as of the Effective Date. If you have entered into a development agreement with us (also referenced in Schedule A), this agreement has been assigned to [Securitization Entity II] as of the Effective Date.]

On the Effective Date, Franchisor entered into a management agreement with [Securitization Entity I] and [Securitization Entity II] whereby Franchisor will perform, on behalf of [Securitization Entity I] and [Securitization Entity II], respectively, all obligations under existing and new franchise agreements and development agreements. In addition, [Name of IP Holder], an affiliate of [Securitization Entity I] and [Securitization Entity II], entered into an IP License Agreement with each of [Securitization Entity I] and [Securitization Entity II], under which [IP Holder] will license the company trademarks and other related marks to them.

There will be no change as a result of these events in the people you currently deal with or the services that are provided to you. Further, your rights and obligations under your franchise and related agreements are not affected by these events.

Please sign, date and return a copy of this letter to us at ______ or via e-mail to ______.

Please do not hesitate to contact us if you should have any questions.

Franchisor Name
Securitization Entity I
Securitization Entity II

____________________________________
Each by: ___________, President & CEO
Acknowledged and accepted by

_________________________________

_________________________________

_________________________________

Date: ____________________________
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Claudia Koeppel Levitas

Claudia Koeppel Levitas currently serves as Executive Vice President, Chief Legal Officer, and Secretary to Hooters of America, LLC (“Hooters”). In this capacity, she oversees all legal matters (including franchising, litigation and employment issues) and the Human Resources department (including training, payroll, benefits, employee relations and talent acquisition). Hooters is a franchisor and operator of 430 domestic and international restaurants. Prior to joining Hooters in 2011, Ms. Levitas was Chief Administrative Officer and General Counsel to Huddle House, Inc. (“Huddle House”). Before joining Huddle House in 1995, Ms. Levitas was an Associate at Ginsburg, Feldman and Bress, Chartered located in Washington, D.C. Ms. Levitas is a 1990 graduate of George Washington University, National Law Center.

Kelly Mellecker

Kelly Mellecker is an associate at Paul, Weiss, Rifkind, Wharton & Garrison LLP. Kelly is a member of the corporate financing group, with a focus on esoteric structured finance. Kelly has represented both issuers and underwriters in connection with whole business securitizations in the franchise industry. Prior to joining Paul, Weiss, Kelly was an associate in the banking and finance group at Mayer Brown LLP in New York. Kelly received her law degree from Cornell Law School and graduated Phi Beta Kappa from the University of Iowa.

David W. Oppenheim

David W. Oppenheim is Shareholder at Greenberg Traurig, LLP. He concentrates his practice on domestic and international franchising, licensing and distribution matters. He advises both emerging and mature companies with respect to planning, structuring and implementing national and international franchise, distribution and licensing programs. David also represents private equity firms and public and private companies in the acquisition of franchise, licensing and distribution systems. David is recognized by Chambers USA as a leading, national franchise attorney. He is a member of the ABA Forum on Franchising Governing Committee and he currently serves as its Publications Officer and served as Co-Chair of the 39th Annual Forum on Franchising in Miami Beach, Florida. David is the Immediate Past Chair of the New York State Bar Association Business Law Section and he is a Past Chair of the New York State Bar’s Franchise, Licensing and Distribution Committee. He has been featured in Best Lawyers in America annually since 2009 and was named its “Franchise Lawyer of the Year” in New York for 2013 and 2017. David has been repeatedly selected as a New York Super Lawyer; and has been featured in The International Who’s Who of Franchise Lawyers annually since 2010 and in Franchise Times as a “Legal Eagle” annually since 2006. He is a frequent author and speaker on the topic of franchising and related legal issues.