The Form of Ownership of the Franchisor: Issues and Concerns

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I. INTRODUCTION

In the past, a franchisor grew primarily through sales of individual franchises. The franchisor quickly learned that it could accelerate its growth through area franchising, master franchising or subfranchising arrangements. A franchisor could also expand its presence through co-branding, enveloping small groups of independent or competing dealers, or through the occasional merger. Now, large mergers are common, multi-branding has replaced co-branding, and franchisors and franchisees are often parts of conglomerates which dwarf the franchisors.

At the same time, investors looking for significant returns have been faced with their own challenges: interest rates on traditional products at financial institutions have been at historic lows; new investment alternatives are subject to increasing governmental scrutiny and regulation; worldwide social and political upheaval presents risks which deter even the strongest investors.

The franchisor’s desire for growth, combined with the investor’s desire for a significant return on its investment, has made private equity investment in franchising a dominant force in the franchise world. Given this prominence of private equity, this paper is structured to focus primarily on the private equity investment scenario. When there are significant differences or special circumstances created in a merger, purchase, or public offering situation, such differences or circumstances will be identified.

Previously, private equity had generally avoided significant investments in the franchising space for a variety of reasons, such as traditional corporate concerns over lack of control as well as time consuming complexity regarding strategic changes, that come with the franchise model. Nevertheless, the franchise industry’s diversity and growth in recent years, coupled with private equity’s own aggressive growth and increasing demands to diversify their investment portfolios, has apparently diminished concerns over such conventional “cons” of franchise businesses. Franchisors, as private equity targets, also share many of the appealing traits of corporate targets in achieving the private equity investor’s strategic goals (e.g., complementing an existing portfolio business, reducing competition, or acquiring experience or increased market position). Perhaps most appealing are highly developed brands with relatively reliable income streams and generally low overhead, attributes which tend to be more pronounced with franchisors.

Whether a franchisor is pursuing growth by merger, acquisition, multi-branding, taking its company public, or bringing in private investors, the decision of the franchisor will create an effect upon its entire franchise system. The purpose of this paper is to identify how the key stakeholders in the process, i.e., the franchisor (“Franchisor”), franchisee (“Franchisee”) and the third-party investor, merging company or purchaser will react throughout the growth process.

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1 Due to limitations on scope, this paper focuses solely on investment in, or acquisition of, or other capital raising by Franchisor entities rather than Franchisee or developer businesses.


II. THE FRANCHISOR’S DECISION TO SELL

A. Considering a “Liquidity” Transaction

While the primary focus of this paper is the “effect” that a significant third-party investment, partnering or change of ownership might have on the various stakeholders in a franchise system, the process always begins with a fundamental decision made by the “owners” of the Franchisor. It is important to note at this point that there is often an important distinction between the “owners” and the “management” of the Franchisor, and that the interests of each group may not always be the same. In some instances, management consists of the founders and/or individuals or entities that otherwise control a majority of the equity in the Franchisor. For the purposes of this paper we will call this type of Franchisor a “Management Owned Franchisor.” In other instances, management are merely employees of the corporate Franchisor who may or may not own some equity in the corporation, while control is in the hands of one or more non-executive investors, which may or may not include a Private Equity Group (“PE Group”). This type of Franchisor will be referred to as an “Investor Owned Franchisor.”

Whether Management Owned or Investor Owned, most Franchisor owners will reach a point in the evolution of their systems when they must decide whether to (i) keep growing, and/or (ii) seek a “liquidity event” and trade their equity for cash (i.e., sell their ownership interests in the Franchisor to a third party). Liquidity events typically take the form of initial public offerings (“IPOs”), or acquisitions by other entities, including PE Groups, as further discussed below.

1. The Private Equity Acquisition

PE Groups are attracted to healthy, profitable Franchisors with between $5 million to $10 million EBITDA (earnings before interest, taxes, depreciation and amortization). Interestingly, private equity can be a viable solution to the owners’ desire to continue growing and convert their equity to cash. The founders in a Management Owned Franchisor who have hit their personal “glass ceilings,” or decide to exit for other reasons (health, age, liquidity needs, etc.) might find a PE Group willing to cash them out and take the company to the next level with new management. Similarly, the management group of an Investor Controlled Franchisor might find private equity to be a good source of funds and expertise to acquire the Franchisor from the Investor Owners so they can jointly take the Franchisor to the next level. Finally, whether Management Owned or Investor Owned, private equity is often a perfect “partner” for the emerging Franchisor to raise the capital that may be necessary to take advantage of pending opportunities that would otherwise be lost (i.e., open new markets, develop new products, build company-owned units, acquire a competitor, etc.).

2. The Straight Sale

The sale of the business to a competitor, a Franchisee (or group of Franchisees), conglomerate or other entity may provide significant financial returns but may be limiting with respect to the future of the business as the founders and management envision it. That said, if the primary goal of the current ownership and management is to exit the business entirely in connection with such a sale, then such concerns may be of less importance.

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3. **The Initial Public Offering**

Taking the Franchisor public through an IPO presents a different set of challenges than an investment or acquisition, but can be both financially rewarding and result in significant growth and prominence for the company. However, as discussed in more detail elsewhere in this paper, the founders risk loss of control at the board level and the Franchisor will be subject to additional burdensome disclosure obligations under state and federal securities laws.

4. **The Minority Investor**

Finally, although the focus of this paper is on the impact of various types of sales and acquisitions on a Franchisor’s operations and key business relationships, we wish to note the role of minority investment in the growth of franchise businesses. In those scenarios where the Franchisor has been successful and is focused primarily on pursuing an aggressive growth strategy without a change of control or change in business strategy, it will consider bringing on a minority investor to help finance its growth. Often, relatively young Management Owned Franchisors will be drawn to investors that, unlike a venture capital firm or a significant loan, will have a minimal impact on the control and flexibility of their company and relationships with their vendors and, most importantly, the Franchisees. Thus, they may initially pursue investments from “friends and family.” However, such investments may have limited value in fulfilling an aggressive growth strategy. Alternatively, a Franchisor may seek out an “Angel” investor, such as an individual or entity whose interests are aligned with the management of the Franchisor and who does not have a desire to play an active role in the management of the company. Angel investors typically acquire a mix of equity and some level of debt in the company, and may request certain protections in the operating documents or bylaws of the company to protect their interests, such as certain preferences in distribution of profits. Franchisors could also pursue venture capital, although such investors will often require a significant minority stake, such as 20-30% ownership, a seat on the Franchisor’s board, and more aggressive minority protections, such as rights to approve major business decisions, or rights of refusal with respect to sale of assets or ownership, among others. Venture capital investors, however, may provide expertise and contacts that will help the business grow so the benefits may still outweigh the tradeoffs in equity and control. In any event, while minority investment provides certain advantages, a Franchisor may still consider, or have a need for, a more significant change even after such an investment (or other rounds of financing or fundraising) to grow the company and/or obtain a more pronounced liquidity event along the lines discussed above.

B. **Is it Time to Sell or Take on a “Partner/Investor”?**

Clearly the first decision for the Franchisor’s owners to make is whether this is the time to go to market to raise capital or sell the company. Among the considerations are (i) What exactly are the cash needs of the business and/or of the individual owners? (ii) Can the business generate enough cash flow internally to meet the company’s current needs and any unexpected opportunities? (iii) Are there any financing opportunities other than going to outside sources, i.e., Can the company’s debt be re-financed? Are the current shareholders willing to put in more capital? Is there any available capital from minority investments (such as “family and friends” or Angel investment, discussed above)?). Another issue is what the general market conditions are and whether such conditions will be favorable or unfavorable to doing a deal at that time.
1. **The Unique Role of Timing With a Private Equity Transaction**

Timing is often a critical issue for raising money and/or selling a company and is no less an issue when considering a private equity transaction. Private equity money comes from investors who are looking for big returns and the availability of such funds and the willingness to invest it in a franchise company may very well turn on the economic conditions at the time and the realistic opportunities of the Franchisor to grow the value of the company during the pending and/or projected economic conditions. Similarly, the maturity level of the franchise system and of the owners and management team of the Franchisor can affect the timing of a private equity transaction. There is often a fine line between a management team that has had prior successes and one that is ready for break-out growth. The closer a Franchisor is to the latter, the more likely it is to attract private equity. Again, timing is critical. If more time is needed to build the team and prove out the concept, then now may not be the time for private equity, or, not the time to get the best price for the equity that is to be sold. In making the decision whether now is the time to seek private equity, patience is truly a virtue, and timing may be everything.

2. **How Timing Plays in Pursuing Other Transactions**

For other transactions, timing can play a somewhat different role. For example, a Franchisor may determine that now is the best time to sell to maximize its sale price because its business model has reached its peak and growing competition is not likely to afford an opportunity for significant additional growth in the near future. Or, the desire for a sale may be driven more by a desire to exit the business or a lack of “fire in the belly” to continue the enterprise with less emphasis on price. Or, the decision may share similarities with a private equity sale in that a Franchisor may determine that its future is dependent upon the access to business assets, capital, contacts and networks possessed by a competitor or larger conglomerate and that its current size and growth trajectory makes it most attractive to such potential buyers.

Timing in the IPO context involves different considerations. It will depend in significant part on the size and maturity of the Franchisor, its ability to quickly transition to the demands and transparency required of public companies, and its ability to present the market with an appealing investment in the near term. Other major factors regarding the timing of going public include how the investment community views the Franchisor and its industry overall as well as how the market is generally treating IPOs. It is conceivable that a knowledgeable investment banker could caution against going public, despite the company’s success and maturity, for reasons having mainly to do with current negative market perceptions.

C. **Pros and Cons**

On the positive side, selling some or all of the equity in the Franchisor brings liquidity (i.e., cash) to the selling owners, whether they be founders or previous investors. For founders, the valuation will be a combination of years and capital invested as well as some “emotional value” which often cannot be valued with any certainty (or, in many instances, satisfaction). For equity investors, their valuation will be based upon their investment and a multiple of EBITDA or cash flow.

1. **Private Equity Tradeoffs**

For owners who only partially sell their equity and intend to remain active with the company (and possibly continue to manage it), additional capital from private equity can enable
them to continue growing the franchise brand and, hopefully, participate in a second liquidity event years later, when the company is much more valuable. Private equity also often brings sorely needed management and financial expertise to the franchise company in addition to potential economies of scale related to common goods and services consumed by the PE Group’s other companies/investments.

On the negative side, private equity transactions usually result in dilution of ownership and loss of control of the Franchisor to the PE Group, much more stringent management and financial controls, more debt and a much more formal (and often intrusive) board of directors. Something that must be carefully considered is the fact that most private equity companies have a very specific timetable for an “exit” (i.e., sale of the company), usually 5-7 years, and a significantly high expectation of return on their investment in that time period (5-10 times). There is also often a new “vision” for the Franchisor set by the PE Group and a team of individuals assigned by the PE Group to oversee the investment and make sure the new vision is implemented and financial benchmarks are met. The personal “chemistry” (and, in the case of foreign investors, management of “cultural” differences) is often critical to the continued success of a franchise company after a private equity transaction (or, to the ability of the founders and management to accept and “fit” with the PE Group). PE Groups are very generally savvy investors and, if the goal of the owners is to sell out completely, a company that is in good shape and with lots of potential can bring the owners a high valuation. On the other hand, owners (and management) that intend to remain with the company post-transaction, must carefully consider all of the issues mentioned above (and elsewhere in this paper, as well as some that may not have been addressed), do extensive due diligence on the PE Group (i.e., talk to other owners who have done deals with this group or its principals), make sure that their mutual visions for the company are in sync, and, finally, try to determine if the “chemistry” with the PE Group will be conducive to a positive and mutually rewarding business experience. One additional thing for owners who intend to remain with the company to consider is that some PE Groups will require that they “re-invest” in the company as a quid-pro-quo for a long term employment agreement. It is not uncommon for such owners to be asked by the PE Group to leave 25-50% of their equity in the company over the course of their continued participation in the management team as a commitment to leave some “skin in the game” along with the other investors. Obviously, this will be subject to negotiation and to the degree to which the owners believe in the value that the private equity investors will bring to the company.

2. Advantages and Disadvantages of Going Public

The benefits of going public include easier access to capital to be used for operations, to retire debt or for other purposes and a new “currency” for acquisitions and other growth initiatives. In addition, existing shareholders will receive liquidity for their shares, subject to lockups and certain other restrictions and limitations, management will retain control of the company, and the profile of the company will generally receive a boost, helping to attract and retain talented employees. The negatives of taking a Franchisor public are notable as well, such as the high costs, time commitment and distraction entailed by the frequently necessary pre-IPO corporate housekeeping, which may include: revising organizational documents; “cleaning up” the company’s capital structure; hiring a “public company” ready chief executive officer, chief financial officer and/or investor relations specialist; selecting the lead underwriters and responding to their due diligence requests; hiring and coordinating with the other necessary specialists, including outside counsel and the company’s PCAOB-registered independent public

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accountants; working with this relatively expansive group to prepare, compile and filing the extensive documentation required in connection with an IPO, including a registration statement and exhibits thereto; clearing multiple rounds of comments from staff of the Securities and Exchange Commission ("SEC") regarding the disclosures contained in the registration statement and the company's financial statements; electing a generally independent board of directors and establishing compensation, audit and other committees of the board of directors (and preparing the related committee charters). However, from the Franchisor’s perspective, perhaps the most notable negative may be the voluminous initial and ongoing disclosure requirements and the unique legal risks they may present.

a. Securities Disclosure Issues with the Public Company

One of the most significant and pervasive realities faced by public companies are disclosure requirements at both the federal and state levels, as well as investor and industry expectations regarding the availability of current information. The privately-held Franchisor needs to comply with certain federal and state franchise registration and disclosure requirements prior to the sale of franchises. Once such a Franchisor goes public, however, it will be subject to an additional and perhaps even more invasive set of disclosure requirements under federal and state securities laws and regulations, although the disclosures will likely overlap in many respects. Indeed both securities and franchise disclosure laws seek to ensure that the prospective purchasers are provided with all material information not only regarding the offered securities or franchises, respectively, but also the entity offering them (as well as any affiliates of such entities). Access to these filings is a boon to both prospective and existing Franchisees.

Before a Franchisor can move forward with an IPO, it must prepare a registration statement, prospectus and related documents, which it must file with the SEC. The registration statement consists of a broad array of detailed disclosures, such as risk factors related to the company and the securities being offered, how the proceeds from the offering will be used, a summary of the company’s business operations, analysis of the company’s financial condition and results of operations, and, of course, multiple years of audited financial statements and recent unaudited interim financial statements. Following the IPO, the Franchisor will be required under the Securities Exchange Act to file quarterly, annual and, with respect to various material events and other developments, current reports with the SEC, on Forms 10-K, 10-Q and 8-K, respectively, regarding the company’s financial performance, material developments, and other related matters, as well as annual proxy statements. Although different in form and emphasis, the company’s securities law disclosures will overlap in many respects with the Franchisor’s pre-sale disclosures under applicable franchise registration and disclosure laws. This places a heightened obligation on the Franchisor to be careful to avoid any inconsistencies or outdated information across the franchise and securities disclosures.

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6 See id.


For example, unaudited interim financial statements must be filed with the SEC on a quarterly basis as part of the Franchisor’s quarterly Form 10-Q filings and short-form earnings releases are typically filed with the SEC on Form 8-K (and released by newswire) shortly in advance of, or concurrently with, the quarterly and annual report filings. In contrast, a Franchisor is not required to update its financial statements in its franchise disclosure document on a quarterly or other interim basis, unless there has been a material change from its audited statements or applicable state regulations require updating. Thus, to avoid claims that financial statements disclosed in the Franchisor’s franchise disclosure document (“FDD”) are materially different than the more current financial statements submitted to the SEC, the Franchisor should consider ensuring that any financial statements disclosed to state franchise regulators or prospective franchisees are current and consistent with the financial statements contained in the Franchisor’s SEC disclosures. The same vigilance and consistent treatment should be applied with respect to other updates provided to the SEC, such as material changes to management, material developments in litigation, material acquisitions or financing transactions and other material impacts on operations, which may or may not fall within the scope of state or federal franchise registration or disclosure laws.

Another potential risk that a public company securities law disclosure obligations may present relate to potential “financial performance representations” that may be found in such disclosures. Under the Amended and Restated Uniform Franchise Offering Circular Guidelines (the “FDD Guidelines”), financial performance representations must be included in Item 19 of the FDD. The FDD Guidelines broadly define a “financial performance representation” as:

“any representation, including any oral, written, or visual representation, to a prospective franchisee, including a representation in the general media, that states, expressly or by implication, a specific level or range of actual or potential sales, income, gross profits or net profits. The term includes a chart, table, or mathematical calculation that shows possible results based on a combination of variables.”

Given the breadth of this definition, it is conceivable that the detailed disclosures contained in public securities filings regarding a public company franchisor’s recent operations history, forward-looking statements and other similar matters could inadvertently constitute a general media financial performance representation to a prospective franchisee, which may have to be disclosed in the FDD.

Aware of the potential conflict between a public company franchisor’s disclosure obligations under the securities laws and the scope of the financial performance representations definition, the FTC, in its Franchise Rule Compliance Guide (the “Compliance Guide”), has made clear that it does not interpret statements made in securities filings as constituting general media representations. However, an issue may still arise where a Franchisor provides guidance regarding anticipated earnings or other information to its investors. Such guidance is often provided through a public press release and thus conceivably could fall within the definition

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12 FED. TRADE COMM’N, FRANCHISE RULE COMPLIANCE GUIDE, 133 (2008) ("Publicly filed financial performance information submitted to the Securities and Exchange Commission (e.g., 10-Qs and 10-Ks) are not considered general media representations.").
of a general media financial performance representation. That said, the Compliance Guide again appears to provide a basis to argue that such information does not constitute a financial performance representation, stating that:

“Ordinarily, company statements in speeches, press releases, and the like will not be considered “general media representations,” unless they are specifically directed at members of the public interested in purchasing a franchise. For example, financial performance information appearing in a franchisor’s press release or in the investors section of the franchisor’s website ordinarily would not be deemed a general media representation because such information is not necessarily directed at, or intended for, potential franchisees. The mere fact that those interested in purchasing a franchise can find such information in a newspaper or online does not make it a general media claim.”

The Compliance Guide notes, however, that where the Franchisor includes or references such information in franchise promotional materials (including websites) or in meetings or discussions with prospective franchisees, then the information will be considered a financial performance representation that must be set forth in Item 19 in the manner set forth therein.

It should be noted that the above interpretations only apply to the Franchise Rule and are not binding on state franchise regulations that have similar (or identical) provisions with respect to financial performance representations (although the FTC’s position in the Compliance Guide is arguably persuasive). While we are not aware of any cases involving claims of general media financial performance representations in either securities filings or in earnings guidance, it is nonetheless an issue that public Franchisors should keep in mind as they prepare their securities disclosures and assess whether to provide earnings guidance and other information.

In addition to regulatory disclosure issues, the quarterly reporting requirements also raise operational considerations for both the Franchisor and the Franchisees. By releasing earnings statements on a quarterly basis, public Franchisors must frequently prove their earnings ability to all shareholders, whether they are franchisee shareholders or new investors. Some Franchisors have seen this result in a push to continually improve the franchise system and keep the communication lines with Franchisees open. Indeed, the pressure on Franchisor management to meet earnings targets could presumably result in increased pressure on Franchisees to improve their own performance. This, in turn, could result in a greater focus on short term strategies to generate revenue at the expense of implementing long term changes that are

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13 It is not clear whether including such a press release as an exhibit to a Form 8-K filed with the SEC would cure this potential issue.

14 FED. TRADE COMM’N, supra note 11, at 132.

15 Id. at 132-33 (“However, where a franchisor utilizes financial performance information disseminated, or intended to be disseminated, to the public generally in its franchise promotional materials (e.g., in a brochure or franchisee section of a website), and includes in its franchise promotional materials a reference to general financial information on its website, or otherwise repeats the general financial information to lure potential franchisees (such as in a face-to-face meeting with an audience of prospective purchasers), such information will be deemed general media financial performance representations.”).

necessary to grow and continue the success of not only the individual Franchisees, but the system as a whole.

3. Other Transactions

Selling the Franchisor to a buyer such as a competitor, strategic buyer, Franchisee or other entity share the advantage of a potentially high purchase price. Further, under circumstances where the Franchisor is selling to a strategic buyer, such as a company that will use the Franchisor to open new markets and brand directions, or that will partner with the Franchisor and provide additional expertise, with the intent of continuing to play a significant role in the management of the Franchisor, the seller may see those strategic goals realized. However, unlike a PE Group or similar investor that is likely to be focused on growing and expanding the business and brand, these buyers may not have the patience or resources to support and grow the business. Thus, the Franchisor may suffer and decline from neglect, or it could be quickly resold to another buyer with very different goals for the brand than the Franchisor originally envisioned when it pursued the initial sale.

4. Impacts on the Franchise Disclosure Document

From a franchise disclosure compliance perspective, any significant liquidity event along the lines of those discussed in this paper will likely require the Franchisor to update its FDD to reflect the new ownership. Although a more comprehensive discussion of FDD disclosures is beyond the scope of this paper, this section discusses a few key examples and disclosure considerations to keep in mind. Other potential disclosure issues (depending upon the parties’ plans with respect to the franchise system, as well as Franchisor entity formation or restructuring) should also be considered by the Franchisor in advance of the sale and the reader should carefully review the FTC Rule and state franchise laws to determine if additional disclosures are required under the particular transaction being considered.

a. Disclosing the Potential Transaction

The first issue the Franchisor should consider in contemplating a sale is whether (and when) to update its FDD to reflect the impending sale or public offering or suspend sales until the transaction is complete and a new, more fully updated FDD, which reflects the new ownership has been drafted. Several states with franchise registration and/or disclosure laws expressly identify a change of control, or of the management, of the Franchisor as a material change that must be disclosed in the FDD.17 This does not address, however, whether and when a potential change of control should be disclosed, although some courts have held that a Franchisor may be liable for failure to disclose a planned change of control or disposition of the Franchisor.18 The earliest point in which a Franchisor is required to update an FDD to disclose a pending sale or other liquidity event is not expressly stated in the Franchise Rule or FDD Guidelines, although one commentator has proposed looking to the Federal Securities Act regarding amendment of registration statements and prospectuses, which suggests that the duty to amend to disclose a potential sale arises no later than the point at which the Franchisor enters

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17 See Meretta & Karp, supra note 7, at 121.

into an agreement in principle or similar agreement that is binding on the potential purchaser.\textsuperscript{19} Such disclosures, however, could be problematic. For example, the Franchisor may not have adequately notified key investors, Franchisees, suppliers, vendors and employees, among others, in advance of the disclosure with the result that such parties may react negatively to the potential sale and adversely impact negotiations. Competitors may seek to exploit the potential sale to their own advantage and public Franchisors may also risk a negative reception in the markets to the potential sale, among other risks (although disclosure by public Franchisors of such information under a confidentiality agreement may be possible under certain circumstances).\textsuperscript{20} Of course, the Franchisor could simply hold off on sales once negotiations with a potential buyer commence, although this may be challenging particularly for large Franchisors.

\textbf{b. The Acquisition by a Larger Entity or Conglomerate}

In addition to the disclosure of a change of control of the Franchisor, the transaction may have significant unexpected impacts on the Franchisor’s sales, as the disclosures with respect to the Franchisor’s new ownership, affiliates and management may result in profound and negative or discouraging changes to the FDD.

For example, if prior to the sale the Franchisor was a small, closely-held company with no affiliates, it likely had a fairly basic and straightforward FDD, which may have been a key advantage in its franchise marketing. If, however, the Franchisor is acquired by a conglomerate or other large business with multiple affiliates, various lines of business, or other franchise or competing operations, it will be required to amend its FDD to disclose such new developments to the extent they fall within the scope of the required disclosures. Indeed, the scope of several of the items in the Federal Trade Commission’s amended Franchise Rule (the “FTC Rule”)\textsuperscript{21}, such as Items 1 through 4, may pick up material information that will need to be disclosed -- and of which the Franchisor (and potentially the buyer) was previously unaware.

Item 1, for example, requires the disclosure of parents, as well as the affiliates and their business and franchising (if applicable) operations and history, if any such affiliates offer franchises in any lines of business or otherwise provide products or services to the Franchisees of the Franchisor.

Under Item 2, the Franchisor will be required to disclose the prior 5 years of business experience for the Franchisor’s “directors, trustees, general partners, principal officers, and any other individuals who will have management responsibility relating to the sale or operation of the franchises offered for sale.” Prior to this sale, this list may have included a small handful of people, but after the sale, this list will likely grow significantly. Further, such new additions may not have notable experience in the Franchisor’s industry, which may raise concerns from prospective franchisees.


\textsuperscript{20} See Meretta & Karp, supra note 7, at 120-22 (discussing potential disclosure of sensitive confidential information by a public Franchisor under the confidentiality exemption of Regulation FD).

\textsuperscript{21} 16 C.F.R. § 436 (2007).
Moreover, the new persons listed under Item 2 (along with any parents or affiliates of the Franchisor that promise to support the Franchisor financially or guarantee the Franchisor's performance, or that offer franchises under the Franchisor's principal trademark) will have to disclose certain civil or criminal litigation history under Item 3, including without limitation: pending complaints alleging franchise, antitrust, or securities law violations, or alleging fraud, unfair or deceptive practices, or comparable allegations; convictions or pleadings of nolo contendere with respect to any felony charges within the past ten years; or if they have been held liable in any civil actions involving allegations of violations of any franchise, antitrust, or securities law violations, or alleging fraud, unfair or deceptive practices within the past ten years. Thus, the Franchisor may be surprised to find that after its sale, it will need to add either individual or corporate litigation histories to its FDD that it may not have known existed prior to the sale.

Item 4’s required bankruptcy disclosures may have a similar impact. In addition to the Franchisor and its predecessors, any parent, affiliate, officer, or general partner of the Franchisor, or any other individual who will have management responsibility relating to the sale or operation of the offered franchises must disclose whether during the prior ten years it filed as debtor (or had filed against it) a petition, or obtained a discharge of its debts, under the Bankruptcy code, or was a principal officer of a company or a general partner in a partnership that filed as debtor (or had filed against it) a petition, or obtained a discharge of its debts, under the Bankruptcy code, while, or within one year after, such officer or partner held those positions with the company.

Such additional disclosures, particularly under Items 3 and 4, can be very discouraging to prospective franchisees and may adversely impact the Franchisor's sales and anticipated growth. In addition, to the extent the buyer or its affiliates seek to provide goods, services or financing to the Franchisees after the sale, this will trigger yet more disclosures regarding such transactions.

c. Additional Considerations when the Transaction Involves Competitors

Another complicating issue for sales of franchise systems by and/or to competitors, which is discussed in more detail below, is the effect it can have on FDD disclosures for both systems. In addition to the typical FDD changes made at the time of an acquisition (i.e. new principal owner(s), new officers and directors, new financial statements, etc.), acquiring a competitive franchise system poses unique challenges. For example, Item 1 should be revised to add information about the competitive system including, the name of the corporate entity/affiliate that offers franchises for the competitive brand, the prior business experience of the affiliate, whether the affiliate has offered franchises in any other line of business, the number of franchises sold by the affiliate, etc. Item 1 should also list the competitive brand in the description of “Competition” that franchisees will face in operating the business. Item 2 should include a description of any role each person disclosed plays in the operation of the competitive brand. Item 12 should disclose that any “exclusivity” granted does not preclude the Franchisor or its affiliate from operating or granting franchises to third parties to operate the competitive brand in the exclusive territory, if that is the case (as should the franchise agreements for each brand). These are just a few examples of disclosure issues that should be addressed when a competitive brand is acquired.
D. **Consequences of NOT Doing a Transaction**

Another issue to consider, which is often a hard one for founders, is what will happen if a transaction is NOT done at that time. Will there ever be a “better” time to do a deal? Will there be better value at a different time? Will the company lose momentum or the ability to create value by doing acquisitions for which it does not have sufficient capital? Will the competition “eat us alive” if we do not grow? These are legitimate questions which should be considered and contrasted with the alternative option of steady, continued growth from internally generated capital. There is no “right” answer and no crystal ball. Different courses will be chosen by different owners and management teams based on their respective visions for the company and the particular opportunities facing the company at the time. If, on the other hand, the owners are intending to sell out completely, there are probably only 2 questions to ask: (i) am I really ready to sell now? and (ii) will this buyer or strategy give me the best value? In either event, if the answer to both questions is “Yes,” we go on to the next issues.

E. **Type of Buyer or Partner the Franchisor Would Like**

1. **Finding the Best Private Equity “Fit”**

Another critical issue for owners to consider is what type of private equity partner would they be comfortable with, assuming they stay with the company after the transaction. Since private equity investors are rarely “passive,” this is not the type of transaction for entrepreneurs who have the need to be in total control of the business. On the other hand, not all PE Groups are the same. Some will insist on daily interaction with management and frequent meetings and written reports, while others will limit their interaction to setting the short term and long term financial expectations followed by regular (weekly or monthly) calls or meetings with the company’s CEO and one or more formal Board Meetings during the year. In either event, it is the Board, which is controlled by the PE Group, that sets the future vision and financial goals of the company after a private equity investment. While management is consulted, and often deferred to, owners considering a private equity investment must be clear on the fact that they will no longer have control over these decisions, which could very likely lead to disagreements regarding strategy, expenditures, new initiatives, etc. Accepting and embracing this new reality can prove very difficult for owners, and make negotiations very challenging even after the deal has been approved, particularly if they are the founders of the system. This is another reason why owners need to clearly understand the vision and expectations of the potential private equity investor as well as the fundamental relationship of private equity and management, as well as the investment and management philosophy, and prior history and reputation of the PE Group. Finally, and probably most important and hardest to evaluate, is whether the personalities of the owners/management and the private equity personnel will be a good “fit.” This is often a “gut issue” but, since the deal process will bring the two groups into close proximity over an extended period of time, potential personality and/or culture clashes may be exposed and should not be dismissed.

2. **Considerations for the Strategic Partner**

The Franchisor may also consider a different type of strategic partner than a PE Group. This could include a company that already has relationships in the franchise world or that is otherwise in the Franchisor’s industry (such as a supplier or distributor), or perhaps a manufacturer that would benefit from the Franchisor’s retail network. Such prospective buyers may benefit the Franchisor by increasing efficiencies in certain critical areas (such as reducing manufacturing and supply costs, or obtaining the buyer’s marketing or other expertise,
alternative channels of distribution). From the buyer’s perspective, purchasing a mature Franchisor may allow them to enter the franchise world without the cost of developing a new concept and franchise infrastructure, or simply to gain the necessary expertise and systems to develop a competing brand.22

a. The Strategic Minority Investor

A strategic partner transaction also would not necessarily require a change of control. For example, the strategic partner may agree to provide expertise, labor or licenses of valuable intellectual property or technology in exchange for a minority equity position. Or, as discussed above, the Franchisor could seek out a venture capital investor that would take a significant minority stake, while providing assistance to help position the company for a more significant liquidity event, such as an IPO or an acquisition by a larger private equity buyer. In such circumstances, the venture capital firm may not only provide capital and contacts, but also may provide significant operational or management expertise (or serve as an operating partner) to help achieve the company’s goals.

b. Different Dimensions to Assessing Compatibility

Similar to a PE Group buyer, the Franchisor will want to ensure that any such strategic buyer is a good fit for their business and will not negatively affect key business relationships, particularly with respect to its Franchisees. It is important, however, to understand the perspective of the strategic buyer or partner in the transaction and to ensure that their understanding of a good relationship is consistent with that of the Franchisor. This is particularly true with respect to strategic buyers who are not looking at the Franchisor as a separate investment, but as an integrated part of the their business going forward, in which case the long term success of the Franchisor as a separate business or of its Franchisees may not be a significant priority.

3. Selling the Franchise System to a Competitor

Another, less common, change of ownership in franchising is the sale of the system to a competitor in the same or similar business (i.e., Popeye’s Chicken acquisition of Church’s Chicken, YUM Brands acquisition of A&W and Long John Silvers, Dessange Paris’ acquisition of Fantastic Sams, etc.). While the most obvious benefit of this type of acquisition is the buyer’s existing knowledge of the seller’s industry, other issues can make these much more complex transactions. Consider the following:

a. Overlapping Exclusivity

Often in these transactions, the exclusive territories previously given to some of the Franchisees of each brand overlap each other. This must be carefully reviewed during due diligence and, when such conflicts are identified, the language of the respective franchise agreements must be reviewed to determine if the mere ownership of the competing brands by the same company would be a breach of either franchise agreement. If so, a strategy must be developed to mitigate the risk (e.g., buy-out of one or both of the conflicted units; relocation of one of the conflicted units, compensation to one of the conflicted units, etc.).

22 See Cannon, supra note 17, at 2 (noting that Pillsbury and General Foods followed a similar approach with their acquisition of the Burger King and Burger Chef franchise systems, respectively).
b. Future Development

Even if there is no de facto breach of either franchise agreement resulting from the acquisition, management must still be prepared to address the concerns of one or both of the brands’ franchisees arising from such perceived conflicts (e.g., determining which brand gets the next location in close proximity to the existing units). Exclusivity provisions in new franchise agreements must also be carefully drafted to make clear that development of the “other” brand by the Franchisor (or its “parent, subsidiary or affiliate”) will not be deemed a default or breach of that Franchisee’s exclusivity, regardless of how close to the franchised unit the other brand’s unit is developed. Another issue to be addressed is whether the Franchisor will permit dual ownership of both concepts by the same Franchisee and, if so, whether any changes to the non-compete provisions of either brands franchise agreement will need to be made to address this added complexity. Similarly, the buyer will need to consider whether there are opportunities for Franchisees of one brand to convert their units to the other brand and, if so, under what conditions and terms. This then raises the issue of whether conversions may result in one brand “dying on the vine” and if so, to what degree the buyer must continue to support and promote innovation for the shrinking brand and its Franchisees.

c. Marketing and other Confidentiality Concerns

When operating competing brands after an acquisition, the Franchisees of one or both brands may be extremely sensitive about information concerning one brand somehow being “leaked” to the Franchisees of the other brand (e.g., marketing plans, product introductions, sources of supply). Consequently, the Buyer must determine whether it needs to establish a “fire wall” between the brands and, if so, how high and how wide it must be. On one extreme, a Franchisor may want to have entirely separate organizations for each brand. A slightly different approach is to have separate “operations” and “marketing” staffs but to maintain a common “shared services” group for functions such as legal, accounting, franchise administration, etc. On the other extreme, the buyer may want to get the maximum economies of scale and have the same staff provide all services to both brands. Whatever approach the buyer chooses, it is important to clearly address the concerns of the Franchisees of each brand that its competitive information will somehow be shared with the Franchisees of the other brand to its detriment. The buyer must demonstrate to the Franchisees of both brands that there are sufficient benefits arising from the acquisition and common ownership by the buyer for both brands to benefit in the long term (e.g., combined purchasing power, financial strength, executive experience).

4. Selling to the Franchisees

An even less common form of ownership is the acquisition of the franchise system by all or some of the Franchisees of the system (i.e. Ground Round, Pioneer Chicken, Best Western, Fantastic Sams, Long John Silver’s, etc.). This type of transaction has historically occurred when the Franchisor files for bankruptcy and the system Franchisees pool their resources, with or without private equity investment, to purchase the system assets from the bankruptcy estate. In the Ground Round situation, the Franchisees partially financed the acquisition by “trading” their aggregate claims against the Franchisor as part of the purchase price for the system’s assets.

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Another benefit of this type of acquisition is that many of the Franchisees are experienced business people with available capital as well as long term banking relationships that can be brought to the table to help finance the acquisition.

One of the first post-acquisition hurdles for this type of transaction is determining how to structure ownership and management of the system. One alternative is to run the system as a cooperative with all decisions made collectively by the Franchisee owners. A less cumbersome structure is to hire professional management to maintain and/or improve system standards and attempt to grow the system. However management of the system is structured, an agreement must be reached as to how system standards will be enforced against the Franchisee owners, what continuing fees will be required by the Franchisee owners, how marketing decisions will be made, how new locations will be allocated among Franchisee owners, etc. A related issue is whether the system will continue to offer and sell franchises to new, third party Franchisees and, if so, who will pay for the preparation and registration of the new FDD and, whether new Franchisees brought into the system will be permitted (or be required) to buy-in as owners of the system. Another question to be addressed is whether an owner Franchisee must be disclosed for each and every additional franchised unit that the owner Franchisee desires to develop in its territory (and upon what terms such additional franchises will be issued). The content of the FDD of the Franchisee-owned Franchisor itself presents interesting disclosure issues. For instance, the FDD must describe the bankruptcy and purchase of the system assets by the Franchisees, whether offers to owner Franchisees will be made on terms different than to new third party Franchisees, etc. Additionally, with so many Franchisee owners, the disclosures in Items 2, 3 & 4 could be extensive and not always conducive to new franchise sales, as discussed in more detail above in the discussion on impacts of a sale on the franchise disclosure document.

As illustrated, Franchisee-owned franchise systems present a whole host of complexities that must be considered and dealt with in both the short term and long term, not the least of which is managing and growing a system with many owners with diverse experiences and sometimes conflicting opinions. This may be the reason that instances of this form of franchise system ownership has, to date, been few and far between.

F. To Sell or Grow With the Private Equity Partner

As mentioned above, for a Management Owned Franchisor, the decision to bring in a private equity investor is a very complicated one which has both financial and emotional considerations. Entrepreneurs are, by nature, innovators and risk takers. They have often “put it all on the line” to launch and grow their franchise system. To be fair to them, the system would not have been created or grown without their vision and direction. Some recognize their limitations and some do not. In considering whether or not to pursue a private equity transaction, owners must make a fundamental decision: (i) do I want to sell all of the equity I have built in the company and move on to something else (i.e., have I built the company as much as I can?) or (ii) do I want to participate in the next chapter in the company’s growth and ride it out with the private equity investors? If the answer is the former, then the only issue is “valuation” (i.e., what multiple of EBITDA will I get for my equity). If, on the other hand, the motivation for the transaction is to participate in the continued growth of the company, the owners must be confident that they have chosen the right “partner” to grow with and that their respective visions and growth timetable for the company are in sync. If there is doubt about this, it might probably be better to find a different PE Group, sell out completely, continue growing the company internally and go to market at a later date.
III. TRI-PARTY TREPIDATIONS

A. Preliminary Evaluation of the Franchisor Target

In contemplating an investment in a Franchisor, the PE Group will review to what extent the target meets the group’s strategic and investment goals. Such considerations will include whether the target company is (or is capable of) undergoing rapid growth or has become a mature franchise that can be further refined, in each case to provide strong and consistent returns. To this end the PE Group may focus on those issues discussed above as well as whether the Franchisor has sustained positive cash flow, success of company-owned operations, geographic expansion limitations and opportunities, the success of the Franchisees and the nature of their relationship with the Franchisor, effective operations and franchise sales structures, among others.24

Careful attention will also be paid to the management team to take the company forward. Will the PE Group want to transition longstanding senior management to replace them with a “next level” team? Will the system itself require substantial overhaul, branding changes, etc.?

These issues are discussed in further detail below in connection with diligence considerations, but they will likely be in the forefront of the minds of the PE Group as they commence initial discussions.

B. Why Would a Franchisor Consider Private Equity?

Once the decision is made to seek an investor, the Franchisor’s owners must ask whether private equity is the best option. Assuming that the primary motivation is to continue growing the company and maximizing the value of the owner’s equity, the benefits of a private equity investor would include the following:

- Availability of capital (PE Groups raise large amounts of capital from institutional investors looking for a larger return on investment).
- Experience growing other companies and increasing equity value.
- Banking and capital markets relationships.
- Management expertise.
- Understanding of the franchise business model (This has become more common in the last few years as PE Groups such as Roark Capital [Arby’s, Moe’s, Carvel, Money Mailer, Cinnabon, etc.] have made major investments in the franchise companies.)
- Economies of scale related to other companies owned by the PE Group (e.g., bulk purchasing power, cross-company sales opportunities, common Franchisees)

24 Id.
C. The Added Franchisee Dimension

1. A Third Party to the Transaction

While the PE Group and the Franchisor are respectively developing their goals and determining if private investment is desirable, they might want to keep in mind that a third party—one which will not be making any proposals, preparing scenario sheets, calculating EBITDA, divining trends, or signing any agreements—will nevertheless become a significant, if not critical, factor in determining whether private investment is economically and logistically viable: the current class of Franchisees. The Franchisees will have to produce the income flow upon which the PE Group and Franchisor are making their plans. The Franchisees will choose to embrace or resist whatever changes may occur in the franchise system. The Franchisees will choose to welcome new Franchisees or decide to protect their turf at all costs. As franchise attorney, David Kaufmann, observed, it is the existence of a Franchisee population which distinguishes an investment in a Franchisor from other private equity investments.

Complicating matters is the fact that not all Franchisees are the same. Unlike the PE Group and Franchisor, who will each present a single approach and goal to the transaction, the Franchisee population may contain within itself dozens of different circumstances, priorities and personalities. Franchisees are differentiated by the number of units they own or control, the location of the units, the length of time left in the terms of their franchise agreements, the financial health of their franchised businesses, and their own financial health. Some Franchisees may own units which are the sole basis of their existence; others may own several different franchised units or other businesses. Some Franchisees have “special deals” or understandings with their Franchisor (or even their local or regional operations manager). Some Franchisees may be in the midst of their own exit strategies. Some may be part of a conglomerate which is larger than the Franchisor. As the PE Group and Franchisor proceed, the myriad situations and varying responses of the Franchisees will require continuous attention, and, often as not, creative action.

2. Who Are These People?

Regardless of the size or situation of the Franchisee, the first question that will come to the Franchisee’s mind about the PE Group will be “Who are these people?” The Franchisee may recognize the name of the company and may even know one or more key individuals of the entity, but name recognition is hardly the issue. Franchisee concerns will focus on key issues that, collectively, may impact (for good or bad) their own investment in their business and likelihood for future success. Is the PE Group known for expanding a system or excising struggling Franchisees? Does the PE Group own competing brands? Does the PE Group understand franchising in general? Does the PE Group understand the industry? Will the PE Group expand the system by bringing in more Franchisees, and, if so, will the PE Group own or control the new Franchisees?

Though the identity and business style of the PE Group will be at the forefront of the Franchisee’s mind, the Franchisee will also want to know as much as possible about the people who will become part of the franchise system. Are the PE Group’s representatives going to allow the current leadership to remain in place, or are they going to “take charge?” Are they approachable? Are they open to new ideas? Are they hardliners? Do they have a vision for

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the company which encompasses more than the bottom line and extends beyond their exit strategy? Will they be any more or less concerned with Franchisee profitability than the seller?

Though it would seem logical to suggest that Franchisees have a legitimate interest in who controls the Franchisor, there are no reported opinions providing that this nebulous interest can be solidified into a right of Franchisees to participate in the decision-making process or the transaction itself. Moreover, there is no reported case providing to Franchisees a right to demand "Franchisor competence." Instead, such claims are generally brought in terms of breach of contract, negligence or breach of the implied covenant of good faith and fair dealing.

3. **Identity Concerns**

Of course, at the heart of every franchise organization are the Franchisor's names and marks (together as "marks"), and the Franchisor's system. Franchise attorneys know-and conscientiously point out to their potential Franchisee clients -that, even though the Franchisee's success will greatly depend upon the goodwill of the marks, the Franchisee does not own the marks, and the Franchisee has nothing more than a restricted license to use the marks for a finite term. Nevertheless, as the Franchisee pays the advertising fees, wears the uniform, spends the money on trade dress and upkeep, and works to maintain customer and supplier relations, the Franchisee becomes identified, and identifies himself, herself or itself, with the marks. It should be pointed out, however, that there does not have to be years of identification with a brand in order to be concerned about a change in marks. Ask any Franchisee who chose to become a *Cottman Transmission* Franchisee in late 2005 or early 2006, only to be told a few weeks or months after opening that the competing *Aamco Transmission* Franchisee down the street was no longer a competitor, and that the *Cottman* marks were going to be phased out.

It is hardly a surprise, therefore, that, after the Franchisee has learned about the PE Group, almost invariably, the next thing the Franchisee wants to know is whether the marks are going to be changed.

The same reasoning can be applied to the Franchisor's system of operation. From the time a person first investigates becoming a Franchisee, through training class, and then during each visit from an operations manager or district supervisor, the Franchisee is attracted by, and then taught to accept, the mantra that "Following the system is the way to success." If the Franchisee becomes successful by following the system, the Franchisee embraces the mantra. If the Franchisee is not successful and decides to try something different, the Franchisee is threatened to "follow the system, or else..." It is hardly a surprise, therefore, that when a Franchisee learns that there may be changes to either the system or the way the system is enforced, the Franchisee will be skeptical, confused or angry. If the Franchisee is not brought into the decision-making process, the opportunity for Franchisee discontent and an unsuccessful ownership or structural change of any kind will be increased.

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28 *Id.*, at 19-21.

Regardless of whether a change in Franchisor structure is the result of a sale, merger or private equity investment, the savvy Franchisor will take the marks and systems issues into consideration ab initio, instead of waiting until the determination to proceed has been made. By either avoiding the change of identity altogether, or developing a strategy to minimize the problems if a change is contemplated, the Franchisees will not only be less wary of the private investment transaction, but the PE Group will be viewed in a much more favorable light. If the Franchisee feels that the Franchisee is part of the decision-making process, then the risk of Franchise discontent (or outright revolt) is minimized.\textsuperscript{30}

Thus, in light of the uncertainty that a private equity transaction may create among this critical component of the franchise system, the Franchisor and/or the PE Group would be best served by addressing such concerns as early as possible in the deal assessment process to the extent possible after the Franchisees become aware of the buyer.

IV. PRELIMINARY STEPS / BUYER ASSESSMENT

A. Setting the Wheels in Motion for the Franchisor

1. Using an Investment Banker

How does a Franchisor find buyers or investors (including PE Groups) willing to buy or invest in the Company? One way is to do research on the internet or in the business press about previous franchise companies that have been sold to PE Groups. Another way is to engage the services of a professional investment banker to manage the entire process. Because of the added fees involved (which could range from 1% to 5% of the amount raised), this is usually limited to larger transactions or ones in which the owners or management are not experienced enough or have the time to manage the process.

Again, picking an investment banker with experience and a good reputation is critical. Asking for references from the banker’s current and former clients is a good idea. Experience selling a franchise company may be helpful but not necessary. Much more important is finding a banker that can understand the Franchisor’s business, the franchise “model” and one that has had significant experience (and success) both selling businesses, in general, and, dealing with private equity investors in particular.

Counsel for the Franchisor and its owners must carefully review the proposed “Engagement Letter” with the investment banker to make sure that the fees and expenses payable by the Franchisor are clear, as well as the obligations of the investment banker. If a Confidential Offering “Book” is to be prepared, it should be spelled out in the Engagement Letter. Similarly, if there is to be a specific “bidding process” followed or avoided, it should also be spelled out. Furthermore, once one or more buyers are identified, any follow-up role of the investment banker during the due diligence process and agreement negotiations should also be covered.

2. The Process of Finding the “Right” PE Group or Other Buyer

Whether an investment banker is to be used or not, the next step in the process is “packaging” the company for sale. This often begins with the preparation of a Confidential

\textsuperscript{30} Id.
Offering Memorandum (a/k/a “the Book”) which presents the story of the Franchisor from its founding to the present. The Book will also contain extensive financial information and charts about the Franchisor and the franchise system, as well as post-transaction “Projections” that will consider various scenarios (i.e., how fast the System will grow with new Capital injected by the PE Group; acquisition of competitors, etc.).

The Franchisor’s owners and management must invest significant time and energy pulling together this information and preparing the Book regardless of an investment bank involvement. If no investment bank is used, and if the internal personnel of the Franchisor is limited, an experienced financial “consultant” should be considered to help pull together and analyze the information needed to prepare the Book. A sloppily prepared Book will most likely be seen by prospective PE Groups or other buyers as an early warning sign that the company may have other shortcomings and might cause them to not want to take a closer look. As in many things, “first impressions” in such transactions can be very important.

In transactions involving a PE Group, some of the other considerations that should be taken into account when putting together the list of potential groups are the following:

- Capital under management/number of funds formed and invested.
- Years in business.
- Total deals funded and type of deals (number of franchise company transactions).
- Total deals exited (and, if available, return on investment).
- Prior deals.
- “Synergies.”
- Exit “horizon” (i.e., when will they want to sell the company again?).

Once the Book is completed, a list of potential PE Groups is put together. As mentioned above, the list can be compiled by the investment banker that has dealt with the PE Groups previously or has heard of their previous acquisition activities. Or the Franchisor’s owners and management team may assemble the list themselves, prioritizing those PE Groups that have previously acquired franchise companies or that have publicly stated their interest in doing so.\(^{31}\)

The PE Groups are then contacted to see if they have any interest in seeing the Book. A significant “chicken and egg” dance takes place here, since the Franchisor usually does not want it publicly known that it is “in play,” but the PE Groups cannot exhibit interest until they know who the company is. This is easier to address when a third party investment banker is representing the selling Franchisor and can gauge a PE Group’s interest by giving limited facts about the Franchisor (i.e., industry, number of units, system-wide sales, etc.).

Obviously, regardless of the potential buyer or investor (PE Group or otherwise), if the owners or management contact the PE Groups or other potential buyers or investors directly, there is always the risk that word will get out to the franchise system’s Franchisees, vendors and competitors that the company is for sale. In either event, before the Book is provided to any potential investor or buyer, a carefully drafted Confidentiality and Non-Disclosure Agreement should be signed by such party.

\(^{31}\) Many PE Groups will identify the criteria for acquisitions on their websites (see, e.g., http://www.roarkcapital.com/invest_criteria.php, last visited on September 13, 2013).
3. **The “Dog and Pony” Show**

Once a potential buyer has reviewed the Book and shows preliminary interest in the company, it will usually ask for a face-to-face meeting with the management team to learn more about the team and the company, as well as their vision for the future and how the buyer will “fit” with the current culture of the company. At these meetings, the buyer will dig deeper into the numbers and the “assumptions” behind them and take a measure of the management team’s competencies. Again, the deeper into the organization that the buyer delves, the greater the risk that word of the transaction may leak out. Sometimes this is addressed by limiting the employees to whom the buyer will have access or, in some instances, having the buyer use a third party to question the Franchisor’s employees (and/or vendors or Franchisees) using a pretense such as posing as a prospective Franchisee. The objective of the buyer is to get enough information to decide whether to make an offer while the Franchisor wants to limit the risk of disclosing the potential transaction too soon and creating unnecessary anxiety on the part of these other stakeholders. It is a delicate balancing act that takes a different form in each transaction and requires careful counseling by the Franchisor’s lawyers and other professional advisors. This process is also very time consuming for the Franchisor’s owners and management team and can distract them from the day to day business. Franchisors should, however, take all necessary steps to continue operating the company without consideration of, or reliance on, the potential transaction. Years ago a senior executive of a major Wall Street Investment Bank gave one of the authors of this paper the following advice: “When seeking a liquidity event, run your company as if the transaction will never take place, otherwise, if it doesn’t, the company will be in a much worse condition than when the process began.” Sound advice indeed!

4. **Preliminary Due Diligence**

In addition to the dog and pony shows and other personal meetings, this initial dating dance between Franchisor and PE Groups or other buyers will include a request to see increasingly more information about the company and the franchise system. While the Confidentiality and Non-Disclosure Agreement should protect the information from being disclosed publicly, there is a careful balance between providing enough information to get the buyer to make an offer and providing too much information before a formal offer is made. Franchisor’s counsel can play a critical role in helping define this line and, at the same time, keeping the deal momentum moving forward. One way to accomplish this is to set a tight deadline for pre-bid meetings and due-diligence and a fixed date for each buyer to submit its offer. Obviously, the fewer bidders there are, the less leverage the Franchisor will have in dictating these deadlines.

5. **Picking the Winner**

Picking the winning bidder in an “auction” process by buyers is not always a matter of who offers the most money (although it is ONE of the most important factors). This is especially true with PE Groups. Other considerations include: (i) the ability of the buyer to close the deal (i.e., is it contingent on outside financing, etc.?), (ii) is there going to be a significant “holdback” or escrow? (iii) are there any contingencies to payment of the entire purchase price? (iv) will management be required to leave some of its equity in the company so they have some “skin in the game” and, if so, how much must be re-invested? (v) what type of Employment Agreements
V. KEY DEAL DOCUMENTS AND STRUCTURAL CONSIDERATIONS

A. Letter of Intent

As mentioned above, the winning bidder is usually selected based on a non-binding offer letter from the buyer to the Franchisor or its owners. While the proposed purchase price is usually clearly addressed, many other critical deal issues are not. At this point, the Franchisor has two options: (i) begin negotiating the asset (or stock) purchase agreement or (ii) hash out some more of the deal points in a written letter of intent (or “LOI”). Among the many reasons to do an LOI is to see how close the parties really are on the specifics of the deal, get an early sense of how the other side will negotiate, define what issues may be contentious and, finally, avoid the time and expense of legal and other professional fees on a deal in which the parties are still far apart on many issues. Once again, this process is a very tough balance of not negotiating every detail of the final agreement but defining enough of the terms of the deal so that the parties are willing to commit the resources to begin the legal and business due diligence process and to engage counsel to begin drafting the Asset or Stock Purchase Agreement and related closing documents. Note that the LOI will likely include some form of exclusivity or “no-shopping” provision that will prohibit the company from soliciting or pursuing other prospective buyers for a specific period of time (typically, several months on the assumption that the transaction will close before such period expires). The company should strive to keep such period as brief as possible to motivate the buyer to conduct its diligence and negotiate the agreement as expeditiously as possible. As a practice tip, the following are issues that should be addressed in the LOI:

- Whether the deal is for stock or assets.
- Purchase price.
- Holdback/escrow, if any.
- Contingencies (i.e., is purchase price dependent on a specific number of franchised units being open and in operation? If so, is there any upward or downward adjustment in purchase price if there are more or less units open as of the closing date?
- Most LOIs are non-binding, with certain defined exceptions (these should be spelled out).
- Exclusivity/“No-Shopping” provision (a/k/a “Stand Still Agreement”).
- Proposed closing date.
- Confidentiality and Non-Disclosure.

B. Private Equity Considerations for Deal Mechanics and Structure

In addition to standard terms, a PE Group will need to think through the deal structure in negotiating the LOI. The PE Group should ensure that the mechanics and structure of any potential transaction are aligned with the group’s management and revenue goals, balanced against the risk tolerance for entering into the transaction. Careful consideration will likely be given to the following factors:
1. **Deal Structure**

Common options include a full buyout of shares or ownership interests, acquisition of majority control, or a minority stake with minority protections.

2. **Target Restructuring**

There may be a need for corporate restructuring of the Franchisor target prior to closing, which may be dictated by the PE Group’s governing documents (operating agreement, bylaws, etc.) or perhaps for tax issues. In assessing any restructuring, the parties should consider any rights of consent to the restructuring or approval of any change of control with respect to other existing owners, or significant vendors, suppliers, or, of course, any Franchisees. If such rights exist, then the PE Group and the target may need to work with such parties to obtain their consent at minimal cost to the target or PE Group.

3. **Investment Horizon**

The PE Group will also need to carefully consider the duration of its ownership. PE Groups hold on to their investments for several years, often ranging from 3 to 7 years. The specific hold period may be dictated by the parameters of the PE Group’s investment authorization from its owners. Whatever the rationale, the PE Group needs to have a clear understanding of the types of risks the target will encounter during that period. One important issue is the potential expiration of a significant number of franchise agreements (or the expiration of certain key or large Franchisees) during that period, which, if not renewed or quickly replaced may significantly impact revenues.

4. **Financing**

If the PE Group will use financing, what type of vehicle will it use (e.g., secured debt, mezzanine financing, etc.)? Further, what, if any, will be the structural demands of the lender? For example, lenders may require that key assets, like intellectual property, be placed in separate “special purpose” or “bankruptcy remote” entities. In addition, lenders can require certain representations, covenants and restrictions in the loan documents that can restrict the target’s management and operational flexibility.

5. **Employee Retention**

The PE Group will need to develop a strategy for employee retention. This should include identifying employees with historical knowledge of the franchise system, as well as the relationships with (and personalities of) the Franchisees, in addition to top performers and key management employees. The PE Group must then determine how to persuade such employees to remain with the target post-closing. Options could include equity incentives for management, or other benefits in addition to compensation. As noted above, as opposed to an incentive, the PE Group could also condition continued employment for key executives upon contribution of capital to the business so that such performers have “skin in the game.”

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terms, such as stay bonuses, non-competition and non-solicitation, will also need to be carefully
considered for any continuing employees.

6. **Key Closing Conditions**

The PE Group should also identify as soon as possible the key conditions to closing. These can include consents to the sale from owners, members of shareholders, or vendors, suppliers, landlords, etc. Often, the company’s operating documents or third-party agreements may also provide for rights of first refusal either with respect to certain assets or to the business as a whole. Such rights have to be carefully reviewed because they may delay closing at the very least or be used as leverage in negotiations with the third party.

7. **Regulatory Clearances**

In addition to the issues above, the parties will need to assess whether any regulatory approvals are needed for the transaction. In the U.S., a proposed acquisition may need to be approved under the Hart-Scott-Rodino Act. Specifically, the Hart-Scott-Rodino Antitrust Improvements Act of 1976 amended the Clayton Act to establish the Federal Premerger Notification Program. The Clayton Act requires that parties to certain mergers or acquisitions notify the Federal Trade Commission (“FTC”) and the Department of Justice (“DOJ”) (the enforcement agencies) before consummating the proposed acquisition. Premerger notification involves completing a “Notification and Report Form for Certain Mergers and Acquisitions” (“HSR Form”) with information about each company’s business. Most commonly, notification is required if the parties meet both the "size-of-person" and "size-of-transaction" thresholds. The "size-of-person test" is met if one party to the transaction has $141.8 million or more in annual sales or total assets and the other has $14.2 million or more in annual sales or total assets. The "size-of-transaction test" is met if, as a result of the transaction, the buyer will acquire or hold voting securities or assets of the seller, valued in excess of $70.9 million.\(^{33}\)

The parties must wait a specific period of time, usually 30 days (15 days in the case of a cash tender offer or a bankruptcy sale), while the enforcement agencies complete their review. Any person filing an HSR form may request that the waiting period be terminated before the statutory period expires. Such a request for "early termination" will be granted only after compliance with the rules and if both the FTC and DOJ Antitrust Division have completed their review and determined not to take any enforcement action during the waiting period.\(^{34}\)

HSR filings are not public filings, although if the parties ask for early termination of waiting period and such early termination is granted, then that decision will be published by the government. In the event of a publicly announced deal, if a Franchisee, Franchise Advisory Council or independent Franchisee association were to contact the DOJ or FTC to determine which agency is reviewing the filing, the agency may direct such party to the appropriate agency. The DOJ and FTC are also willing to accept, and will consider, additional information from persons other than the parties to the transaction. Moreover, the DOJ and FTC may contact third parties to learn more about the deal, but there is no formal process for third parties to participate in the review.\(^{35}\)

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\(^{34}\) 16 C.F.R. § 803.11 (2013).

If either the FTC or the DOJ determines during the waiting period that further inquiry is necessary, the determining agency may request additional information and documentary materials from any person required to file notification. A second request extends the waiting period for a specified period, usually 30 days (10 days in the case of a cash tender offer or a bankruptcy sale), after all parties have complied with the request (or, in the case of a tender offer or bankruptcy, after the acquiring person has complied). This additional time provides the reviewing agency with the opportunity to analyze the information and to take appropriate action, if necessary, before the transaction is consummated. If the reviewing agency believes that a proposed transaction may violate the antitrust laws, it may seek an injunction in federal district court to prohibit consummation of the transaction.

In addition to the U.S. regulatory authorities, compliance may also be required for foreign governments (such as the European Union).

C. Purchase and Sale Agreement

As mentioned above, after the LOI is signed, two processes commence simultaneously: (i) due diligence (which is addressed in the next section of this Paper) and (ii) drafting of the closing documents. Whether the deal is a “stock” deal or an “asset” deal, the most critical closing document is the purchase agreement. While a comprehensive discussion of the scope and content of such Purchase Agreements is beyond the scope of this Paper, the following issues should be addressed in every such agreement with a buyer:

- Description of major assets of the franchise system (i.e., intellectual property, franchise agreements, development agreements, company-owned units (if any), vendor agreements (including manufacturing and supply agreements, if any), etc.
- Purchase price, contingencies and adjustments.
- Proposed closing date.
- Escrows and holdbacks (if any).
- Representations and warranties of seller and purchaser.
- Preparation of the “schedules.”
- Covenants of sellers and buyers
- Sellers indemnification obligations (limited by escrow or “cap”?)
- Limitation on the survival of seller’s representations and warranties.
- Continued employment of management and future business plan.

D. Other Closing Documents

In most acquisitions (including private equity deals), there are other closing documents, that must be drafted and negotiated. These will include disclosure schedules, as well as possibly a new stockholders agreement, management employment agreements, and

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management restricted stock agreement or stock option agreement (if applicable). Of particular note are the following:

1. **The Loan Agreement**

   Since most private equity deals involve re-financing of the Franchisor, new or revised loan agreements will need to be negotiated and concluded at closing.

2. **PE Group Management Agreement**

   In a transaction with a PE Group, the group will often require a separate agreement with the Franchisor under which the PE Group will be compensated for its role in overseeing the investment and providing advice, counsel and possibly some services (financial or otherwise) to the Franchisor, as well as re-imbursement for expenditures related to the business of the Franchisor, including travel to and attendance at board and/or management meetings. Often, these fees are limited or "capped" at the request of the Franchisor’s lender(s) to ensure that the PE Group is not draining the Franchisor of necessary working capital.

3. **Franchisee Estoppels**

   In order to better measure the health of a franchise system and mitigate potential risk after the deal closes (and the loss of the cash flow it was paying for), a buyer may ask that some or all current Franchisees sign estoppel agreements confirming the terms of their franchise agreements and certifying that the agreements are in full force and effect and have not been amended, and that they have no claims against the Franchisor. On the other hand, Franchisors will resist this process as it will alert the Franchisees of the proposed transaction in advance and might embolden them to assert claims to get concessions from the Franchisor at a time when they know (or think) that the Franchisor can least afford negative comments and/or actions from Franchisees. In the worst case scenario for the Franchisor, the Franchisees might respond with litigation in an attempt to kill the deal or get better concessions from the Franchisor before the deal closes. In either event, Franchisors will often resist agreeing to Franchisee Estoppels, insisting instead that the buyer get this information through the due diligence process.

VI. **DILIGENCE**

   A. **Franchisor Preparations for Due Diligence**

   As with any acquisition, the Due Diligence process is where the deal will be made or where it will die, and, therefore, both the Franchisor and the buyer, and their respective lawyers, must be totally engaged. For the process to go smoothly, the Franchisor must be prepared to pull together whatever documents the buyer and their lawyers request, whether it be on-site, at the Franchisor’s premises, or, with today's technology, through the use of a “Digital Data Room” (a secure website with limited access available to the buyer and its legal and financial advisors for a limited time period). Obviously, having lots of outside lawyers show up one day at the Franchisor’s offices can raise lots of questions from employees so the manner in which Due Diligence is done, and the degree to which employees are brought into the loop must be carefully considered. Also, in deals with PE Groups, which tend to be sophisticated buyers, there may be multiple levels of Due Diligence covering matters including: (i) franchise disclosure documents and state registration issues, (ii) franchise offer and sale practices, (iii) forms of franchise agreements and development agreements, (iv) trademarks and other intellectual
property, (v) supplier/vendor agreements, (vi) franchise broker arrangements, (vii) insurance matters, and (viii) pending and threatened litigation. These and other key issues are discussed in more detail below. Of course this is only the tip of the iceberg since PE Groups and other buyers will also do very extensive financial due diligence to confirm the existence and strength of the on-going cash flow from existing Franchisees, which forms the basis of the purchase price they are offering for the equity in the franchise company. From the Franchisor’s perspective, franchise files should be as clean as possible when provided to the buyer or its attorneys to review, and should include all original agreement, subsequent amendments, correspondence and documents related to current or prior disputes with the Franchisees.

Often the buyer will ask to speak to the Franchisor’s employees, vendors and possibly with the Franchisees themselves. This is always a dilemma for the Franchisor and often a point of contention in the due diligence process. Permitting access to these groups comes with inherent risk, especially if the deal does not close. On the other hand, limiting due diligence by prohibiting access could put the deal at risk. Every franchise system and every deal is different and the Franchisor must balance the risk of permitting the buyer to speak to Franchisees and vendors directly and/or whether there are alternative due diligence methods available for the buyer to get comfortable with the facts (i.e., pretense interviews by a third party not disclosing the pending transaction). Another sensitive issue is whether to give the buyer and/or their lawyers access to the files of the Franchisor’s in-house and/or outside counsel, where much of the information regarding pending and previous disputes may be found. Query whether permitting such review acts as a waiver of the attorney-client privilege? In any event, as critical as the due diligence process is in closing a PE Group investment or other sale transaction, it is a complicated, time consuming and often disruptive process that the Franchisor must carefully plan for and manage on a day-by-day basis. The more prepared the Franchisor is, and the more aware of potential deal risks, the better the chance is that the deal will close.

B. Diligence Goals for the Private Equity Group or Other Buyer

As previously noted, legal and commercial due diligence for a Franchisor target can be notably more complex and challenging than for a traditional corporate target. Atypical issues unique to Franchisors include compliance with federal and state disclosure, registration, and franchise termination laws, franchise quality control, and the Franchisor’s unique relationships with its Franchisees. Thus, a preliminary consideration for the PE Group or other buyer is whether to add to its transaction team franchise specialists, such as franchise counsel, consultants and accountants experienced with franchise systems similar to the target.

Other more common diligence items that, in many cases, take on greater significance in the Franchisor context can include the following:

1. Growth Assessment

The target’s ability to expand its franchise operations not only geographically but into complementary service or product lines should be considered. Regarding geographic expansion, the buyer should assess the competitive environment for the concept domestically as well as internationally. Are there practical or commercial limitations to territorial expansion (such as excessive competition with the concept in other markets, seasonal or climate considerations, or dependence on proximity to geographic features, such as bodies of water, mountains, etc.)?
As part of this analysis, the buyer should also look carefully at the target’s development agreements and investigate the development pipeline to confirm that the relevant parties are continuing to build out their territories in compliance with their agreements. The buyer does not want to be surprised after closing to find that the pipeline is significantly underperforming or otherwise unlikely to reach its potential.

In addition, a buyer should consider any legal obstacles, such as holders of similar trademarks that are senior to the target, or industry-specific regulations that may bar or otherwise significantly increase the costs of operations in certain territories.

2. **Assessment of Relationship With Management**

As is the case with any acquisition, the buyer will need to determine that, to the extent it is going to retain all or part of the current owners or management team, such retained employees will be a good fit for the target going forward. Specifically, the buyer should assess whether the owners and top managers can stay on in constructive roles and adapt to post-closing reporting and other oversight structures typically required by a sophisticated investors. Related issues that may come into play can include: (i) if any owners or management employees will retain ownership in the Franchisor, will they have minority protections, including approval rights for management decisions? (ii) Will they have day-to-day control? If so, the buyer will need to determine the level of oversight necessary to advance its agenda while not proving to be an obstacle to the management’s continued operation of the Franchisor.

In contrast to the above scenario, a key term of the transaction may be to facilitate the retirement of the previous owners and managers and transition of such duties to current management. If this is the goal, the PE Group or other buyer should be sure that there is a post-closing management transition / improvement plan that is viable and acceptable to the relevant parties prior to closing.

3. **Assessment of Relationship With the Franchisees**

With respect to the franchise network, because the Franchisor’s success is conditioned in significant part upon the success of the Franchisees, special care must be given to discovering the current state (and likely future) of the target’s relationship with these operators. This can be a sensitive subject, particularly with respect to a purchase by a PE Group, whose investment window overlaps with significant number of Franchisee renewals. There are a series of issues to be considered, such as:

a. Are there large or uniquely successful Franchisees with substantial influence or authority within the system? As a practical matter, is their “buy-in” needed for the success of the deal? If so, what should or could the buyer do to secure such buy-in?

b. The buyer should also identify Franchisee chief concerns (e.g., training, support, Franchisor personality, territorial threats, encroachment), and, where possible, conduct interviews with Franchisees (or top performers), any Franchisee association or advisory council. As noted above, the buyer should consider requiring estoppels from the Franchisees, subject to consultation with the Franchisor.
c. The post-closing relationship with Franchisees should be positive to help spur growth not only with the existing units but also through continued sales of additional units to existing Franchisees. The buyer should therefore understand limitations of scope and timing of significant system revisions, buy-backs / company-unit launches, enhanced monitoring and reporting / refurbishment and upgrades, which the group may view as necessary to achieve investment goals.

d. Franchisee compliance should also be considered from the relationship perspective. If the number or percentage of Franchisees failing to comply with minimum sales or other performance requirements is significant, it may suggest other issues, such as poor communications, support or other issues with the Franchisor that may take time and resources to address after closing.

e. In assessing Franchisee relationships, the buyer should seek to gain an understanding of the practical limitations of the target’s control (beyond contractual rights) over its franchise network. How efficiently can system changes be implemented?

4. Infrastructure Assessment

Efficiency in system operations and communications is a critical component to a successful and competitive franchise network. The buyer will need to assess what, if any, additional investment in infrastructure, such as with respect to information technology, back office systems and communications, will be needed to optimize operations and meet the buyer’s expectations. Alternatively, can the buyer merge these with its existing system? To the extent such updates will necessarily involve the Franchisees, the buyer should also consider the time and expense of the additional training and business disruption that this will entail.

5. Legal Assessment

While the buyer should strive to have a strong and comprehensive set of representations, warranties and covenants in the purchase agreement, particularly with respect to franchise matters, the buyer will be better served if it pursues all available opportunities to conduct its own diligence on the target (time and resources permitting). The buyer’s legal due diligence should not only assess to what extent the Franchisor has been challenged by its Franchisees or franchise regulatory bodies, but also identify risks of future actions or challenges or that risks otherwise may limit the Franchisor’s operational flexibility in the future.

a. Registration, Disclosure and Sales

Thus, the buyer should carefully scrutinize regulatory compliance over at least the past 5 years. This includes not only a careful review of the UFOC or FDD content, including retained receipt pages, but also careful review of the Franchisor’s sales practices, standard guidelines, advertising and related state filings, website notices and marketing practices. Counsel should be sure to advise their private equity or other buyer clients that approval by the state for purposes of registration does not foreclose the ability of the state (or Franchisees) to successfully pursue claims for violations state examiners may have previously overlooked.
b. Disputes, Litigation and Government Actions

Careful review of Franchisee litigation matters, settlement agreements, disputes, government investigations and formal actions, etc. will be a standard requirement in any diligence. Counsel should also be on the lookout for other disputes that could still significantly impact the business, such as with franchise brokers, suppliers and other vendors, or with owners, employees, lenders or other investors, or with government authorities, such as tax or industry-specific authorities.

c. Compliance with Franchise and Ancillary Agreements

The Franchisor’s obligations under franchise agreements can include obligations with respect to exclusivity, training, support, and advertising, among others, and with varying degrees of restrictiveness. Sometimes these obligations are fairly limited. Nevertheless, counsel should seek to get some idea of the Franchisor’s compliance with these obligations, to identify significant system wide problems or that may present challenges with respect to specific Franchisees. For example, is the Franchisor honoring its exclusivity commitments? Are there potential risks of encroachment claims? Are there significant indications that Franchisees have not received sufficient training or support? What steps has the Franchisor taken to advertise or promote the brand? How have advertising funds been spent? Any relevant correspondence assessing these issues requires not only review of the franchise agreements themselves, but also operations manuals and other policies or notices communicated to the Franchisees.

Counsel for the buyer should also assess the Franchisor’s quality control and enforcement practices. For example, limited Franchisee litigation may be the result of aggressive pre-litigation dispute resolution efforts that have resulted in a patchwork of differing obligations for Franchisees. Collectively, these efforts, while avoiding costly litigation, may nevertheless impair the system by restricting the buyer’s efforts at quality control and standardizing compliance enforcement.

Franchise counsel should be sure to review the Franchisor’s practices for documenting and approving transfers. Have the relevant parties complied with their respective obligations (and have releases been obtained from the transferors)?

Terminations or non-renewals should also be reviewed to assess risks of future claims. All correspondence regarding such matters should be reviewed carefully. Counsel should also investigate whether the bases for termination have been consistently applied throughout the system.

d. Contraventions

Although not common among franchise agreements, the buyer’s counsel should confirm that there are no restrictions on transfer of the franchise agreements or the Franchisor’s change of control. Counsel should be sure to identify similar restrictions on transfer in all supplier, vendor, lender or other agreements with the Franchisor to assess whether consents or approvals will be necessary and any obstacles they may present.

e. Intellectual Property Enforcement

Counsel for the buyer should undertake the necessary searches and clearances to determine whether the Franchisor’s brand is available in current and potential expansion
territories. As part of this analysis, counsel should determine to what extent there is widespread unauthorized use of marks similar to the Franchisor’s marks and what steps (if any) can be taken to strengthen the Franchisor’s rights in its brand. Internal company licenses, such as with an IP holding affiliate, should be reviewed and counsel should assess whether the parties have complied with the terms (quality control, royalty payment, etc.) to assess any risks to either the IP itself or the liability protections of the holding company.

Counsel may also want to investigate the Franchisor’s procedures for protecting its trade secrets and confidential information to ensure the Franchisor can enforce its rights if necessary and that it has acquired rights to all intellectual property generated by its employees or vendors (through inventions assignments). Any non-competition restrictions may also need to be reviewed to assess their enforceability.

f. **Franchisee Association and Advisory Councils**

The buyer’s counsel should also be sure to review the activities of any Franchisee associations or advisory councils as well as any related documentation, agreements, understandings, etc. to assess the role that such organizations play in the system. Specific issues for the buyer’s counsel to consider and assess are addressed in more detail in Section VI.C. below.

The goal of diligence should be for counsel to provide to the buyer a picture of the Franchisor’s past and current legal and contract compliance as well as to assess to what extent any risks exist and provide a reasonable estimate of the time and resources that will be required to address or minimize the risks following the closing. To the extent any risks are significant, the buyer may consider options to limit their exposure, such as by lowering the purchase price, or placing a certain portion of the purchase price in escrow pending resolution of such issues.

C. **Franchisee Engagement During the Diligence Period**

1. **Getting to Know You**

As the buyer’s personnel and professionals pore through piles of paper, perform projections, peruse portfolios and prepare protective policies, the buyer must appropriately appreciate the importance of the positions of the population of Franchisees. Rather than Franchisees and the buyer perceiving this portion of due diligence as a potential for perfidy and problems, the parties should perceive this period as one perfect for positive action.

Of course, the buyer will be critically scanning the individual and overall performance figures, checking for cash flow, and determining if there are any particular strong or weak areas of the system. But the due diligence of the buyer should hardly be limited to a sterile review of paper. Indeed, there may be certain Franchisees, or a group of Franchisees, whose numbers do not reflect the feeling those Franchisees have for the current system, or whether (or how) those numbers are going to be changed by the investment. Just as experienced counsel for a potential Franchisee advises his or her client to speak with as many Franchisees as possible before investing in the franchised business, so should counsel for the buyer advise the buyer’s personnel to personally connect with as many Franchisees as possible. By so doing, the buyer will be able to determine whether existing Franchisees will be a source of potential growth. Moreover, the buyer changes from being merely a distant, faceless entity, to a person, or a few people, with whom the Franchisee can relate. The buyer can set forth its strengths, tell its story, describe its plans, and (hopefully) dispel any myths and correct any misperceptions of the
Franchisees. At the same time, the Franchisee, by being consulted in advance, will appreciate the fact that the buyer is interested in more than just the Franchisee’s royalty stream and advertising fee contributions. [Obviously, in a merger situation, all parties will find it difficult to personally connect.]

In a private equity takeover, sale or merger, bringing the Franchisees into the decision-making process runs directly contrary to the mutual desire of the Investor (or purchaser or merging party) and Franchisor to keep the matter of a change in control under wraps. However, it could at least be argued by the Franchisees (and at least considered by the Franchisor), that Securities and Exchange Regulation FD (17 C.F.R. §243.100, effective October 23, 2000) will allow the Franchisor to share the takeover information with at least some of its key Franchisees, or its Franchise Advisory Council (“FAC”) or its independent Franchisee association, because the information must not be acted upon by the parties until the information is made public.  

More important, however, is that the buyer listen to the Franchisee. Franchisees can provide priceless insight into the Franchisor’s leadership, as well as its technical and operational personnel and systems. Even when the Franchisee is overly harsh or unbelievably enthusiastic, the buyer is learning something of value. What is it about the Franchisor or its system which would cause a Franchisee to be so pessimistic or optimistic?

2. Concerns of the Franchisee

The amount and nature of Franchisee contact will vary with the type of investment being considered. However, in all cases, every Franchisee, regardless of size or status, should view the buyer due diligence inquiry as a golden opportunity. Initially, the Franchisee may contact the Franchisor and attempt to obtain certain benefits or concessions, in consideration for a favorable report to the buyer. While meeting with the buyer, the Franchisee can express the concerns and ideas the Franchisee has, which to date may not have been expressed, which have not been appropriately dealt with by the Franchisor, or which may have been handled well in the past and which the Franchisee does not want changed. The Franchisee should not be too concerned with whether or not it is at that time a “major player” in the system. Sometimes, the buyer is more interested in building up the smaller or less important Franchisees, because, for various reasons, it does not want a large Franchisee to become too powerful.

a. The Marks

As previously noted, the Franchisee will want to know whether the marks or the system is going to be changed. Closely related to that concern is that of whether the buyer also has an interest in a competing brand. Even if a merger is not being considered, it is natural for Franchisees to believe that no good can come from this situation. Attorneys can identify with this concern. We immediately start thinking in terms of conflict of interest, i.e., what is good for one competitor can only hurt the other. However, in franchising, that is not always the case. A product or service developed or perfected under one brand may indeed help the other to prosper. Creative marketing options also become available. Mock competitions in products or community fundraising heighten awareness of both brands. Of course, if the buyer favors one brand over the other, or requires one franchise system to be used as a testing ground for the other, Franchisee concerns quickly morph into franchise system problems. It is incumbent upon

39 Meretta & Karp, supra note 7, at 122-23.
Franchisees to be as diligent as the buyer. Requesting Franchisor assurance is not enough. The Franchisee must ask the questions of and try to obtain some sort of reassurance from the buyer representative with whom the Franchisee is interacting.

b. Use of Funds to Assist Franchisees

Franchisees will want to know what is being done with the money and resources being supplied by the buyer. Is the capital being used for opening new franchised units? If so, will those units be in new markets, or will they be opened close to existing units? Franchisees will be particularly concerned if the funds are to be used for alternative sales (e.g., using internet, “big box,” supermarkets or wholesale outlets). Will the money be used for research and development, i.e., to improve existing products and services, or develop new products and services? Will the funds be used for additional advertising? If so, will such advertising simply be for marketing the sale of franchises, or will there be an infusion of additional funds to buttress regional or national consumer ads? Will funds be earmarked for national or regional Franchisee meetings?

Franchisees may well consider using the due diligence period to lobby for funding to be directed toward strengthening (and expanding) the existing system. Franchise finance attorney Dennis Monroe has identified several creative ways Franchisors can use private funding to support both franchise expansion (by Franchisors and existing Franchisees) without causing additional problems for struggling or stagnant Franchisees. One approach is to have a pool of money set aside to be loaned to new Franchisees or existing Franchisees wishing to expand. The repayment rights would be subordinated to other Franchisee debt, but would provide for a higher interest rate. The Franchisor benefits by realizing a favorable rate of return, increased royalties from additional units, and system expansion.

Another idea described by Monroe is for funds to be used for “buy-back” purposes, i.e., a certain amount of funds are set aside to buy back the assets of Franchisees in default or who are failing. There will be a set formula to ascertain the buy-back price, and a limit as to how many units can be bought back over a given period of time. By doing this, the Franchisor not only has a means of minimizing losses (or even making a decent return by reselling the assets), but also avoids the cost of termination and, all too often, resulting litigation. The Franchisor’s FDD will probably be a bit more palatable as well. Perhaps the idea can even be expanded to include the buy-back as a part of the franchise offering. When condominium developers were having difficulty selling units as a result of the recent real estate downturn, one developer boosted sales by guaranteeing a buy-back at a certain formula under certain conditions. Potential Franchisees and their counsel may well regard such a safety net to be the deciding factor in determining whether or not to invest in a given franchise concept.

3. Identify Franchisees to be Contacted

Unless the Franchisor has a small number of Franchisees, the buyer will usually be unable to address all of the Franchisees in the system. Therefore, during the duration of its due diligence, the buyer must not only determine the design of its discourse, but decide upon the identity of the Franchisees to whom it should direct its discussions. Accordingly, the buyer should consider speaking with a few members of the Franchisor’s franchise advisory council (“FAC”). Conversely, the due diligence period represents a tremendous opportunity for the FAC to propound the interests of the Franchisees. Counsel for the FAC may even advise the

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40 Dennis L. Monroe, Off Balance—Seven Ways for Franchisors to Lend a Financial Hand, FRANCHISE TIMES, March, 2013, at 63.
leadership of the FAC to reach out to the buyer representatives, or request authority to contact
the buyer’s counsel.

In a situation in which a sale, merger, co-branding or private-to-public ownership is being
considered, there is an increased opportunity to allow Franchisee knowledge and participation at
an earlier stage. This is particularly true if there is a FAC which is part of the Franchisor’s
system. If there is to be a merger or co-branding arrangement, and both Franchisors advise
their respective FACs of the possibility, questions brought up early on by the FACs may enable
the Franchisors to structure the deal in a way which will avoid the problems which might
otherwise arise. Indeed, it might even be a good idea to have members of each FAC meet with
each other, in order to flesh out any operational problems, correct misperceptions of each
other’s systems, products or brands, and even come up with ideas for cooperative advertising or
supplier discounts.41 Bringing in the FAC, or even the independent Franchisee association and
obtaining such organization’s consent or approval, may have the added benefit of short-circuiting
any litigation efforts of disaffected Franchisees who make a claim based upon a purported
breach of the implied covenant of good faith and fair dealing.42

41 Meretta & Karp, supra note 7, at 121, 122.


4. FAC Strategic Input

When a Franchisor is considering merging with or being bought out by a competitor, the
Franchisor will be concerned about discussing its systems and plans in detail, because if the
merger fails, the Franchisor could be at a competitive disadvantage. Accordingly, unlike a
private equity investment situation, in which there may be several meetings between the buyer
and the FAC representatives, there will probably be only a limited opportunity for a Franchisor’s
FAC representatives to meet with the buyer’s representatives when a competitor is involved.

Whether a private equity or merging buyer situation, it is likely that FAC counsel will meet
with the buyer counsel or representatives.

Before any discussions take place, FAC counsel and leadership should spend the time to
identify a limited number of each of the following categories: (i) Parts of the system which must
be protected or remain unchanged; (ii) parts of the system which require significant improvement
or radical change; and (iii) parts of the system which are woefully deficient and are beyond
reclamation.

In most cases, the FAC representatives are unsure of the effect private investment by the
specific PE Group, or acquisition by another buyer, will have upon the FAC, the Franchisees or
the system. However, if the FAC representatives are convinced that the investment transaction
will be anathema to the Franchisees and the franchise system, the FAC representatives (and,
perhaps counsel) will want to meet with the buyer’s representatives (and counsel) in order to
provide strong reasons as to why the buyer should abandon its investment plans. Such
reasons would include fundamental flaws in the system, the lack of growth potential, decisions
by well-performing Franchisees to not renew or extend their franchise terms, the relative strength
and growth of the market share of competitors, and increasing government regulation. FAC
counsel may even direct the buyer’s counsel to contact counsel of Franchisees who left the
system under unhappy circumstances, because those matters may not have resulted in litigation or anything else which would appear in an FDD or the Franchisor’s records.

The approach to be taken at the meeting is almost as important as the meeting itself. If the meeting deteriorates into a “gripe session,” the buyer may well discount the position of the FAC, and legitimate concerns and suggestions could be disregarded. If too many issues are raised, the FAC representatives run the risk of having the buyer representatives not realizing which matters are priorities. Unless the meeting is approached by the FAC representatives as a last ditch effort to ditch the investment plan, threats are of little value, and may indeed damage the FAC regardless of whether the investment transaction takes place. In the majority of cases, the goal of the FAC is to maintain or increase its presence in the franchise system. By presenting a limited number of points in a cohesive manner, the FAC representatives will increase their opportunity to have the positions of the FAC taken into serious consideration under the new or changed regime, and may even allow the FAC or its counsel to have a “seat at the table” as plans are finalized regarding the Franchisor’s use of the funds to be provided by the buyer, and its method of proceeding. In fact, the FAC may decide that it is a good idea to invite into the FAC Franchisees controlled by the buyer. The FAC counsel must keep in mind that, almost invariably, the FAC is and will remain a viable entity only as long as the Franchisor wants it to be. Accordingly, suggestions and recommendations, rather than demands, become the order of the day. Referring to the system as a whole will make a lot more sense than demonstrating an “us versus them” mentality. Failing to adhere to that approach may well yield one of two results: Either the investment transaction takes place with the condition that the FAC be disbanded, reorganized or disregarded, or the investment transaction doesn’t take place, and the Franchisor will blame the FAC (and perhaps its counsel).

5. Franchisee Association Input

An independent Franchisee association (“FA”) is, of course, different from a FAC. The FA’s very independence opens the door for all Investors to meet with the FA’s leadership. However, some things will not change. The buyer will still want to obtain information about the FA and its members, and try to determine if there are any problems which will indeed hinder the opportunity for the buyer to realize its goals, and the FA may indeed have the same agenda and goals of a FAC. However, counsel for the buyer knows that, unlike a FAC, the FA probably cannot be disbanded by the Franchisor. Accordingly, while the ultimate resolution of a problematic FAC could be the dissolution or reorganization of the FAC, the ultimate resolution of a problem between the FA and the Franchisor may be litigation. Buyers know that such litigation is not only expensive and distracting, but may serve to significantly erode the goodwill associated with the Franchisor marks.43 Therefore, the buyer’s short term and long term goals are threatened. There may be no instances of pre-investment litigation, but there is no shortage of instances in which several Franchisees or an FA threatened, delayed or prevented an investment or merger from being consummated.44 Nevertheless, even if the FA decides that it wishes to make things difficult for the Franchisor, FA counsel should be cautious about litigation as an option. The question should not only be “how can we stop or reverse this decision?” Counsel must also ask the FA members of what benefit is the stopping or reversing the process.

The fact that litigation may be expensive and goal threatening for the Franchisor or the buyer does not stop it from being just as expensive and goal threatening for the Franchisees, and,


44 Id.
often as not, the Franchisees are not as well situated to withstand or recover from such problems.

6. Competition, Covenants and Encroachment

When a Franchisor sells to a competitor, significant risks arise for the Franchisor. Almost invariably, when one competing Franchisor sells to another, there will be overlapping Franchisee territories. In those cases, one or another Franchisee may have to have its franchise agreement terminated or have the business relocated. If a Franchisee is terminated and is unhappy with the terms of termination, the Franchisee will undoubtedly make the full panoply of claims, i.e., breach of fiduciary duty, breach of the implied covenant of good faith and fair dealing, tortious interference with contract, and breach of contract, and even intentional infliction of emotional distress. Though not a guaranteed winner, the breach of contract claim is the strongest argument of the Franchisee.

Though Franchisors may try to argue that selling the entire chain is no different than making a decision to go out of business, such defense has generally not been persuasive--particularly if the Franchisor retains interest in another competing brand, remains in business in another capacity, or has received significant consideration for the sale of the business.

Since the Franchisor will not be able to sell franchises if its franchise agreement contains a provision which allows the Franchisor to terminate the agreement upon a sale or merger, how can a Franchisor wishing to sell or merge protect itself against a claim of breach of contract to be made by a Franchisee facing termination? First, the Franchisor should consider that the risk of disclosing to potential Franchisees the possibility of there being a sale or merger would be far less dangerous than the risk of facing the terminated Franchisee in court. Second, the Franchisor and the purchasing or merging entity could set aside funds to buy back or assist in the relocation of affected Franchisees. Third, the Franchisor may invoke the assistance of the FAC or FA to act as an intermediary.

Of course, the most effective means of avoiding the risk of litigation following termination would be to simply not terminate the existing Franchisee’s franchise agreement, and to allow the existing Franchisee to co-exist with the unit of the merging or purchasing party. Most franchise agreements now contain an affirmative right of a Franchisor to operate competing businesses under a different name within the Franchisee’s purported “exclusive territory,” and the right to sell the same name product or service under an alternate method of distribution. Accordingly, the Franchisor can allow the Franchisee to remain in business along with the other unit. The Franchisee can no longer claim that the Franchisor is breaching its own contract, and the Franchisee is left with pressing the less effective “good faith and fair dealing,” “fiduciary duty,” and “interference with contract” claims.

45 Lundy, supra note 22, at 102.


47 Lundy, supra note 22, at 103.

7. Supplier Relationships

One more item of concern to all parties should be whether the Franchisees, as an informal group, through FAC and Franchisor cooperation, or through an FA, has a special relationship with a supplier of an important product or component of the franchise business. (A typical example would be franchised window blinds systems.) If the buyer ignores the special relationship which the Franchisees have with the supplier, or is doing business with a competitor of the supplier, the buyer does so at its peril. Even if the Franchisees can be required under their franchise agreements to switch suppliers, the increased cost, loss of delivery priority and new payment terms may make Franchisees less profitable, or even cause Franchisees to fail. Special supplier relationships should accordingly be at the forefront of the mind of counsel to the FAC or FA.

8. Special Arrangements

Finally, Franchisees who have “unwritten understandings” or “special deals” with the Franchisor or an employee of the Franchisor, such as a regional operations manager or advertising advisor (or, as mentioned above, an important supplier), should take steps to try to have their respective understandings reduced to writing. There is hardly a guarantee that this can be done, or that, if done, such agreements will be binding or enforceable. Nevertheless, the Franchisee should attempt to protect such arrangements, which are often the difference between making a profit or operating at a loss.

VII. THE CLOSING AND BEYOND

A. Focus After Closing

1. Post-Closing Strategies

Once the deal closes, the buyer will need to work quickly to implement necessary changes to bring the Franchisor’s systems in line with the buyers. In the private equity scenario, the PE Group will need to quickly pivot to working with the Franchisor to establish internal reporting and management procedures. An overriding goal of the PE Group will be to implement changes as efficiently as possible with its focus on improving returns for its investors, ideally while establishing (or maintaining) a “win / win” balance for both the Franchisor and the Franchisees.

As part of this process, the PE Group will need to work with the Franchisor to establish broad performance standards and business development goals and timelines. Issues that may be considered could include whether to expand the system to new geographic territories; whether to change the mix of “company-owned” outlets versus franchised outlets (which could include buy-outs of existing Franchisees or conversions of existing company-owned units, as applicable); or reduction of capital expenditures by eliminating redundant systems and assets.

This planning should also incorporate the PE Group’s ultimate exit strategy for selling its interest in the Franchisor. Will the PE Group want to position the company for sale to another private equity firm? Will it seek to take the Franchisor public? Or, is there another opportunity

that may be under consideration, such as potentially selling the system to a Franchisee, competitor or other private buyer?

The parties will need to cooperate to assemble the Franchisor team to implement these goals and then the PE Group will need to formulate its own internal procedures for monitoring the Franchisor’s performance.

The PE Group will also need to keep in mind that its changes will likely result in a “new reality” for both the Franchisor operations and Franchisees. This may be particularly true if the company is a Management Owned Franchisor. In this case, the entrepreneurial founders, owners or managers will be adjusting to what likely will be a new culture and a much more professionally managed operation, which may take some time.

B. Post-Closing Strategies for the Franchisor

1. Short Term Considerations

Following the closing of the deal and the investment by the buyer, a number of short term actions need to take place including the following:

a. The “Announcement”

The deal and the new ownership structure must be formally announced to the employees, vendors and, most importantly, to the Franchise System. Considering the potential impact that this announcement may have on the System, the Franchisor might consider a separate announcement to the Franchisees prior to the public announcement of the transaction. It might also be beneficial to do the announcement via conference call or a webinar, where the Franchisees can be introduced to members of the buyer or PE Group and where there is time allotted for Q&A. A trial run with anticipated questions might also be considered to fully prepare responses to questions that the Franchisees are sure to raise.

b. New Ownership and New FDD/FA

Since the Franchisor has most likely been re-capitalized and a new credit facility has been finalized (i.e., new debt), and since other material changes may have taken place including addition of new directors and officers of the Franchisor, the FDD will have to be revised to reflect these changes. Note that, as discussed previously in this paper, if the buyer, including a PE Group, owns other Franchise companies, disclosures about these companies may also have to be added to the FDD as well as any changes to the Franchise Documents requested by the buyer. Also keep in mind that increased debt and diminished stockholders equity on the Franchisor’s new balance sheet might result in some State Franchise Examiners rejecting the registration and/or requiring that franchise fees be deferred or put in “escrow” until the franchised units open, or that the buyer agree to permit a cross-guarantee by an affiliate with stronger financials.

c. The Budget and Business Plan

In a private equity acquisition, one of the most significant actions the management team and PE Group must complete as soon as the transaction closes is preparation of the Franchisor’s budget for the remainder of the year and for the following year, as some assumptions and priorities may have changed from those of prior ownership. It is also important
to develop a short term and long term business plan so that management and the PE Group are on the same page as the development of the franchise system continues post-transaction. It is also a good idea to share some, if not all, of the business plan with the Franchisees to reassure them that the changes to the business, if any, will be beneficial to them, as well as to the new owners (the PE Group).

2. **Long Term Considerations for Private Equity Ownership**

As the management team and the PE Group settle in for business, a great deal of planning should be done to prepare for the continued growth and management of the franchise system, including the following:

- **a.** Elect new directors (if applicable) and define the role of the Board.

- **b.** Defining the respective roles of management and the PE Group (i.e., what matters must or should be brought to the PE Group? What process will be implemented for capital investments, acquisitions, changes to the franchise system, etc.). If the PE Group is not familiar with franchising, in-house counsel should educate them as soon as possible so they can be prepared if and when franchise specific issues arise. A lack of understanding of basic franchise law issues can result in significant, although inadvertent, mistakes that could have notable legal consequences.

- **c.** Define the PE Group’s “vision” for the system.

- **d.** Identify possible changes to be made to the system (e.g., financing program for Franchisees, new purchasing opportunities related to other companies owned by the PE Group, etc.).

- **e.** Decide what, if any regular contact the PE Group will have with the Franchisees (i.e., will it lead to potential “forum shopping” by the Franchisees or diminish the authority of management?).

- **f.** Prepare for negative reaction to the transaction by some Franchisees and potential litigation. Work with the PE Group to define the “Exit Plan” of the PE Group and incorporate it into the business plan. Decide if it should be shared with the Franchisees after consideration of the pros and cons of such an action.

3. **Considerations With Other Types of Buyers**

The above considerations may apply equally to other buyers of the Franchisor, although given the likely differing rationales for purchasing the Franchisor (i.e., other than primarily as an investment) the short and long term considerations may be different or more limited. For example, a strategic buyer may focus more on adapting the Franchisor’s systems to the company’s business model while quickly exploiting the Franchisor’s operations to enhance the buyers existing business. Similarly, a Franchisee buyer may believe that changes in the way the Franchisor manages its Franchisees provide the best opportunity for increased returns and may focus primarily on those aspects. Thus, the post-closing considerations will likely vary heavily depending upon the pre-closing strategies of the buyer.
C. Post-Closing Adjustments and Acclimation of the Franchisees

1. Franchisee Problems

Just as the PE Group (or other buyer, if applicable) and Franchisor will come to learn whether their projections and plans will be realized, so too will the Franchisees learn whether their concerns were validated and whether their situations and futures have been or will be materially changed. In the perfect world, in a private equity transaction at least some of the funds of the PE Group will be used for developing new products or services, the system will be growing with minimum encroachment, fresh advertising strategies will have been developed, and the amount of technical and operational support will have been maintained or increased. However, the world is not perfect. There will undoubtedly be some problems which Franchisees will face, and counsel for the individual Franchisees (regardless of size), the FAC or the FA, should be prepared for at least some of the following issues to arise:

a. Unhappy Franchisees

Some struggling or underperforming Franchisees will at best be the subject of benign neglect, or at worst, be the target of termination proceedings. The takeovers may not be limited to the Franchisees in dire straits; indeed, those Franchisees doing very well may have their operations or territories coveted by the newly reorganized Franchisor. Other Franchisees may find that they have new “neighbors,” i.e., Franchisees located within a short distance of their “protected” territories, or competitors inside their territories, doing the same business under a different name or mark. Some Franchisees who had “special understandings” or “verbal agreements” with the Franchisor or, as is often the case, the Franchisor’s regional operations manager or technical support team, will find that they no longer have such benefits, and have no recourse for their loss.

b. Strict Compliance Concerns

Sometimes, a buyer will insist upon strict compliance with a franchise agreement provision which had not been previously enforced. For example, many franchise agreements contain a provision that requires the Franchisee to submit quarterly financial statements, and that such statements be prepared in accordance with generally accepted accounting principles. However, many Franchisors will not insist upon such quarterly statements, or will only require such statements if the Franchisee has been in breach or is struggling to remain in operation. A PE Group or other sophisticated buyer, however, is much more likely to require strict compliance with such a provision, because it must monitor the various sources of cash flow or the strength of a given region of the Franchisor’s system. The Franchisee, arguably being bound by the non-waiver and other “boilerplate” protective provisions of the franchise agreement, will find itself spending time, money or both in order to comply, or choose not to comply and challenge the Franchisor’s ability to require such compliance.

c. Franchisor Distractions

It is also possible that the Franchisor, as a result of the transaction, now has additional responsibilities of its own. Whether such responsibilities are in the form of repayment terms under a loan agreement, reporting requirements, or promised cuts in payroll or other expenses, the Franchisor may find that its finances and resources are stretched to the extent that it is unable to provide needed services and support to the Franchisees, even if it is willing to do so.
2. Franchisee Options

In franchise situations, as in many business activities, early intervention is a significant factor in preventing a potential or small problem from becoming a large problem.\(^\text{50}\) It can be the difference between keeping a Franchisee’s unit compliant and healthy and being in breach or in the red. It can be the difference between a problem being limited to one or two Franchisees and becoming a system-wide disaster. However, if the Franchisor is distracted because of its obligations to a demanding buyer (usually a PE Group), or if the Franchisor’s executives do not want the matter brought to light for fear of PE Group disapproval or interference, the chance for early intervention is lost.

As a result of any or some combination of all of the above, some Franchisees may find themselves left with the choice of abandoning their franchised businesses or attempting to recoup their losses through litigation. If they choose to litigate, there are a variety of means to do so. Some Franchisees will make individual claims. That will often occur when a particular set of circumstances fits that Franchisee’s business. An example would be a claim of encroachment or cannibalization, based upon the Franchisor adding new Franchisees or competitors within that Franchisee’s territory.

Other Franchisees may be those who entered into or renewed their franchise agreements at or shortly before the Franchisor entered into the private investment agreement. They may claim that the Franchisor breached its duty of disclosure, based upon the FTC or state disclosure laws. Though the scope of this paper necessarily limits our treatment of Franchisee consideration to existing Franchisees, we would be remiss if we failed to point out that a Franchisor’s plan to sell the company or change its structure, if “reasonably certain to occur,” would have to be disclosed under both the Franchise Rule, FDD guidelines, various state acts and Section 5 of the FTC Act.\(^\text{51}\)

Franchisees who are new to a Franchise system and who are unhappy can also point to FTC staff opinions that a failure to disclose a possible merger or change in structure is a violation of Section 5 of the FTC Act.\(^\text{52}\) Accordingly, a Franchisee can argue that, even if the Franchisor who did not disclose a change may have technically complied with its FDD disclosure obligations, the Franchisor had a separate obligation to disclose under Section 5.\(^\text{53}\) There are also potential remedies for existing Franchisees in situations in which a Franchisor actively misrepresents or simply fails to disclose that it is planning to sell its franchised chain, even if the sale or change of ownership relates to a non-competitor.\(^\text{54}\)

Others may resort to claims of common law fraud.\(^\text{55}\) Other Franchisees, such as those unsuccessful claimants in the recent Hollywood Tans litigation, may claim that a buyer or PE

\(^{50}\) Michael S. Levitz, Kenneth P. Milner & Robert L. Purvin, Jr., Franchisee Representation and Recourse Beyond the Franchise Agreement, 30th Annual ABA Forum on Franchising, 33 (October, 2007).

\(^{51}\) See generally Meretta & Karp, supra note 7.

\(^{52}\) 15 U.S.C. §45(a)

\(^{53}\) Meretta & Karp, supra note 7, at 118, 119.

Group, either *ab initio* or fairly early into the investment term, decided that its best strategy would be to strip the assets of the system and thereafter allow the system to disintegrate.  

However, we can find no reported case of a Franchisee using litigation to prevent an influx of capital from a PE Group. Moreover, it should be noted that when a Franchisor sells its entire system to a non-competing third party, Franchisees have had little success in using litigation as a means of preventing the sale or being compensated for acceding to the change in the identity or control of the Franchisor.  

Whether the claims of the Franchisees were based upon the fraudulent misrepresentation that no sale would occur, a fraudulent failure to disclose an intent to sell, a duty of disclosure by the Franchisor, the purported purchaser’s tortious interferences with the franchise agreement, or a breach of a Franchisor’s fiduciary duty to the Franchisee, Franchisees have fared poorly in their attempts to obtain relief through litigation.  

Bringing, and maintaining, these actions requires a great deal of money and a willingness to pursue the actions through all sorts of preliminary motions in various venues. Therefore, Franchisees will often form a franchise litigation trust or use its Fair Assistance (FA) to prosecute the litigation.  

### 3. Restrategizing Exit Strategies

Every Franchisee, small and large, should have an exit strategy when the Franchisee initially invests in the franchise system. The appearance of a PE Group should be the catalyst for the Franchisee to re-evaluate that exit strategy. Such re-evaluation should take place only after the Franchisee has had the opportunity to fully evaluate the Franchisee’s situation under the changed circumstances, i.e., a few years after the investment. If the Franchisee did not already have an exit strategy, the appearance of the PE Group should be the trigger for forming one. In so doing, the Franchisee will have to consider all of the following: Will any of the Franchisor’s original personnel remain in the franchise system? Will there be increased competition, or will key competitors have become part of the franchised system? Are there new marketing and advertising strategies in place which should last well beyond the PE Group’s exit? Will the Franchisor be able to thrive (or survive) after the PE Group leaves? Have the value of the marks increased or decreased? By answering these questions, the Franchisee will be better able to determine if and when the Franchisee should exit the franchise system, and the strategy for such departure.  

### VIII. POST-MORTEM AND CONCLUSION

Whatever the reason, investors’, buyers’ and in particular, private equity’s interest in franchising continues to grow, even in the face of the recent economic headwinds. It is therefore a prominent factor in the assessment of any purchase or sale of a franchisor business for the foreseeable future. Indeed, developments over the past few years, such as the general reopening of lending after the great recession of 2008 and 2009, lower corporate debt rates and pent-up cash on hand that must be deployed, have continued to support private equity’s

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57 Lundy, *supra* note 22, at 94.

58 *Id.* at 96-100, Notes 5, 6, 7, 21, 27 and 28.
expansion into franchising, and there are no signs that private equity’s interest in Franchisors is tapering off. Instead, it appears that private equity will continue to be an option for Franchisor owners looking to raise capital or to take their businesses to the next level.

This Paper provides a series of considerations from the viewpoints of the third-party investor / merging company / purchaser, the Franchisor and the Franchisees on key aspects of the life cycle of an acquisition or investment, particularly as it relates to a private equity investor. Each stakeholder has different goals and preferred outcomes with respect to any such transaction, although there are certainly key areas where the parties’ interests are aligned. Nevertheless, given the different priorities and potential risks of significant change (for better or worse) that a change of ownership or similar transaction may bring, both the Franchisor and the investor will need to consider whether, at the end of the day, the transaction is worth the time, effort and investment of resources. Further, Franchisees will need to constantly assess whether this change’s impact on their business and anticipated returns is adding to or detracting from the value they have built up in their businesses and adjust their expectations and business strategies accordingly.