THE FUNDAMENTALS OF AN M & A TRANSACTION IN A FRANCHISE SYSTEM

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I. INTRODUCTION TO MERGERS & ACQUISITIONS

Over the past ten years the franchising landscape has dramatically changed. Where once the franchise landscape was populated by nascent individual franchise systems owned by their founders, today there are many franchise systems that have been consolidated or are now owned by strategic as well as private equity groups. As organic growth of franchise systems becomes more challenging, growth through acquisition or consolidation has become the norm.

This paper will address the core issues that form the basis for a merger and/or acquisition of one franchise system by another or the acquisition of a franchise system by outside investors or a combination of both. In addressing this issue, the topics that will be explored, include: what motivates franchisors to acquire other systems or to be acquired; what a buyer should consider when finding a target; how transactions are structured; due diligence considerations; what issues generally arise during a transaction; and, what should be considered when operating a franchise system post-acquisition. These issues are all interrelated and should be considered together when determining whether a transaction is viable for both the purchaser and the seller.

II. IDENTIFYING THE ACQUISITION TARGET

There can be many reasons that precipitate a desire to sell or purchase a franchise system. A primary motivation for the founders seeking to sell their system is the ability to realize a significant return on their initial investment in the franchise concept. Additionally, as the franchise system evolves often the founders come to understand that they are not suited to take the system to the next level, whether that means accelerated growth domestically or internationally or growing the product or service offerings. Conversely, a purchaser may determine that a purchase of another franchise system, competitive or otherwise, may be the solution for in-filling markets where the purchasing company has not been able to grow organically. A purchaser also may determine that its franchise structure presents management with a platform to operate multiple systems, either in the same or different product or service category. The reasons supporting an acquisition of a franchise system are legion. These decisions are often driven by the immediate needs of the particular system, which will in turn dictate what a purchaser or seller will seek from its sale and how it will seek and identify the proper acquisition candidate.

The opportunity to complete an acquisition or the sale of a franchise company will be viewed from different sides of the same prism based on whether one is the buyer or the seller. Will the franchise system that the purchaser wishes to acquire provide it with a sufficient return on its investment? Conversely, for the seller, can the seller obtain an acceptable price? While the buyer and seller will conduct different analyses, they both will analyze the health and future prospects of the target franchise system.

In identifying a target the first thing that a purchaser will do is to examine the market for the products and services of the franchise system it seeks to acquire. How will the market change and how fast will this occur? If a buyer acquires a particular franchise system it will be critical for the buyer to understand the future of the market for the products and services that are

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1 The authors would like to thank Ted Pearce, Vice President and General Counsel of Driven Brands, Inc., for his assistance in drafting portions of this paper.
at the core of the system it intends to purchase. Additionally, understanding the specific market will better enable the buyer to determine the level of investment necessary to be able to realize a specific return on its investment. A purchaser may seek to purchase a heritage brand, which is to say a brand that has a powerful and historically recognizable trademark, but the system may need to be materially refreshed. In that situation, the purchaser should understand that substantial investment will need to be made to the basic infrastructure of the system and should consequently seek a substantial discount from the asking price.

Alternatively, a purchaser may seek a younger franchise system that has tremendous growth opportunities and a strong track record. The price may then be dictated by what the growth potential is of the particular system. By the same token, a purchaser may seek to add multiple young brands to its stable of brands to balance its portfolio of older and more established brands. Identifying the type of target will be dictated by the purchaser’s business strategy. Whatever the type, there will be some common characteristics in all types of targets.

After making a determination that the state of the industry for a particular franchise concept meets the acquirer’s threshold, in most cases the purchaser will identify and evaluate the particular franchise systems that may be available. Whether a perspective purchaser shops using an investment banker or through its own search, the characteristics are the same.

The first thing that a purchaser should look at is the number of units and their geographic location. Are the units primarily old or new? Do they maintain a similar look and size throughout the chain? Review the franchisor’s franchise disclosure document (“FDD”) to understand the franchise offering. An acquirer should review the FDD in many of the same ways that a franchisee prospect would look at the document before deciding to join a franchise chain. What is the age of the system? How many units does the system operate? What are the ages of the individual units? How many franchises were sold during the last three years? How many franchisees left the chain, and for what reasons? What is the renewal rate over the past five years?

The acquirer also will want to carefully review the franchisor’s financial statements. The accountants will review the earnings to ensure that what is shown on the statements is in fact true. But one also will want to look at the character of those earnings. What is the major source of the target’s income? Do the vast majority of the revenues come from royalties, initial franchise fees, or product sales? The question for the acquirer will be whether these income streams are sustainable after the purchase. A close examination of the financial health of the target is paramount, especially if the purchaser requires financing to complete the purchase of the target franchise system. What amount of leverage can the target handle and at the same time continue to achieve its business plan or financial model? In some cases this may be the first time that the franchise system has been leveraged and therefore the target must be able to generate cash flow sufficient to sustain both operations and the annual debt service. Any financing will be accompanied by a substantial credit agreement that will require the franchisor, among other obligations, to maintain its financial operations within certain financial ratios, and to sustain certain target earnings or EBITDA (earnings before interest, taxes, depreciation and amortization).

In ascertaining whether a target is financeable, a potential banker will assess a number of components of the franchise system to determine if the system can support long term financing. If the franchisor is involved in maintaining a leasehold position on the various unit locations, a banker will want to review and analyze the terms of the various leases. With respect to these leases, the purchaser, as well as its banker, will want to understand the lease
turnover rate. A lease that shows significant churning will be viewed negatively for financing purposes. The leased locations also will be examined to determine if the locations are located in healthy or declining markets. Another question often asked by bankers is whether there are any environmental issues. Certain types of franchise systems, such as automotive repair facilities, may require a more in-depth environmental analysis. All of these issues will go into the calculus of whether the target is financeable, and specifically in determining at what interest rate and how much will a lender be willing to finance.

The acquiring company, as well as its potential financier, will look at the health of the relationship between the target and its franchisees. An acquirer will want to know how many franchised units have been terminated over the past three to five years, and the franchisee renewal rate. A chain that shows a high turn-over or churn rate may not be as attractive to an acquirer that is looking to replicate and increase the then-current cash flow. If the acquirer is looking to rejuvenate a heritage brand, the acquirer may be more willing to purchase the chain with a less stable franchisee base believing that it will be able to reverse the turnover with a newer business model. Of course, the purchase price will reflect this instability. How about the financial health of the franchisee? Are they struggling to make it or doing fine?

Another important analysis to be undertaken by a potential acquirer is the company’s ability to leverage its existing infrastructure to integrate the target. In other words, what synergies will the acquirer be able to realize from the acquisition? In plain and simple language, what duplicate costs will management be able to cut out of the existing system after the acquisition? The easy cost cutting measures likely will come from combining much of the back-office operations, such as legal, accounting, and corporate administration. In addition, there may be a certain amount of value in combining real estate, training functions, franchise development, and possibly advertising. The caveat to taking advantage of these synergies is to ensure that they do not dilute the operations of the target. The acquirer’s management team will need to take a hard look at whether, for example, combining two competitive chains’ advertising will result in a reduction of meaningful advertising for one or both of the chains. If the franchise sales departments for two franchise systems are combined, this could result in sales personnel focusing their efforts on the franchise system where it is either easier or more profitable to sell franchise opportunities, thus potentially causing harm to the “less favored” franchise system. In essence, while focusing on synergies as a means to increase the ultimate net cash flow for the acquirer, these synergies must be analyzed from a long term-perspective in the context of what the acquirer’s goals were when deciding to make the acquisition. As will be discussed later, once the acquirer purchases the target, management will have to govern it for the ultimate benefit of the franchise system, less they risk destruction of the assets that they purchased. It is not uncommon for an acquisition to be driven by the financial benefits to be realized by each party resulting from the actual sale; what sometimes gets lost in the transaction is the realization or attention to the details of running the target on a post-acquisition basis.

Another key analysis in identifying a potential target is to review the location of the target’s existing company-owned and franchised units. This becomes especially important if the buyer is acquiring a system that offers products and services that compete with the buyer’s current system. Here the purchaser will need to overlay the location of its centers with the target’s locations. Is the acquirer planning to run parallel systems, combine the two systems, or operate co-brands if there are complementary products and services? There are distinct consequences surrounding each of these strategies. If the purchaser seeks to run parallel systems, that may require that it keep the systems separate. In that situation, the acquirer may need to run parallel operations, real estate, and franchise sales departments post transaction. Running parallel systems may in fact interfere with the synergies that the buyer wishes to
accomplish from the transaction. By the same token, if the purchaser wishes to combine both systems, management will have to address how such combination affects the territorial exclusivities granted to the franchisees of the existing franchise system. The result of the combination may require the franchisor to buy-out existing franchisees in either the target or the acquiring chain in order to maintain the territorial integrity of the two chains.

Likewise, the target may offer complementary products and services to the existing chain that would result in being able to capture more customers who would ordinarily go to two different establishments to obtain the different products and services. A “combo unit” may be a great way for existing franchisees to increase their revenues by not only attracting customers for the multitude of products or services but also enable the franchisees to realize synergies of their own such as having a single unit to offer the products and services instead of two. As part of the overall due diligence that is conducted in the transaction, which is discussed later in this paper, close attention will need to be paid to the governing documents of each franchise system including the FDDs and the franchise agreements.

Identifying a target will be a direct function of the acquirer’s business strategies. In some cases, the acquirer may be looking for another source of EBITDA to satisfy its investors. Another reason may be to fill in a geographic area that a franchisor has been unable to penetrate for a variety of reasons. In addition, a specific acquisition may be found opportunistically, which is to say that the transaction appears to be too good to pass-up. By the same token, the selling franchisor will market its system by playing into the needs of the potential suitor, and therefore emphasizing the particular advantages to meet the various special needs of the suitor. The strategy of marketing a franchise system may best be left to the investment bankers. They will have the experience of how to market the strengths of a particular franchise system. As just one example, an investment banker may help the potential suitor understand the significance of a franchisor’s cash flow that employs very few assets. In that regard, the cash flow of a franchisor may be more valuable than a similar cash flow of a manufacturer, which likely will require a portion of its cash flow be reinvested on a regular basis in its plant and equipment in order to remain competitive. Most every franchise system can be marketable to a potential suitor depending upon the goals and needs of that suitor. It goes without saying, a franchise system with an established and growing cash flow from the receipt of on-going royalties is one of the most attractive targets for any would-be suitor.

III. PREPARING THE CONFIDENTIAL INTEREST MEMORANDUM AND NEGOTIATING THE LETTER OF INTENT

When engaging in a purchase or sale of a franchise system, the seller will likely prepare, and the purchaser will want to see a confidential interest memorandum, which will describe the target, the target’s industry, and provide a financial statement and financial model of the company. These memorandums or marketing pieces, which can be over 100 pages in length, are meant to provide an overview of the target and to give the purchaser an ability to commercially “kick the tires” of the target. Be mindful that before the purchaser will be able to view the confidential interest memorandum, and sometimes before the target is identified, management will need to execute with the seller, or the representative investment banker, a non-disclosure and confidentiality agreement. Most of these documents are similar in substance, if not form. The confidentiality agreement will require the receiving party to agree to the confidentiality of the information that they are receiving and also will likely require the recipient to agree to keep the name and financial data of the target confidential. This last point is extremely important because the seller does not want to reveal, until absolutely necessary, the fact that its franchise system may be up for sale. Of course this fact is greatly important if
the selling franchisor is a public company, but even if it is privately held, a premature identification of the target may cause great commotion and anxieties within the franchise system. Whether the fact that a franchise system is “up for sale” triggers a FDD disclosure requirement must be considered and will be addressed in more detail later in this paper.

While not every sale of a franchise system will demand a letter of intent, the document can be a valuable tool for both the buyer and seller. The seller may wish to go right to a binding sales agreement, since its primary concern is receiving the purchase price from the sale. However, from the purchaser’s standpoint, the letter of intent can do more than describe the terms of the sale. The purchaser will want to include a provision granting it a period of exclusivity. While an exclusivity agreement may be a separate document or agreement, it is very common to see an exclusivity provision in a letter of intent. Even if the letter of intent is written as a non-binding document, there are likely to be certain binding provisions within the letter, including the exclusivity period. The authors have included a sample letter of intent as Exhibit A to this paper.

The due diligence phase may take anywhere from 15 to 90 days and beyond. The time frame will be determined by the complexity of the transaction, the size of the system, and the level of interest the buyer shows in completing the transaction. As discussed later in this paper, conducting due diligence is a daunting task that requires the buyer to assemble a sizable legal, operational, and accounting team to review all aspects of the company or assets being purchased. Consequently, time, effort and money will be expended by the purchaser. From its standpoint, it does not want to undertake this aspect of the transaction if it knows that the seller is continuing to market and take bids from competitive bidders.

The time and scope of the exclusivity provision may be hotly negotiated in this phase of the transaction. As you would expect, the purchaser will want a longer time while the seller seeks the most abbreviated timeframe that it can obtain. The exclusivity provision may require the seller to cease marketing as well as taking bids from others in order to give the buyer a solid chance to complete the transaction without interference or allowing the seller to play the purchaser’s preliminary bid against other suitors.

While the purchaser will want the letter of intent to contain an exclusivity provision the seller is not going to agree to one without receiving something in return. The quid-pro-quo likely will be an agreed upon sales price. The process for establishing the price could consume its own paper. There are numerous methods of determining a sales price, including using a price multiple of the assets being sold. However, the most common method used to establish a sales price for a franchise system is for the parties to agree upon a multiple of EBITDA. What the actual multiple will translate to will depend upon many things, including the availability of credit to purchase the target. The price multiple also will be driven by the market and the history experienced in the sale and post sale performance of other franchise systems in general, with a special focus on franchise systems that are in the same industry as the current target. Another factor taken into account when establishing the multiple includes what percentage of, or how many times, annual earnings a creditor will lend the purchaser to purchase the target.

If the buyer is purchasing the target for cash without the need for third-party financing, the purchaser will be in a position to assert more leverage in the transaction. A well financed purchaser will have a greater opportunity to dictate the term and structure of the exclusivity clause in the letter of intent. In establishing the sales price for the purchase of a franchise system, the quality of the earnings used will be of great importance to the purchaser. As discussed earlier, the purchaser will want to understand the nature of the earnings generated by
the target franchise system. Are these earning loaded with initial franchise fees because the target has undergone tremendous growth, which may not be available to the purchaser? On the other hand, are the earnings dependent on continuing franchise fees from a mature system with fewer years left on the franchise contracts and a spotty history of renewing franchisees? There are countless questions that the purchaser will need to ask the target and will need to include in its due diligence examination. Suffice it to say that the purchaser and its investment bank will be put to the highest business judgment in establishing the sales price.

It is not uncommon for the sales price to contain language regarding post-sale adjustments to take into account the working capital available to the buyer at the time of the closing of the sale. In essence, this post-closing calculation will take into consideration many short term working capital components such as the payment of accounts receivables, accounts payables, refunds of initial franchise fees, and other adjustments of short term assets and liabilities. The letter of intent may contain an agreed upon working capital target post-closing, which if not met will require a post-closing adjustment to the originally agreed upon sales price. The time period for making post-closing adjustments usually extends up to 90 days after the closing of the transaction.

In examining the purchase of a target, the purchaser will examine the synergies that it may be able to realize post-closing. From the purchaser’s standpoint, it will not wish to include these money saving possibilities in the calculation of the sales price. Conversely, the seller may try to factor into the sales price cost savings for the purchaser, which is likely to result in an adjusted EBITDA number that will translate to a higher sales price when multiplying it by the agreed upon earnings multiple. The identified synergies could include a whole host of annual expenditures, including saving the salaries of certain corporate officers, as well as eliminating expenditures for planes, boats, and other personal items that likely will not continue post-sale.

In establishing the sales price the parties likely will want to agree upon a hold-back provision. This hold-back is intended to insure that money is available to the purchaser to cover indemnification items resulting from third party claims or from breaches of representations and warranties in the purchase agreement. The need for a hold back will be obvious to the purchaser who reasons that at closing the seller is not likely to keep the money in one bank account available to the purchaser as is necessary. Instead there may be multiple selling shareholders who will doubtless have other plans for their proceeds, other than to keep them available for a purchaser seeking to recover a post-closing indemnification claim. The length and time frame for a hold-back will be specifically negotiated between the purchaser and seller. In addition, the parties will also have to agree whether the hold back is to be kept with a third-party escrow agent necessitating a third party escrow agreement. It is not uncommon to see hold-back amounts equal as much as ten percent of the sales price and the hold back period to last as long as eighteen months after the closing.

Other components of the letter of intent will likely contain the structure of the sale, including whether it will be a stock or asset purchase. Other topics will generally include the time frame for negotiating the binding purchase agreement, how the purchase price is to be paid, and any other financing or other contingencies relevant to the sale.

A final provision that may find its way into a letter of intent is a break-up fee. This fee represents compensation for the damages that a seller would suffer if the purchaser does not carry through with the purchase of the sale. A breakup fee may be triggered by a number of reasons, including failure of the purchaser to obtain financing or as the result of issues discovered in due diligence. While break-up fees are not always included in the sale of a
franchise system, they constitute a provision that the seller may want to keep in its quiver and one that both parties should remain conscious of.

Another provision that will be important in a letter of intent to purchase a franchise system is the availability of visiting or interviewing representatives of the franchise system. Without a doubt, the purchaser will have a need to investigate or analyze the health of the franchise system. How much access they will be granted to the franchisees of the target will be of concern to the seller who will fear that too much access may cause unnecessary disruption and also could signal to the franchisees that a sale of the system is afoot.

The letter of intent is an important element in the process of selling a franchise system. It not only covers certain very important matters that cannot wait to be addressed until there is a binding purchase agreement, but also it provides both parties with a road map regarding how to proceed with the complexities of the sale of the target franchise system.

IV. STOCK VS. ASSET ACQUISITION

One of the first decisions that an acquiring company must make when examining a potential acquisition is whether to acquire the stock of the target company or to instead merely acquire the assets of the company. This issue should be considered even before an initial offer is made to acquire the target company because the structure of the proposed transaction will be a critical element to address in the proposed letter of intent. Each approach has benefits, risks, and significant tax consequences to both the buyer and the seller. This section examines each option, and the attendant tax consequences.

A. **Stock Acquisition.**

In most cases, the easiest and the cleanest approach to structure the acquisition of a franchise company is for the buyer to acquire all of the stock of the target company. By doing so, the buyer is acquiring the existing company intact. This enables the buyer to continue to utilize the franchise company’s existing audited financial statements and continue offering and selling franchises through the transaction and after the acquisition is complete. This approach also avoids the requirement that the franchisor “go dark” after the acquisition is complete while a set of audited financial statements are prepared for the new entity and the new franchise entity secures initial registrations of its FDD in the relevant registration states. Instead, in a stock purchase, the target company’s disclosure document and state registrations merely need to be amended to reflect the new owner of the entity, as well as the change of its financial circumstances. If the stock acquisition occurs at the parent company level, the franchisor may not be required to make any changes to the disclosure document or to amend its registration filings. Finally, because a stock sale effectively leaves the existing entity in place, this strategy enables the franchise company to continue to take advantage of any registration exemptions available to large franchisors.

A stock acquisition is not without some risk. The acquiring company takes control of the assets of the target company, but also generally assumes all of the liabilities owed by the acquired entity (except those that are specifically excluded). Some of these liabilities may not be fully disclosed to the buyer, and in some cases they may not even be known by the management of the acquired company. In other cases, the liabilities may be contingent, but the contingency could be significant if the liability mature. In a stock acquisition, there is no real way for the buyer to avoid taking on both known and unknown liabilities of the target company. The best way for the acquirer to insulate itself from unknown or
undisclosed liabilities is to negotiate a strong indemnification provision into the purchase agreement, and to ensure that the indemnifying party retains sufficient assets to be able to cover its indemnification obligations in the event the buyer needs to make a claim. Of course, the risk is that the seller will have exhausted its assets prior to the time the buyer has to make a claim for indemnification. In such instances, the buyer may find that it is saddled with liabilities that infringe on its ability to execute its growth plan for the acquired entity. In a worst case scenario, the liabilities may be so significant that the acquired company is forced to reorganize its debts under Chapter 11 of the bankruptcy code, or even to liquidate its assets.

B. **Asset Acquisition.**

On balance, many buyers prefer to acquire the assets of a target company, rather than the stock. The primary reason is that in an asset acquisition the buyer can pick and choose the assets it wants to acquire and the liabilities that it is willing to assume. Most asset purchase agreements include a provision that states that any asset or liability not expressly included in the agreement is excluded by the parties. This generally allows the buyer to avoid assuming any undisclosed or contingent liabilities of the seller.

The downside for the buyer is that an asset acquisition usually requires the buyer to place the assets in a newly formed entity. Because the entity is new, state and federal franchise laws require that the entity have a new opening balance sheet audit prepared and that the entity obtain original registrations. This means that the new franchisor entity will be prevented from offering or selling franchises in all states until the audit is complete, and from offering or selling franchises in registration states until the state registration permits are issued. The new entity will also not be able to take advantage of any state-level large franchisor exemptions because such exemptions require an extended period of operating history.

C. **Tax Issues.**

One of the primary concerns of both buyers and sellers in determining whether to make the acquisition a stock acquisition or an asset acquisition is the tax ramifications of the sale. In this respect, the primary goal of the seller is to minimize the tax its shareholders must pay on the gains they receive from the sale. The primary goal of the buyer is to structure the transaction to step up the value of assets acquired in the transaction. These goals are often in conflict, and generally are mutually exclusive. In other words, if one side receives favorable tax treatment, the other side often pays more in taxes.

These tax issues can be particularly acute in the acquisition of a franchise system. Most franchise companies do not acquire and maintain significant tangible assets. Instead, the heart and soul of a franchise company is its intangible assets – the trademark, system, and franchise agreements. In most cases, franchise companies do not have to spend significant dollars to build this asset base and, as a result, the basis in these assets is generally fairly low. However, because these assets can generate significant net cash flow in a franchise system, a buyer is often willing to pay a hefty premium over the net asset value of the company in order to complete the acquisition.

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2 States with large franchisor registration exemptions that require a period of operating history include California, Illinois, Indiana, Maryland, North Dakota, Rhode Island and Washington. See CAL. CORP. CODE § 31101; ILL. ADMIN. CODE tit. 14, § 200.202(e); IND. CODE § 23-2-2.5-3; MO. CODE REGS. 02.02.08.10; N.D. CENT. CODE § 51-19-04; R.I. GEN. LAWS § 19-28.1-6; and WASH REV. CODE § 19.100.030.
In the case of a stock sale, the shareholders pay tax on the difference between their basis in the company’s stock and the net proceeds they receive from the sale.\(^3\) By selling stock, rather than assets, shareholders can take advantage of the long-term capital gains tax rate, which is lower than the ordinary income tax rate. This long term capital gains tax rate is available to any shareholder who held shares longer than one year.

For the buyer, a stock acquisition is generally not as beneficial. In a stock sale, the value of the assets is generally not adjusted after the sale because the acquired company remains a separate taxpaying entity. Instead, any premium paid by the acquirer is treated as an additional investment in the company.\(^4\) While this means that the acquiring company will have a basis in its stock equal to the price it paid for the stock, it will not receive any tax benefit for stepping up the value of the assets.

The opposite is true for the buyer in the case of an asset acquisition. Because a new tax-paying entity is formed to own the assets, the buyer can step up the basis of the assets in accordance with the price paid to acquire the assets. This enables the buyer to begin new depreciation and amortization periods for the assets, and to depreciate or amortize the assets at the higher value.\(^5\) As a result, the tax benefits to the acquirer can be significant.

After the sale of all or substantially all of its assets, the selling entity is left with a significant amount of cash. If the entity is a C corporation, it must pay income tax (at the corporate level) on the difference between the basis of the assets and the proceeds received from the sale.\(^6\) It might then distribute the remaining cash to the shareholders (or perhaps retain some or all of the after-tax proceeds if the entity anticipates starting a new business or redeploying the proceeds in some other way). If the entity does distribute proceeds (after due accounting for entity liabilities and taxes), the distribution is considered a dividend for tax purposes to the extent the distributing company has adequate “earnings and profits” (which is likely in the context of a post-sale distribution unless there are significant net operating losses to be accounted for first).\(^7\) The shareholders will be subject to tax on an individual basis to the extent the distribution is made from adequate earnings and profits; under current law, the distribution would be taxed at 15% if from a domestic company, though the law may be changed by Congress for future tax years. If the entity is instead fully liquidated (that is, all its remaining net assets – cash here – are distributed in complete liquidation and wind-up of the entity), then the shareholders may or may not be able to pay taxes on the liquidating distribution at the long-term capital gains rate depending on their personal tax positions and the length of time they held the shares. Regardless, the shareholders end up paying double tax when the assets of the franchise entity are sold and they receive a distribution of the sales proceeds.

In some cases, the acquiring company wants to acquire the stock of the target and at the same time receive the step up in basis and other tax benefits of an asset


\(^4\) Id. at 192.

\(^5\) Id.

\(^6\) Id. at 184.

\(^7\) Id.
acquisition. In such case, the acquiring company can elect to have the stock acquisition treated like an asset acquisition for tax purposes under IRS Code Section 338. An election under Section 338 (h)(10) has the effect of adjusting the basis of the new entity’s assets to reflect the price paid for the stock. In the eyes of the IRS, “the acquired corporation is treated as though it sold all of its assets for a price equal to the price paid by the buyer for the stock and simultaneously repurchased the assets for the same price.”

This election enables the newly formed entity to step up the basis of its assets and to reset the depreciation and amortization schedules. However, the new entity must also recognize any gain from the deemed sale of the assets and pay income tax on the difference between the newly assigned value of the assets and the adjusted basis of the assets before the sale. Even though a tax on the gain is paid in the year in which the election is made, some companies make this election because an amount greater than the tax can be recovered in future years through increased depreciation and amortization deductions. This is particularly true if the buyer anticipates that tax rates will increase over time or Congress has amended the tax code to provide for accelerated depreciation of certain asset classes.

The IRS requires that a number of conditions must be satisfied before an acquiring company can make a Section 338 election, and therefore this approach may not be available under all circumstances. Another issue to bear in mind is that the target corporation is treated as a new tax paying entity after the deemed sale. As a result, all of its former tax attributes, including “its earnings and profits, net operating losses, tax credits, or other carryovers, are lost forever.”

V. CONDUCTING DUE DILIGENCE

A critical part of any acquisition of a franchise company is the due diligence process. Most failed franchise acquisitions die in the due diligence phase, often because the acquiring company learns one or more facts about the target that were not readily apparent at the letter of intent stage. The due diligence process is the one time that an acquirer can get a free look “under the hood” of a franchise organization. The time period for due diligence is often limited by the terms of the letter of intent or the purchase agreement, so it is critical that the acquisition team and its lawyers are as efficient and effective as possible. This section addresses some of the key aspects of a franchise acquisition that should be given particular attention during the due diligence process. This section highlights some of the most common due diligence issues addressed in the acquisition of a franchise system. It is by no means exhaustive, and there are many other issues that should be reviewed in the sales process. The authors have also included a sample due diligence check list as Exhibit B to this Paper.

A. Franchise Disclosure Documents and Franchise Agreements.

A prospective buyer can learn a lot about the target entity by reviewing the company’s FDD and franchise agreement. Of greater importance in the due diligence process, the buyer needs to carefully review how the document has evolved over time. In that context, the buyer should request black lines of the beginning and ending version of the

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8 Id. at 190.
9 Id. at 193.
10 Id.
disclosure document for each year to be examined during the due diligence period. The buyer should also request a black line highlighting the changes made during each fiscal year examined. Buyer’s counsel should review the various black lined versions carefully to determine what changes were made to the document, when the changes were made, and why the changes were required.

The buyer should also conduct a fairly exhaustive review of the files of current and former franchisees dating back at least six years. This review should confirm that all required documents are included in each file, identify any documents not available, and analyze any disclosure or other legal violations. In the case of violations, the buyer should assess the nature of the violation and determine the risk that the system might face as the result of each violation. In some cases, the buyer may want to insist that the current owner resolve outstanding issues with the franchisee prior to consummating the transaction. This may include offering rescission to the franchisee, agreeing to a mutual termination and the waiver of the franchisee’s non-compete agreement, or reaching a monetary settlement in exchange for a full release.

The analysis of current franchise files should also examine the state of relationships with existing franchisees, paying particular attention to any disputes that currently exist or may be brewing. It is critical that the buyer understand the nature of any disputes and that the buyer and current owner work together to resolve as many outstanding issues as possible prior to closing. It is never good for a franchise system to be acquired while the state of franchise relations are in turmoil. The best time to address franchisee concerns is before the acquisition is complete because all parties have the greatest incentive to negotiate prior to closing.

In reviewing the files of former franchisees, buyer’s counsel should concentrate on understanding why and how each franchisee left the system. The analysis should confirm that the seller complied with state franchise relationship laws in cases of franchise terminations or non-renewals. If the franchisee left the system as the result of a transfer, the file should include documentation verifying that the new owner was properly disclosed and that all transfer paperwork was completed. Each file should also have contact information for the former franchise owners in order to ensure that the franchisor can comply with its disclosure requirements. Finally, in a perfect world, each file will contain a release signed by the former franchisee and all guarantors.

B. **Franchises in Renewal Pipeline or up for Renewal Within Five Years.**

The buyer should also get a handle on the renewal pipeline for the franchise system. The fact that franchisees are looking to renew their agreements is always a positive sign in a franchise system. If franchisees are up for renewal but are choosing not to renew their rights, the buyer should be concerned that there may be significant issues in the system. More importantly, the buyer should evaluate whether it will be faced with the prospect of trying to enforce the franchise agreement’s post-termination covenant against competition against a series of former franchisees who have chosen not to renew their agreements. Finally, the purchaser should review the current owner’s process for managing the renewal process to ensure that all required renewal dates are docketed and that all franchisees with upcoming renewal dates are contacted and given the opportunity to renew. The buyer should ensure that no one has “fallen through the cracks” and is operating its franchise under the terms of an expired franchise agreement. If such circumstances are unearthed during the due diligence
process, the buyer should insist that all such franchisees be required to sign current franchise agreements prior to closing.

C. Franchise Sales Within the Last Three Years; Unit Count Within Last Five Years.

The buyer should examine franchise sales trends for the prior three years. Where were the franchise leads coming from, what was the conversion ratio, what were the costs per closed lead? How did the lead flow change during that period? Most buyers looking to complete transactions in the early part of the current decade will see significant impacts in franchise leads and closings as the result of the Great Recession of 2008 and 2009, but the purchasers must look beyond the relatively short term impact of the recession to determine whether the franchise sales model has fundamentally shifted over the years. A buyer should also examine the quality of the candidates during that time frame. Was there a material increase or decrease in the experience and financial resources of such candidates? Did existing operators open more units? What was the primary driver of unit growth? All of these questions will help the buyer analyze the short-term and long term prospects of the target.

A buyer should also carefully analyze the trends in unit count during the past five years. Did the system grow on a net basis or contract during that period? Were some regions more impacted than others? Does the brand have strong resonance in some parts of the country and struggle in others? Is the product offered by franchisees subject to environmental factors, such as winter weather in the northern part of the country, that impacts its year-round demand? Has growth been limited in certain markets as the result? In the alternative, is there opportunity for unit growth in untapped parts of the country? If so, what level of investment and market penetration will be required to successfully expand into those markets? Like the analysis outlined above, determining answers to these questions will enable the buyer to evaluate future cash flow and growth opportunities available to the target.

D. Franchise Financing Issues.

Perhaps no aspect of the Great Recession has impacted franchising and the growth of franchise companies as the significant reduction in available financing for franchisees. During the height of the Great Recession, most major franchise lenders left the industry or considerably reduced the amount of loan dollars available, while at the same time significantly increasing the amount of capital a franchise prospect had to bring to the table.\footnote{Julie Bennett, Bank On It – Tips from Experts on Navigating the New Lending Environment, Franchise Times, March 2010, at 30.} While the lending environment appears to be improving slowly, at the time frame that this paper is being written, many industries and regions of the country are still struggling to find financing options for new franchisees.\footnote{Id.}

The key inquiry for a purchaser in this environment is “can we be reasonably certain that we can assist our prospective franchisees in securing the financing they require to open more units?” If the answer is anything other than a solid yes, then the buyer must assess what steps it will be required to take to improve the financing opportunities for new and existing franchisees. In some cases, franchisors have begun offering credit enhancements...
to induce lenders to finance franchise growth. However, these programs generally necessitate creative structuring and require that the franchisor make real dollars available to lenders. If such steps are required to make a franchise acquisition viable, the buyer must factor the additional resources required into its working capital allocation. In other cases, traditional commercial financing may simply not be available. In those instances, the prospective purchaser should consider whether it can source alternative financing from non-traditional sources and evaluate the costs to the franchisor and franchisees as it pursues such options. In the end, it is critical that franchisees have access to capital in order to facilitate growth. If the buyer cannot satisfy itself that capital will be available, it may be best to walk away from the opportunity until the lending market improves.

E. Supplier Contracts.

Any buyer of a franchise system should spend time reviewing agreements with key designated and approved suppliers of the system. The buyer should pay particular attention to any exclusive arrangements that could interfere with agreements or objectives that the buyer intends to implement after the closing. The buyer should also confirm that any special pricing or delivery terms currently being offered to the system under such agreements will continue to be available after the transaction is complete, and it should require the seller to obtain any advanced consents required to transfer such contracts prior to closing. As part of this review, the acquirer should confirm that all rebates, marketing fees and other forms of consideration have been properly disclosed and accounted for over the years. Finally, the buyer should prepare a summary of all special deals and obligations contained in these contracts and evaluate how the revenue flow and corresponding obligations impact the projected profitability of the system after the transaction is completed. Additionally, the acquirer should check to see if any of the supplier contracts contain “change of control” provisions that require the parties to a transaction to obtain the supplier’s approval of the proposed sale. In some cases, a change of control provision may trigger a supplier’s right to terminate an existing contract. Accordingly, these contracts should be reviewed very closely to ascertain what types of disruptions can occur in the event of a change of control.

F. Leases.

Depending on the makeup of the system, a buyer should focus on two distinct areas when conducting due diligence on location leases. First, the buyer should review and evaluate all leases related to “company store” operations of the franchisor or any affiliate that will be acquired as part of the transaction. Can each lease be assigned to the new entity? If so, what requirements does each landlord impose prior to assignment? Is there a possibility that a landlord will request additional consideration or attempt to renegotiate the lease prior to proving the assignment to the buyer? Most importantly, in cases where the lease requires the landlord’s consent prior to transfer, it is critical to begin the process of securing consent well before the projected closing date. Depending upon the size of the landlord’s organization, this process can sometimes take significant time, and no one wants to hold up a closing because one or more landlord consents remain outstanding.

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13 For example, Marco Pizza has created a program to guarantee new franchisee loans.

14 The hotel and lodging industry has been particularly hard hit during the current recession.
The buyer should also conduct a cursory review of leases for franchisee locations. While most landlords will not care about a transaction undertaken by the franchisor, because the franchisor is not a party to the lease, it is important to get a general understanding of the lease requirements imposed on franchise locations. In addition, if franchisee leases provide the franchisor with notice and cure rights and the opportunity to assume the lease from a struggling franchisee, then the buyer will likely need to be made a party to such leases in order to be able to maintain such rights. Finally, the buyer should review relevant radius clauses in franchisee leases to ensure that the acquisition does not somehow negatively impact the rent to be paid by franchisees.

**G. Franchisee Satisfaction.**

No franchise acquisition due diligence project can be considered complete until the buyer has had the opportunity to spend time interviewing some or all of the existing franchisees in the system. The extent of the number of interviews will be determined in large part by the size of the system. Obviously, the greater the number of franchisees, the harder it is for the buyer to speak with everyone. In addition, the buyer’s ability to interview franchisees in advance of the sale is dependent on the confidential nature of the transaction.\(^{15}\) During the interview process, the buyer should focus on the level of satisfaction franchisees have with the system, and identify areas that franchisees believe should be changed or improved. The buyer should also use these discussions to discern whether the proposed acquisition will create legal issues with any franchisees for either the buyer or the seller after the sale closes. In addition to avoiding unnecessary legal problems, this process will also provide the buyer with insight into how current franchisees will validate with prospective franchisees. Understanding this aspect of the franchise relationship will provide the buyer with some additional insight regarding its prospective growth plans.

**H. Franchisee Litigation.**

An important corollary to the franchise interview process is the review required of current and previous franchise litigation. These files will often reveal any history of franchise law violations or contract breaches by the seller that were significant enough to lead to litigation, and at the same time the review will help the buyer assess any precedents set by the franchisor in the process of settling litigation.\(^{16}\) The buyer will also want to establish a reserve for any potential liability that may accrue to the franchise organization from pending litigation. This process will also enable the buyer to adjust the value of the transaction, if necessary, or to establish appropriate indemnification thresholds and the size of the required purchase price escrow.

**I. Management of the Advertising Fund.**

Since most franchise agreements expressly state that the advertising fund is managed by the franchisor for the benefit of the franchisees, it is important that the buyer review the manner in which the fund has actually been managed. For example, if the franchise agreements require that the advertising fund be held in an account separate from the

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\(^{16}\) Id. at 18.
franchisor’s operating funds, the buyer should confirm that the fund has been handled in that manner. The buyer should also determine if fund collections have exceeded expenditures and whether the buyer will therefore be assuming a liability. “Even if the purchaser does not specifically assume the liability, the buyer is acquiring the obligations of the franchisor under the franchise agreements and franchisees will not likely sit quietly when the seller disappears into the night with the franchisees’ advertising payments.”

In the alternative, the franchisor may have spent more funds than collected from franchisees, and may therefore be looking for some additional compensation from the buyer. Finally, the buyer should review the expenditures planned or committed from the fund in the coming year to ensure that sufficient funds will be available to meet the projected expense. If it turns out that the fund will not likely have sufficient money to cover the planned expenses, the buyer will likely seek an adjustment to the purchase price to compensate for the shortfall.

J. Special Deals Given to Franchisees.

“Special deals” given to franchisees can be one of the most vexing issues when acquiring a franchise system. It is critical that the purchaser review each franchisee’s file, talk to management personnel, and talk to each franchisee to discern whether the franchisee believes he or she has some special arrangement with the franchisor. These “deals” can be found in various forms, including: (1) reduced royalties or advertising contributions, (2) special territorial, expansion or development rights, (3) the right to sell different products or services, (4) different operating hours or other standards, (5) special pricing on goods sold by the franchisor or suppliers, (6) rights of first refusal, and (7) the right to renew using the franchisee’s existing contract. It is imperative to ferret out these deals because they can wreak havoc on the buyer’s expansion or development plans. They can also create animosity with other franchisees if they are discovered. Most importantly, however, these deals can become potential mine fields for the new owner if they are not honored after the sale is complete. It is critical, therefore, that a buyer identify and develop a plan for addressing each of these “deals” before completing the transaction.

K. Franchisee Association.

In most franchise companies, franchisee associations come in two stripes – the association organized and approved by the franchisor, and one or more “unofficial” associations organized by franchisees or third-parties. Due diligence on the franchisor-sponsored association should include minutes, initiatives undertaken by the association, and the process associated with selecting the organization’s governing body.

It is often harder to conduct due diligence on the unofficial associations. When possible, the buyer should endeavor to have conversations with the leaders of the association to discern the issues that led to the creation of the outside organization. The buyer should also review all correspondence between the franchisor and such organization. This due diligence will often reveal latent issues and simmering disputes inside the system that might not otherwise be detectable in the due diligence process.

\[^{17}\textit{Id. at 13.}\]
L. Territory Issues.

Some of the more vexing “special deals” granted to franchisees come in the form of territorial grants or protections provided to franchisees. Many of these deals are granted when the franchisor is in early development years, and they are often the product of the steps the franchisor had to take to “get the deal done.” In the days when territory seems unlimited and the franchisor is more interested in collecting a check for the initial franchise fee than protecting the integrity of the system, franchisor management teams often make deals that come back to haunt them. It is essential for the buyer to learn of and build a strategy regarding these deals prior to closing the sale.

Territorial issues generally come in a limited number of “flavors.” Often times the franchisor agrees to provide a larger “protected” territory than initially provided in the franchise agreement. In some cases, the territorial protection comes in the form of limits on the products the franchisor can offer directly in the territory or rights granted to the franchisee to sell in different channels of distribution. In other cases, the franchisee may have “rights of first refusal” to acquire additional territory in the event the franchisor finds a prospective franchisee for such territory. Finally, franchisees may have (or claim to have) the right to market and service customers living or working outside of their territorial boundaries. In these situations, the franchisor has often granted express or implied rights to sell the franchisor’s goods or services to such customers. Often times these types of “rights” only become an issue when the franchisor attempts to sell a territory adjacent to an existing franchisee. It is critical that a purchaser learn of these “special deals” prior to completing the acquisition or the buyer may find that its expansion plans are unduly limited after the sale closes.

The last territorial issue that must be explored arises when the purchaser is a competitor of the franchisor. When this situation occurs, the buyer must review the reservation of rights clauses in each of the existing franchise agreements to ensure that none of the agreements prohibit the franchisor from selling to a competitor. In addition, the buyer should confirm that it has the right to operate a competing brand using different trademarks and systems in each franchisee’s territory. This is particularly critical in situations where the buyer is a competitor and knows that it has existing company-owned or franchise-owned stores in a target franchisee’s territory.

If the buyer determines that the language in one or more franchise agreements presents a problem based on the location of the purchaser’s existing company-owned stores or franchisees, it is best to address this issue before closing in order to avoid a protracted legal battle after the sale has closed. In some cases, the issue can be resolved by reaching an economic settlement with the affected franchisee. In other situations, more drastic steps must be taken, including reaching an agreement to terminate the affected franchisee and to let the owner continue to compete as an independent operator. Sometimes, the issues are too significant to overcome and the purchaser may decide the best course is to walk away.

VI. NEGOCIATING THE PURCHASE AGREEMENT AND THE CREDIT AGREEMENT

While part of the acquisition team is conducting due diligence on the transaction, another part of the team is generally engaged in negotiating the definitive purchase agreement. This agreement usually comes in one of three forms: (A) if the buyer is acquiring the equity of the seller, the agreement is generally called a Stock Purchase Agreement (or a Membership Interest Purchase Agreement if the seller is a limited liability company); (B) if the buyer is purchasing the assets of the target company, the agreement is called an Asset Purchase
Agreement; and (C) on the rare occasion that the seller is contributing assets or an equity interest into a newly formed entity in which the seller will own a continuing interest, the agreement is referred to as a Contribution Agreement. For purposes of this paper, all three types of agreements will be referred to as Purchase Agreements.

A. Establishment and Payment of Purchase Price.

One of the primary roles of the Purchase Agreement is to clearly define the final purchase price and to outline the payment terms and any hold back provisions negotiated by the parties. While much of this negotiation takes place at the letter of intent stage, this topic may be revisited in the event the buyer learns of new facts or a significant change has occurred in the economic outlook for the company during the due diligence process. In some cases, the buyer is looking for a downward adjustment to the purchase price based on contingencies or undisclosed liabilities discovered during the diligence. In other instances, the fortunes of the target may have improved or deteriorated due to economic conditions beyond the control of the company’s management team. In such an event, the parties will often adjust the purchase price, either up or down, to reflect the new economic reality facing the company.

Final payment terms are also outlined in the Purchase Agreement. Payment is usually made in two phases. The bulk of the payment is generally made by the purchaser at closing. The balance of the payment is often held back and paid to the seller at some point in the future. As noted earlier, this “hold back period” may last as long as 18 months after the date of the closing. In some cases, the seller may also be providing financing to the buyer as part of the transaction. If this is the case, the Purchase Agreement will outline the terms of the financing, including total amount financed, timing for payments, the applicable interest rate charged by the seller, any security granted by the purchaser, and the implications to the purchaser in the event of a default. (These terms are often also included in the promissory note and security agreement used to facilitate the financing, both of which will be attached to the Purchase Agreement as exhibits). Additionally, some Purchase Agreements contain “earn out” provisions which enable the seller to receive a higher payment based upon the performance of the acquired entity or assets during some specified period after completion of the sale. These provisions require that the parties agree to a set of metrics to measure the performance of the entity after the sale has closed and a formula for calculating additional payments due to the seller if the new entity exceeds specified targets. Finally, in some cases the seller is allowed to retain an equity stake in the entity or to use some of the sale proceeds to purchase an equity stake in the new entity. The Purchase Agreement will define the rights of the seller to an equity stake in the new entity and specify the way in which the equity stake will be acquired or transferred to the seller. All of these items are usually subject to final negotiations during the sale process, and many of these provisions will be “tweaked” during the negotiation of the Purchase Agreement.

B. Assignment of Franchise Agreements.

A key element in the sale of any franchise system is the transfer or assignment of the system’s franchise agreements. Since the franchise agreements represent the bulk of the revenue generating assets of any franchisor, it is critical that the assignment of the agreements is done correctly. The Purchase Agreement will address this issue and outline the process for making the transfer effective at closing. In most cases, the agreements will be identified on a disclosure schedule and all contracts will be transferred using one assignment document. If any agreements require advanced consent, the seller will be required to secure such consent prior to the closing. The failure to secure consent can result in the seller retaining one or more
franchise contracts, which creates significant confusion regarding which entity is obligated to perform services for the franchisee. It is therefore critical that all required consents be obtained in advance of the closing.

**C. Negotiating Representations and Warranties.**

The buyer and seller will each make a series of representations and warranties to each other in the Purchase Agreement. The buyer’s representations and warranties are usually fairly simple and are generally limited to establishing that the buyer is duly organized, operating in good standing, in compliance with all material laws governing the buyer’s business, and that the buyer has the authority to enter into the Purchase Agreement.

The seller’s warranties are generally much more comprehensive. They often include the same provisions outlined above and also address a broad range of additional issues, including warranties regarding the ownership and protection of intellectual property; the identity of franchisees and the material provisions of their franchise agreements; representations as to compliance with domestic and, where appropriate, international franchise laws; the seller’s prior enforcement of its franchise contracts; the nature and extent of exclusive territorial grants; the nature of ongoing arrangements with suppliers; and warranties as to the collections and expenditure of the advertising fund managed by seller.\(^1\) The representations and warranties being made by the seller serve three overlapping functions: (1) they elicit disclosure regarding the seller during the due diligence period and as of the date the Purchase Agreement is signed and the sale is closed; (2) they often provide the buyer with the ability to exit the transaction if the representations and warranties prove to be materially incorrect during the due diligence period or at any time prior to closing; and (3) the representations and warranties often survive closing and serve as the basis for claims of indemnification or breach of the Purchase Agreement by the purchaser.\(^1\)

During the negotiation of the Purchase Agreement, most practitioners find that the extent and scope of the seller’s representations and warranties will be the area in which the most disagreements arise.\(^2\) However, they are critical if the parties desire to avoid future surprises. They also play a significant role in facilitating the due diligence process because they identify the areas of most concern to the parties. The risk to the seller can also be ameliorated to some degree by preparing a comprehensive set of disclosure schedules that identify elements of risk for the buyer. As a general rule, if an item is identified on a disclosure schedule and fully disclosed to the buyer prior to the sale, any loss or other negative consequence incurred by the buyer after the closing will not be the subject of an indemnification or breach of contract claim. In the end, the representations and warranties made by the seller serve to allocate the economic risk of the transaction between the buyer and the seller.\(^3\)

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\(^1\) *Id.* at 12.

\(^2\) Claudia Levitas, Kevin Stichter & Ted P. Pearce, *Exit Strategies for Franchisors* (IFA 40\(^{th}\) Annual Legal Symposium, Program Materials, 6-8 May 2007) at 21 [hereinafter *Levitas*].

\(^3\) *Robertson, supra* note 10, at 8.

\(^4\) *Levitas, supra* note 14.

Once the parties have agreed to the terms of the representations and warranties in the Purchase Agreement, they will turn to the scope and extent of the indemnification provisions. Similar to the representations and warranties, the indemnification provided by the buyer to the seller will be fairly limited. Under most buyer indemnification provisions, the seller would have a claim against the buyer if the buyer breaches its relatively limited representations and warranties or if the buyer fails to make a payment called for by the Purchase Agreement.

The indemnification provisions applicable to the seller will be subject to much more negotiation. The buyer will want to have confidence that if it experiences a loss or other negative consequence after the sale is closed as the result of a breach of the seller's representations and warranties or the Purchase Agreement that it will be able to recover its losses from the seller. The buyer's concern is most often addressed by the establishment of a sufficient hold back or escrow of the purchase price. On the other side, the seller does not want to feel that it is “being nickled and dimed” by the buyer over relatively minor issues. Consequently, the seller will generally try to limit its risk (and thereby assure that it will actually receive the bulk of the funds held back by the buyer) by negotiating a significant “basket” for indemnification claims. The “basket” is generally a threshold loss amount that must be incurred by the buyer before the buyer can make an indemnification claim and seek recovery from the held back amount. In some cases, the buyer is only allowed to recover indemnified losses that accrue in excess of the basket amount. In other instances, once the buyer has crossed the specified threshold, the buyer can recover losses back to the first dollar. The seller will want to establish a high basket threshold and limit recovery to only those amounts in excess of the threshold. The buyer will argue for a lower threshold and the right to reimbursed back to the first loss once the threshold has been surpassed. In most cases, the parties will compromise on both of these extreme positions. The seller will agree to a lower threshold and the buyer will agree to only seek reimbursement for amounts that surpass the threshold.

The seller will also seek to limit its risk by negotiating a cap on its total indemnification liability. As a starting point, most sellers seek to limit the total exposure to the amount of the hold back or escrow. The buyer, on the other hand, will seek to maximize its ability to recover from a catastrophic claim, and consequently will bargain for no cap on the liability of the seller. Liability cap provisions are often hotly negotiated between the parties. While each side can make strong arguments for its position, most negotiations end with an agreement limiting liability somewhere between the hold back amount and the total purchase price paid by the seller.

The final indemnification issue to be addressed in the Purchase Agreement is the survival of representations and warranties after closing. Lawyers representing buyers and sellers will be required to address two distinct issues here. First, the parties will have to specifically identify which, if any, representations and warranties survive closing. Second, the parties must agree on the survival period. As with the other elements of the indemnification negotiation, the buyer and seller each have an incentive to take an extreme position in this negotiation. The seller would prefer to see none of the representations and warranties survive closing and, if any do, that the survival period extend only for the most limited time frame (in most cases no more than three months after closing). If the seller is able to secure these provisions, the seller can be fairly confident that the buyer will have little claim to the proceeds being held back or in escrow. The buyer, on the other hand, would like to see all of the representations and warranties survive closing, and would advocate for an extended survival period (often two to five years). This allows the buyer a significant amount of time to confirm that all of the representations and warranties made by buyer were accurate and to eliminate the
risk that the buyer failed to discover some hidden liability that only matured at some point significantly after the closing date. Like all other indemnification provisions in the Purchase Agreement, the parties in most cases reach agreement by balancing the number of representations and warranties that survive with the length of the survival period.

E. Preparing Disclosure Schedules.

While the parties are completing the negotiation of the Purchase Agreement, members of seller’s management team and its counsel should be preparing relevant disclosure schedules. The schedules are intended to facilitate “the disclosure of virtually all material financial, business, operational and legal information about the [seller].” Depending on the size of the transaction, these schedules can be quite voluminous, often running into the hundreds of pages. The first draft is usually prepared by the seller’s management team, refined by the seller’s counsel, and then negotiated with management of the buyer and its counsel. The schedules not only satisfy the seller’s disclosure obligations, but they can also aid the seller by reducing some risk created by the breadth of seller’s representations and warranties, as described in more detail above. Because of the time and energy required to complete a comprehensive set of disclosure schedules, both parties should ensure that they have provided for sufficient time before scheduling the transaction’s closing date.

F. Negotiating the Financing Documents.

In many cases, the buyer will be financing part of the purchase price with debt provided by a third party. If this is the case, the preparation of the credit agreement will parallel the negotiation of the Purchase Agreement. The seller will want to pay close attention to the terms of this document because the credit agreement will dictate the operating parameters of the surviving entity after the sale in a way that is far more significant than any of the provisions contained in the Purchase Agreement. Specifically, the credit agreement may set limits on the new franchisor’s ability to take promissory notes from its franchisees for the financing of initial franchise fees or delinquent fees. In addition, the credit agreement may limit the new franchisor’s ability to either enter into real estate leases, which it may use to control a unit’s location. Likewise, the credit agreement may restrict the franchisor’s ability to guaranty leases on behalf of its franchisees or any part of an individual franchisee’s financing of a particular unit. It is important that the bank or other creditor understand the operations of the franchise system so that the credit agreement does not function as an impediment to how the new franchisor operates for the benefit of the system. The franchisor must make sure that it still retains enough ongoing cash to continue to grow and manage the system. Finally, it is worth noting that the credit agreement will likely require its own set of disclosure schedules. While these schedules will be similar to the disclosure schedules prepared for the Purchase Agreement, they will not likely be identical. It is important that the buyer, seller, and their respective counsel allocate sufficient time and resources to the preparation of these schedules in advance of the closing.

VII. ON GOING OPERATIONS DURING SALE PROCESS

As the purchase of the target navigates through the sales process there are some fundamental questions facing the target relative to its operations during what should be seen as

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22 Id.

23 Id.
the transition period. During this period, which could extend from the start of negotiations until closing, will the target franchisor be required to curtail its franchise sales efforts? The answer to this question is very tricky since it will involve a business judgment to be made by the franchisor as to whether prospective franchisees have a right to know that the target is in play or involved in a sale. The first question to ask is what affect the transaction will have on the target. For example, at the end of the transaction will management change or will there be a fundamental change to the target’s balance sheet. If what is happening is that the stock of the target is being purchased for cash with no appreciable change to the target’s financial condition then an argument can be made that other than a change in ownership, there has not been a material change until the sale is complete. The judgment process becomes more difficult if i) there is an asset purchase, ii) the purchase involves financing, and/or iii) the transaction will result in a change in the management of the target. Any of these components could trigger a material change in the franchise system necessitating that the franchisor amend its FDD.

Assuming that the transaction will result in a material change to the target’s franchise offering, at what point in the acquisition process must the target franchisor shut down its sales process? While there is no black letter law as to when the transaction must be disclosed, and thus franchise sales temporarily suspended, the benchmark that a target franchisor should use is at what point does the sale become a certainty?24 Certainly, it could be argued that until there is a signed purchase and sale agreement there is no certainty of sale, and therefore there has been no material change to the target franchise system. The trickier question is whether a material change to the franchise system has occurred at the time of an executed letter of intent. As discussed earlier, a letter of intent does not rise to the level of a binding agreement of sale; it likely will be subject to a material number of contingencies including the negotiation of a binding purchase and sale agreement. The negotiation of the purchase and sales agreement also will be subject to substantial due diligence, which may discourage a would-be purchaser from moving forward with the sale. Accordingly, the franchisor’s legal advisor must use his or her best judgment as to when he or she believes that the sale has progressed far enough to where a prospective franchisee would want to know or has a legitimate right to know that there is a likely sale pending for the target franchise system.

In addition to the impact on prospective franchise sales, a pending transaction also could affect a target franchisor’s ability to process re-sales and renewals. For each of those transactions the existing franchisee in a renewal and the incoming franchisee in a resale will be entitled to a new form of FDD at the time of their individual transaction if the particular franchisee is required to sign the franchisor’s then current form of franchise agreement. Under those circumstances, when the sale transaction has reached the point where a material change occurs triggering an amendment, the renewals and franchise re-sales processes would be impacted. On the other hand, if the renewal or resale involve the extension of an existing agreement or the assignment of the existing franchise agreement then it can be argued that the franchisor would not be required to provide those franchisees with a current FDD.

An interesting corollary to an FDD filing after the transaction is whether previous franchise registration exemptions will be affected by the structure of the sale. Many of the registration states provide an experienced franchisor with an exemption from the registration process (some states still require a submission of the FDD in addition to the exemption application). These exemptions are predicated on a threshold net-worth of the franchisor as

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well as an experience threshold determined by the number of units in existence (20-25) for a period of years, usually at least five.

If the transaction involving the target is a stock purchase, the target franchisor remains intact with all of its history, assets, and liabilities -- subject to the terms of the transaction. In that case it is not likely that the experienced franchisor exemption would be affected, unless the transaction results in a significant deterioration of the franchisor’s net worth. Conversely, if the sale of the target franchisor is structured as an asset sale, which would trigger an assignment to a new entity of all of the assets of the franchisor, including its franchise contracts, the ability to retain or obtain the target’s previous experienced franchisor exemption could be impacted. Some of the registration states take the position that since the franchise contracts, and thus the franchises themselves, have been transferred to a new entity, their prior history -- the threshold number of years with the previous entity, is broken. Thus, the “clock” for determining the franchisor’s experience begins to run anew. This strict constructionist position taken by some state franchise examiners will often prove to be frustrating to the franchisor who will be required to make a first time filing of its FDD in states in which it was previously exempt.

A. Notifying Existing and Prospective Franchisees.

The precise moment to advise the franchise chain of a pending sale depends upon when the franchisor determines it to be the right time. While this seems somewhat circular, it means exactly what it says. The target franchisor must know the temperament of its franchisee constituency. There is no black letter law to assist the franchisor in this part of the sale process. There are many different considerations that will need to be reviewed and discussed with members of the management team and the buyer and seller.

If the target is a public company then there will be securities considerations. Leaking too soon that there is a pending sale could constitute a violation of state or federal securities laws. Likewise, waiting too long could trigger both securities laws and franchise disclosure issues. Beyond the legal ramifications, there are practical considerations that can change the dynamics of the transaction. For example, letting franchisees know that a sale is pending may give them the unwelcome opportunity to inject themselves into the sale process. The change of ownership is an opportune time for the franchise body to seek concessions or changes to the franchise relationship. With this type of leverage they may attempt to exact financial changes to the franchise relationship that can have significant effects on the pending transaction, causing a re-trading of the transaction because a change, for example, in the future royalty rate will result in a change in future earnings that may require the seller to agree to a discount on the previously agreed upon sales price.

An earlier than necessary disclosure of a pending sale also may result in the existing franchisees becoming nervous as to the future of the chain and the corollary concern that the change of ownership may result in a change of management. As a result of the pending change, numerous franchisees may seek to sell their franchises or otherwise prematurely exit the system. More importantly, if franchisees begin ruminating about a change of ownership they no doubt will take their eyes off of their businesses to their detriment and to the detriment of the target franchise system. What the franchisor wants more than anything during the sale process is a continuation of the status quo and the ability to control the situation. Therefore, keeping knowledge of the pending sale to a limited number of people from a practical standpoint likely will be the best strategy for the franchisor until it decides that the time is right for disclosure. What this means is that the franchisor will need to be careful not to leak news of the pending sale to any member of the corporate staff that does not have a need to know.
Management should also issue a strict warning to those who are within the inner circle of knowledge to keep the information confidential and to tell no one. The only thing faster than a rumor mill is the speed of light.

Once the franchisor determines that the time is right for disclosure, management must determine the best way to notify all interested parties. The franchisor should choreograph the disclosure weeks in advance of the actual disclosure date, which may occur at anytime without much warning. While every target franchisor that has been sold has its own step-by-step procedure, in the authors’ experience the procedure that has been found to be successful is to start from the top of the franchise chain. If the chain has a well functioning franchisee association the information should be shared with them first preferably through a pre-arranged scripted telephone conference. The disclosure should announce that the sale has just closed, identify the new owner, describe any changes to management that will occur, and reassure all franchisees that the sale is good for the company and that the management is confident that the sale will enhance the value proposition for the franchise system.

Immediately thereafter, the franchisor should, in person where possible, announce the same to members of the corporate staff, providing them with the same assurances. If possible, management should not use the opportunity to announce that there will be immediate synergistic cuts. To the extent that such cuts are inevitable, the franchisor should put together a program that will ease any unnecessary exit of any member of the corporate staff.

Almost simultaneously with the disclosure of the sale to the corporate staff, the franchisor should send out a pre-recorded phone or video message to the franchise chain at large. The talking points in the video message should be similar to the message provided to the franchise leadership. The message should provide the franchisees with a toll-free number or website location in which there will have been prepared for their review a set of frequently asked questions (“FAQ”) section designated to answer their most immediate questions regarding how the sale of the franchise system will affect them. These questions should be vetted amongst management and its legal advisors well in advance of the closing date. It is interesting to note that with many franchise sales the fear of many franchisees is that of the great unknown. Once they know and understand the reasons, and what will happen in the future they likely, after calling some of their colleagues in the franchise system, will go back to business as usual.

This rather simplistic approach can serve as an outline to the target franchisor. Of course it may not be as simple as presented in this paper given the very particular circumstances of each sale. Merging similar franchise systems will raise a whole host of questions beyond the simplistic approach presented here. However, the key goal for any change of control is to try to maintain the status quo as much as possible and to let the franchisees absorb the news without over reacting.

B. Managing the System after the Transaction.

The nature of the transaction will influence the type of challenges that the target franchisor and/or the buyer will face. If the buyer purchased a franchise system that offers products and services that are similar to another franchise system owned by the purchaser, then the question becomes whether the purchaser tries to operate both systems in parallel or whether the strategy is to merge one of the systems into the other. Within these strategies there are numerous subplots that will arise. The issues are almost endless, but at the
heart of the issue will be how the franchisees within both systems will react. The less dominant franchise system will be very sensitive to the ultimate mission that the purchasing entity pursues. As a means of illustrating some of these issues, the buyer will need to consider how advertising and marketing will be conducted? Will each brand have its own managing executive? Will any of the less dominant brand members be invited to join the more dominant brand’s system? Are there territorial issues that will prevent a full integration of one of the brands into another, if that is the intended strategy? The buyer must be cognizant that both franchise systems will be governed by their own specific franchise agreements so any integration will be subject to the terms of those agreements. If the strategy is to combine these systems, then what incentives will the dominant franchisor provide to the franchisees of the less dominant franchise system to induce them to switch brands and modify or terminate their existing agreements? Those who cannot or will not subscribe to the dominant franchisor’s strategy will either force the franchisor to continue to run parallel systems or likely negotiate buy-outs of their interests in the system.

The purchasing franchisor may have purchased a system with unrelated products and services so the absorption of that franchise system may be more seamless. At the same time that the newly configured franchise system is beginning its operation post transaction many of the planned synergies that the buyer and target franchisor have agreed upon will begin to take effect. Doubtless the change in corporate governance will cause the newly combined brands some growing pains as management attempts to meld often different corporate cultures. While the synergies are often found in the supporting functions of the franchise system such as accounting and legal, the franchisees in all of the operating systems will look to the franchisor to provide the same or enhanced services. Often, holding frequent status meetings with the franchisee leadership in an effort to explain to them the changes and progress that the system plans to make and is making post transaction will be of great benefit to the franchisor and the members of the system. These meetings will help to instill confidence in the franchisees, which will pay countless dividends to the franchisor and the franchise system.

VIII. POST TRANSACTION LEGAL ISSUES

While every sales agreement will have its own unique characteristics, one thing will be certain - each sales agreement will contain a detailed indemnification provision, which may be tied to a hold-back of a portion of the purchase price. The hold-back or escrowed amount will be held back for a period of time after the transaction is closed in order to take care of either unresolved legal issues, such as outstanding litigation, or to be there in the event that issues arise related to representations and warranties of the seller. As has been detailed earlier in this paper, most purchase agreements contain a very in-depth representation and warranty section that will address numerous issues from both a general corporate and franchise perspective. During the hold-back period the purchaser should pay attention to the operation of the system to determine whether any issues that arise are covered by the indemnification.

In addition to the representation and warranty provisions, the post termination period will give the parties an opportunity to “true-up” the balance sheet of the target franchise system to ascertain if the working capital targets placed in the purchase agreement have been met. If they are over or under target then post transaction adjustments will be made to the purchase price that will require either the seller to forfeit a portion of the hold-back or require the purchaser to pay to the seller an adjustment to the purchase price greater than what is contained in the hold-back. An audit of the working capital amount usually takes place between 60 and 90 days after the sale and will contain a wide array of mechanics to assist the purchaser and seller to resolve any disputes that they have regarding the ultimate working capital amount.
IX. CONCLUSION

As a lawyer, working on the sale or acquisition of a franchise company can be an exciting and challenging assignment. Because of the ongoing relationship between the franchisor and its franchisees, these deals are often more complex than most merger and acquisition projects. It is critical to take each step in the acquisition process in the proper sequence, and to ensure that the due diligence process is thorough, in order to provide the buyer and the seller with proper assurances that neither party will face any unanticipated surprises after the transaction is completed. In the end, a well orchestrated sales process will result in a satisfied buyer, a fairly compensated seller, and a franchise system poised for growth or renewal under the direction of its new management team.

X. CHECKLISTS AND FORMS

Exhibit A: Sample Letter of Intent
Exhibit B: Sample Due Diligence Checklist
Exhibit C: Sample Closing Checklist
July 14, 2010

TARGET, INC.
456 Elm Street, Suite 200
Englewood, CO 80112

Dear John, Bob and George:

This letter (“Letter Agreement”) sets forth the current understanding between Target, Inc. (the “Company”) and ABC Corporation (“ABC Corp.”) pursuant to which ABC Corp. proposes to acquire the Company, on the terms and conditions set forth in this Letter Agreement (the “Acquisition”).

1. The Acquisition. The Acquisition will be structured as a transaction in which ABC Corp. would acquire 100% of the outstanding capital stock of the Company. The Acquisition will be governed by a definitive agreement (the “Definitive Agreement”) to be entered into by the Company, the Company’s shareholders (the “Shareholders”) and ABC Corp.

2. Purchase Price. The purchase price payable at the closing of the Acquisition (the “Closing”) will be XXX Million Dollars (USD $XXX,000,000) (the “Purchase Price”), subject to adjustment and holdback described below. The Purchase Price has been determined on the basis that, as of the closing of the Acquisition: (a) there will not be any outstanding options, warrants or other rights to purchase any equity interest in the Company, (b) the Company will have no outstanding debt or encumbrances (other than encumbrances relating to real property and equipment leased by the Company), and (c) the Company will not have any cash holdings. The Purchase Price also assumes that the Company’s financial statements provided to ABC Corp. have been prepared in accordance with U.S. GAAP, consistently applied, and accurately reflect the financial state of the Company in all material respects.

3. Adjustment to Purchase Price. The Purchase Price will be subject to adjustment in the event that the Net Working Capital reflected on the Company’s balance sheet as of June 30, 2010 differs from the Net Working Capital reflected on the agreed upon balance sheet of the Company as at the Closing. “Net Working Capital” will be defined as total current assets (excluding cash) minus total current liabilities (excluding debt), each as determined in accordance with U.S. GAAP, applied on a consistent basis. The adjustment, if any, will be made by either reducing or increasing the Purchase Price by the full amount of the difference in Net Working Capital.
Additionally, the Purchase Price will be: (a) increased by the amount of cash held by Company, if any, as of the Closing, and (b) decreased by any Company debt as of the Closing.

4. **Holdback and Indemnification.** There will be a holdback of eighteen (18%) of the Purchase Price (the “Holdback Amount”) to address any claims that may arise from a breach of the Company’s and the Shareholders’ representations, warranties and indemnification obligations contained in the Definitive Agreement. One half of the Holdback Amount would be released after the first anniversary of the Closing, subject to any claims, and the remainder would be released after the second anniversary of the Closing, subject to any claims. No interest shall be payable on the Holdback Amount. The Shareholders will indemnify ABC Corp. in the event that the Holdback Amount is not sufficient to satisfy in full any claim for damages by ABC Corp., up to the full amount of the Acquisition consideration. No claim against the holdback will be brought until such claim or aggregated claims are at least $500,000, at which time the entire amount of the claims will be recoverable.

5. **Definitive Agreement.** The parties agree to use their best efforts to expeditiously negotiate in good faith and to execute and deliver the Definitive Agreement, consistent with the terms of this Letter Agreement. Among other things, the Definitive Agreement will:

   (a) contain comprehensive representations and warranties (which would survive the Closing) relating to Company and its business, operations, assets, liabilities, contracts, intellectual property rights, books, records, legal affairs, financial statements and employees. The representations and warranties made in the Definitive Agreement with respect to: (i) capitalization of the Company and intellectual property will survive indefinitely, (ii) tax matters will terminate on the expiration of the relevant statute of limitations, and (ii) other representations and warranties will be determined in the Definitive Agreement;

   (b) provide that ABC Corp. and its affiliates will be indemnified by the Shareholders against any damages, liabilities or expenses arising from a breach by the Company or the Shareholders of any representation, warranty or covenant contained in the Definitive Agreement; and

   (c) contain other customary provisions mutually agreed upon.

The execution of the Definitive Agreement is conditioned upon (x) the satisfactory completion by ABC Corp. of its business, financial, regulatory, technical, accounting and legal due diligence, the results of which will be satisfactory to ABC Corp. in its sole and absolute discretion, and (y) approval by the respective Boards of Directors of the Company and ABC Corp.

6. **Conditions to Closing.** The Closing will be conditioned upon (a) the negotiation, execution and delivery of the Definitive Agreement and ancillary definitive contracts customary for transactions of this type; (b) any governmental or other third party consents or waivers (including all necessary consents to a change of control under the Company’s agreements); (c) approval by the respective Boards of Directors of the Company and ABC Corp., and all of the Shareholders; (d) completion by ABC Corp. of its due diligence review of the Company to ABC Corp.’s satisfaction; and (e) other customary closing conditions.
7. **Non-competition Agreements.** At the Closing, the Shareholders and certain other Company key management personnel identified by ABC Corp. will enter into Non-competition Agreements with ABC Corp. pursuant to which each such individual would agree, for a period of five (5) years, to refrain from directly or indirectly engaging in, participating in, providing services to or otherwise dealing with any business that competes directly or indirectly with, or is similar to, the business conducted by the Company.

8. **Employees.** As a condition to the Closing, key employees of the Company identified by ABC Corp. shall have accepted offer letters of employment from ABC Corp., with employment becoming effective subsequent to the Closing. Such offers of employment shall be in accordance with ABC Corp.’s standard employment policies and procedures and be consistent with ABC Corp.’s standard compensation and benefits arrangements.

9. **Exclusivity.** From and after the date hereof and until the earlier to occur of the termination of this Letter Agreement or the execution of the Definitive Agreement, Company and Shareholders shall not, and shall not permit their respective officers, directors, employees, advisors, representatives or agents (collectively, “Representatives”) to, (i) directly or indirectly, solicit, initiate, encourage (including by way of furnishing information) or take any other action to facilitate any inquiry or the making of any proposal which constitutes, or could reasonably be expected to lead to, any acquisition or purchase of a substantial amount of the assets or securities of the Company or any tender offer or exchange offer, merger, consolidation, business combination, sale of substantially all assets, sale of securities, recapitalization, spin-off, liquidation, dissolution or similar transaction involving the Company, or any other transaction the consummation of which would or could reasonably be expected to prevent or materially delay the closing of the Acquisition (collectively, a “Transaction Proposal”) or agree to or endorse any Transaction Proposal or (ii) propose, enter into or participate in any discussions or negotiations regarding any Transaction Proposal, or furnish to any other person any information with respect to the business or assets of the Company in connection with a Transaction Proposal, or otherwise cooperate in any way with, or assist or participate in, facilitate or encourage, any effort or attempt by any other person to do or seek any of the foregoing. The Company shall promptly notify ABC Corp. in the event that it receives any unsolicited indication of interest or proposal regarding the acquisition of the Company or its material assets, including the identity of the person indicating such interest or making such proposal and a copy thereof.

10. **Expenses.** Each of the Company, the Shareholders and ABC Corp. will bear their own Transaction Expenses. “Transaction Expenses” means the expenses (whether or not incurred prior to the date hereof) arising out of, relating to or incidental to the discussion, evaluation, negotiation and documentation of this Letter Agreement and the transactions contemplated hereby.

11. **Conduct of Business.** During the term of this Letter Agreement, the Company will conduct its business in a reasonable and prudent manner in accordance with past practices, to preserve its existing business organizations and relations with its employees, customers, suppliers and others with whom it has a business relationship, to preserve and protect its properties and to conduct its businesses in compliance with all applicable laws and regulations. During the term of this Letter Agreement, the Company will not (a) issue, or agree to issue, any capital stock or other securities of the Company (except for the issuance of stock options or restricted stock awards to employees in the ordinary course of business under existing plans) or repurchase or cancel any of its capital stock; (b) incur any debt other than in the ordinary course of business or otherwise encumber its assets, (c) declare or make any dividends or other distributions to, or enter into any agreement with, its shareholders, (d) dispose of or encumber
any material assets, or (e) materially increase the compensation of its employees or establish any new compensation plan, or (f) take any action which would be likely to result in a material adverse change to the net asset position or financial status of the Company. During the term of this Letter Agreement, the Company will notify ABC Corp. before (i) entering into any contracts or commitments (including the issuance or acceptance of purchase orders) with a value in excess of $100,000, or (ii) before making any personnel changes.

12. **Access.** The Company will permit ABC Corp., its agents and representatives to have reasonable access to premises in which it conducts its business and to all of its books, records, patent application files and personnel and will furnish such financial data, operating data and other information as each of them may reasonably request.

13. **Confidentiality; Publicity** The mutual nondisclosure agreement between the Company and ABC Corp., dated May 20, 2010, shall govern the provision and use of all Confidential Information (as defined therein) in connection with this Letter Agreement and the Acquisition. Except as required by law or regulation, in no event shall the Company and its Shareholders on the one side, or ABC Corp. on the other, disclose the existence or terms of this Letter Agreement or the Acquisition contemplated hereunder to third parties or make any public announcement or issue any press release with respect to this Letter Agreement or the Acquisition without (a) first consulting with the other side as to the form and substance thereof and (b) obtaining the prior written consent of the other side.

14. **Amendment.** Any amendment, supplement, modification or waiver of or to any provision of this Letter Agreement will be effective only if it is made and given in writing signed by the Company and ABC Corp. and only in the specific instance and for the specific purpose for which made or given.

15. **Governing Law.** This Letter Agreement will be governed by, and construed in accordance with, the laws of the State of Colorado without regard to the conflicts of law principles thereof.

16. **Counterparts.** This Letter Agreement may be executed in any number of counterparts, each of which when so executed will be deemed to be an original and all of which taken together will constitute one and the same agreement.

17. **Enforceability.** Except for Section 9 (Exclusivity), Section 10 (Expenses), and Sections 13 -17, this Letter Agreement is an expression of intent only and is not legally binding upon any of the parties hereto. This Letter Agreement does not set forth all of the matters upon which agreement must be reached in order for the proposed transaction to be consummated. If the parties have not entered into the Definitive Agreement by September 1, 2010, this Letter Agreement and the obligations of the parties hereunder shall terminate, except for the provisions of Section 13 (Confidentiality; Publicity), which shall be legally binding and enforceable against each of the parties hereto. Notwithstanding the foregoing, the parties may mutually agree to extend the date of execution of the Definitive Agreement.
Please indicate your acceptance and agreement by signing and returning the enclosed copy of this Letter Agreement to the attention of Jane Johnson at ABC Corp. via fax (720-607-3600) no later than July 21, 2010. Upon your acceptance, ABC Corp. will proceed with due diligence and the preparation of a draft of the Definitive Agreement.

ABC CORPORATION

By: _______________________________________
   James Lee
   Vice President, Strategy and
   Business Development

ACCEPTED AND AGREED TO THIS _____ DAY OF JULY, 2010:

TARGET, INC.

By: ________________________________ (signature)

_____________________________(print name)
Exhibit B:
Sample Due Diligence Checklist

Preliminary Due Diligence Request

Set forth below is a preliminary list of documents and information that we wish to review in connection with the proposed acquisition of ________________________ (the “Company”). Please arrange for originals or exact copies of the documents and records described below, including all amendments, schedules, exhibits, supplements, side-agreements, addenda, appendices, attachments and restatements thereto, to be compiled and furnished for our review.

Where not otherwise indicated, and to the extent appropriate, documents requested should be made available for all periods commencing on and after the date of the Company’s formation to the most recent date reasonably feasible. If no document or information exists for which a request is made, please so advise us. If a section of this Preliminary Due Diligence Request would require the production of the same documents and information provided under another section hereof, please provide a statement to that effect and reference the section number pursuant to which such documents and information have been provided. For purposes of this Preliminary Due Diligence Request, “person” includes any natural person or entity and “including” means “including without limitation.”

We anticipate that some documents will not be available for review at this time, and new documents within certain of the categories listed below may be created prior to the execution of the definitive purchase agreement. Please furnish us with copies of all such documents as soon as they become available.

Delivered N/A

1. Company Records

1.1 Articles of Organization and/or other charter document(s) of the Company.

1.2 Bylaws, operating agreements, partnership agreements, shareholder agreements, voting trusts, proxy agreements or other agreements relating to (a) the voting, issuance or transfer of capital stock, limited liability company interests or membership interests, partnership interests or other equity interests (collectively, “Equity Interests”, and the holders thereof shall hereinafter be referred to as “Owners”) of the Company or (b) options, warrants, convertible debt instruments or other rights to purchase Equity Interests and any phantom stock, stock appreciation rights or similar plan or program (collectively, “Equity Rights”, and the holders thereof shall hereinafter be referred to as “Equity Rights Holders”) in the Company.
|   |   | 1.3 | Any agreements relating to registration rights of the Owners or Equity Rights Holders. |
|   |   | 1.4 | All stock books and similar records relating to the issuance, transfer and repurchase of the Equity Interests and/or Equity Rights of the Company. |
|   |   | 1.5 | All minutes of meetings of Owners, directors, managers and board of managers or similar management authority of the Company and of all committees thereof. |
|   |   | 1.6 | Company structure and management organization chart indicating organization of the Company and the titles, functions and responsibilities of the Company’s Owners, directors, managers, members of the board of managers or other similar management authority, officers and key employees. |
|   |   | 1.7 | List of full names of the current officers, directors, managers, members of the board of managers or other similar management authority and all other key employees of the Company, together with, if material, the annual rate of compensation (including bonuses) of each. |
|   |   | 1.8 | Any reports addressed to the Company’s directors, managers, board of managers or similar management authority in the past 5 years. |
|   |   | 1.9 | All agreements, memoranda and other documents relating to any bankruptcy, insolvency or foreclosure proceedings involving the Company or any of its assets. |
|   |   | 1.10 | List of jurisdictions (other than the jurisdiction of its incorporation or organization) where the Company is qualified to do business and a certificate of authority or similar document evidencing authority to do business in each such jurisdiction. |
|   |   | 1.11 | Documentation for, and description of, each transaction in which Equity Interests of the Company were issued, recapitalized or repurchased by the Company, including documentation with respect to any Employee Stock Ownership Plan of the Company. |
|   |   | 1.12 | Documentation for, and description of, each transaction in which Equity Rights of the Company were issued, canceled or repurchased by the Company. |
1.13 List of all current Owners and Equity Rights Holders of the Company, including a description of the Equity Interests and Equity Rights held by each. If an Owner is an entity, describe the nature of the entity and identify its Owners and Equity Rights Holders.

1.14 List of all other entities (including joint ventures) in which the Company has an Equity Interest or owns Equity Rights, and a description of the assets, business and operations of such entity and the amount and nature of such Equity Interest and/or Equity Rights.

2. **Financial Matters and Liabilities**

2.1 All of the Company’s audited and unaudited financial statements (including interim financial statements) for the past 2 years.

2.2 All material correspondence to the Company from, or by the Company to, the Company’s independent public accountants for the past 2 years.

2.3 Any written analyses of the Company or the Company’s operations prepared by management consultants, accountants or other persons, including performance studies, credit reports and other types of reports, financial or otherwise for the past 2 years.

2.4 Schedule of all present indebtedness (short or long term) for borrowed money, capitalized leases, or purchase money financings, including name of creditor, nature of indebtedness, principal amount, interest rate, repayment schedule, and description of any limitations on optional prepayment.

2.5 Bank letters or agreements confirming lines of credit for all outstanding obligations with the Company.

2.6 All documents and agreements evidencing borrowings, whether secured or unsecured, by the Company that are currently outstanding, including loan and credit agreements, promissory notes and other evidences of indebtedness and all guarantees with respect to which the Company is a party, beneficiary, surety, guarantor or maker, and all documents and agreements evidencing any other financing arrangements of the Company, including sale and lease back arrangements, installment purchases, capital leases, etc.
2.7 With respect to currently outstanding obligations, all correspondence with any lender of the Company (including entities that have committed or given preliminary approval to provide financing to the Company), and with any lessor under a capital lease with the Company (including entities committed to lease), including all applications for financing and compliance reports submitted by the Company or the Company’s independent public accountants for all outstanding obligations.

2.8 Schedule of aged accounts and notes receivable and accounts and notes payables of the Company at the end of the most recent month and at the end of the last four quarters.

2.9 Schedule of all the Company’s guaranties, indemnities and commitments which create any actual, potential or contingent liability or obligation.

2.10 All waivers or agreements canceling claims or rights of material value of the Company and any documents relating to any material write-downs or write-offs of notes or accounts receivable of the Company for the past 2 years.

2.11 The Company’s projections, forecasts, budgets and business plans for each of its fiscal years or other accounting period (including future years and periods) for the past 2 years.

2.12 All audit inquiry response letters and all management representation letters provided to the Company’s auditors/accountants for the past 2 years.

2.13 All letters from the Company’s accountants to management regarding accounting systems, accounting controls and other “management letter” items for the past 2 years.

3. Material Agreements

3.1 Any material contract related to the Company’s business to which the Company is a party or beneficiary not otherwise requested herein. For this purpose, a contract is “material” if:

(a) It was entered into other than in the ordinary course of business;

(b) It has a remaining term of more than one year;

(c) It involves payments to or by the Company in excess of $[______];
The Company’s cost of performance or contract price materially exceeds the benefits to be derived by the Company under the contract;

The termination of the contract would have a material adverse effect on the Company;

It calls for the acquisition or sale of any property, plant or equipment for a consideration exceeding $[__________];

It restricts the Company’s ability to engage in any line of business or to engage in business with, or sell or purchase goods or services to or from, any other person in any geographic area; or

It provides for termination or the payment of money or other penalties or consequences in the event of a change of control of the Company.

3.2 All agreements, contracts or commitments currently in effect relating only to capital expenditures and a description of all such agreements, contracts or commitments that have not been memorialized in writing.

3.3 All license agreements currently in effect to which the Company is a party or beneficiary.

3.4 All management, service, consulting, accountants’, attorneys’, agency, finder’s fee, brokerage and other service contracts or engagement letters currently in effect to which the Company is a party or beneficiary.

3.5 All joint venture, partnership, participation, cost sharing and similar agreements currently in effect to which the Company is a party or beneficiary.

3.6 All powers of attorney granted by or to the Company currently in effect.

3.7 All noncompetition and non-solicitation agreements currently in effect with respect to any director, manager, member of the board of managers or similar management authority, Owner, officer or other employee of the Company, in which the Company is a party or beneficiary or that relate to the Company’s business.

3.8 All documents relating to any acquisition or disposition of assets by the Company other than those made in the ordinary course of the Company’s business.
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<th>Delivered</th>
<th>N/A</th>
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<tr>
<td>3.9</td>
<td>All material supply or requirements contracts to which the Company is a party or beneficiary that are currently in effect.</td>
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<tr>
<td>3.10</td>
<td>A list and description of all agreements currently in negotiation by the Company which, if entered into, would be an agreement of the type requested under any section of this Preliminary Due Diligence Request.</td>
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<td>3.11</td>
<td>Any contract not otherwise requested herein between the Company and any director, manager, member of the board of managers, Owner or officer of the Company, or any entity in which such director, manager, member of the board of managers, Owner or officer of the Company or his or her family has any material interest.</td>
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<tr>
<td>3.12</td>
<td>All contracts with distributors, sales agents or other persons providing marketing, sales or distribution services to the Company.</td>
</tr>
<tr>
<td>3.13</td>
<td>All independent contractor, consulting, commission, agent, service, production, manufacturing, sale, agency, distribution, purchase, marketing, consignment, finder, broker, advertising, and similar contracts to which the Company is a party or beneficiary and where the estimate annual amounts payable thereunder exceed $50,000.</td>
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<td>4.</td>
<td><strong>Real and Tangible Personal Property</strong></td>
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<tr>
<td>4.1</td>
<td>Schedule of all real property, including improvements, owned by the Company.</td>
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<tr>
<td>4.2</td>
<td>Schedule of all real property, including improvements, leased by the Company.</td>
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<td>4.3</td>
<td>Schedule of all material equipment and other tangible personal property and fixtures owned by the Company.</td>
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<td>4.4</td>
<td>Schedule of all material equipment and other tangible personality and fixtures leased by the Company.</td>
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<tr>
<td>4.5</td>
<td>All leases of real property and all material leases of any tangible personal property currently in effect, to which the Company is a party or beneficiary, either as lessor or lessee.</td>
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<td>4.6</td>
<td>All material correspondence between the Company and any landlord, or leasing agent for the past 5 years.</td>
</tr>
</tbody>
</table>
Deeds to all real property owned in whole or in part by the Company, title reports and title policies relating thereto and all surveys of any such property.

Title insurance policies for real property owned or leased by the Company, and documentation for any title exceptions.

All mortgages (including leasehold mortgages), deeds of trust or other liens on real property owned or leased by the Company.

All security agreements covering material machinery, equipment, vehicles, inventory or other tangible personal property.

Letter or other documentation from zoning authorities indicating that use of real property complies with zoning requirements for the past 5 years.

Description of any pending or threatened condemnation proceedings affecting real property owned or leased by the Company.

5. Environmental Matters

All current environmental permits issued by federal, state and local agencies, including wastewater discharge permits, air emissions permits and hazardous waste treatment, storage and disposal permits.

All correspondence regarding alleged or actual liability under the CERCLA for disposal of hazardous substances on real property owned or leased by the Company or at other locations because of hazardous materials shipped from such properties.

Statements or reports given by the Company to, and notices, complaints or similar documents given to the Company by, the federal Environmental Protection Agency or any other federal, state, local or foreign environmental protection agency relating to the Company’s properties or operations, to the extent involving any violation or alleged violation of environmental protection laws or any action required to be taken by the Company to comply with such laws.

All correspondence from the Company to regulatory agencies regarding failure to comply with environmental permits, violations of permit limitations and requests for variances from permit requirements.

All of the most recent applications for all existing environmental permits.
5.6 All data and reports (including any Phase I or Phase II Environmental Assessments) regarding sampling analyses for contamination of groundwater and soil at or in the vicinity of any real property owned or leased by the Company.

5.7 All environmental audits previously performed at or in the vicinity of any real property currently or formerly owned or occupied by the Company.

5.8 List of facilities with (i) known above ground and underground storage tanks or injection wells (including a description of the age and condition of each such tank or well, and any known leaking of such tanks or wells), (ii) PCB containing equipment or (iii) asbestos containing structures or materials.

6. **Intellectual Property**

6.1 List all trademarks, service marks, trade names, copyrights, software and patents that relate to the Company’s operations or names, whether or not held or owned by the Company.

6.2 A schedule of all unregistered trademarks and service marks owned by the Company.

6.3 Copies of unregistered trademarks and service marks and any pending applications.

6.4 Schedule of any unregistered trademarks and service marks used by the Company and owned by another person.

6.5 Policies regarding treatment or disclosure of proprietary materials, including all agreements concerning confidentiality and nondisclosure with employees, contractors, visitors or other parties.

6.6 Documents concerning registration of trademarks and service marks, service providers and Internet access providers relating to services or date.

6.7 Form (or forms) of end user agreements.

6.8 A list of any exclusive rights (product or geographical) granted by Company with respect to its products or services.

6.9 A list showing where the Company conducts business using any trademark, service mark, trade name, copyright or patent.
6.10 Licensing, royalty or similar agreements by which (a) proprietary materials of the Company are used by others, or (b) proprietary materials of others are used by the Company.

6.11 Correspondence, pleadings, etc., in the possession of the Company, relating to any claim (a) by the Company for infringement of its intellectual property rights, or (b) against the Company for infringement of the intellectual property rights of another person, if the claim was made within the past five years or is still pending.

7. **Personnel Matters**

7.1 All employment contracts between the Company and any of its current or former employees to whom benefits (other than pension benefits) are still owed by the Company, including any contracts relating to special compensation of any employee, severance benefits, “golden parachute” payments and any contract restricting competition or protecting confidential information.

7.2 All personnel manuals, summary plan descriptions or similar documentation furnished to employees setting forth personnel policies, procedures or benefits for the past 5 years.

7.3 Actuarial reports and Form 5500 for employee benefit plans and copies of IRS determination letters for any qualified plans for the past 5 years.

7.4 All collective bargaining or union agreements, and a list of any labor unions or similar organizations that have represented or attempted to organize the Company’s employees, if any, and all correspondence relating thereto as well as details of any strikes, organizing activity, grievances filed, hearings held, and any other labor related problems for the past 5 years.

7.5 Statements or reports given by the Company to, and notices, complaints or similar documents given to the Company by, any federal, state, local or foreign governmental agency or authority or individual claimant involving any violation or alleged violation of laws or regulations relating to employment discrimination, minimum wages and hours or overtime pay, occupational health and safety, retirement plans or benefits, or other conditions of employment or personnel matters for the past 5 years.

7.6 Details of workers compensation loss history, reserves and insurance for the past 5 years.
7.7 Copies of any currently outstanding executive or management compensation plans or programs of the Company, including plans or programs relating to bonuses, phantom stock, Equity Interests, incentive compensation, rights to severance pay, stock options or other Equity Rights or appreciation rights or any similar compensation plan or program, and the funding arrangements related to each.

7.8 Information regarding retiree medical and life insurance benefits of the Company, including cost figures, any reserve amounts carried on the books of the Company and any projections for liability under FASB standards for the past 5 years.

7.9 Copies of other personnel policies, including fringe benefits, perquisites, holidays, and vacation, together with copies of all employee handbooks for the past 5 years.

7.10 Copies of any complaints filed in any employment or benefit related matter (including citations or violations by OSHA or other similar state or local authorities) for the past 5 years.

7.11 Copies of all contracts for the payment of royalties, licenses, fees, etc. to managers or employees of the Company for the past 5 years.

7.12 All currently outstanding liability insurance policies for directors, managers, members of the board of managers, Owners and officers of the Company.

7.13 Brochures, information, booklets, policies and procedures manuals or other written material given to employees or potential employees of the Company to acquaint them with the Company’s business and with services, compensation, and benefits offered to employees for the past 5 years.

7.14 All reports concerning compliance of the Company’s plans with ERISA requirements for the past 5 years.

7.15 Schedule of all currently outstanding employment, bonus, commission, deferred compensation, severance, contingent compensation, supplemental unemployment compensation plans or programs, insurance coverage, relocation reimbursement (including any commitment to pay any of amount of loss related to the sale of an employee’s residence), pension or retirement plans, agreements, arrangements or practices, all medical, vacation, retiree medical, severance pay plans, programs or benefits and all other agreements or fringe or other benefit plans, practices or arrangements, (either formal or informal) of the Company and copies of all written documents or other instruments governing or relating to such plans, programs,
benefits, arrangements and practices not otherwise provided in response to other document and information requests hereunder.

7.16 A description of each currently outstanding oral employment, bonus, commission and other compensation or benefit agreement or understanding.

8. **Taxes**

8.1 All U.S. income tax returns, statements and reports and any accompanying schedules and attachments and supplements and amendments thereto filed by the Company for the past 5 years.

8.2 All state and local income tax returns, statements and reports and any accompanying schedules and attachments and supplements and amendments thereto filed by the Company for the past 5 years.

8.3 Any notices, correspondence, reports and communications, of significance, from or with local, state, U.S. and foreign taxing authorities, including those relating to any tax disputes or proposed or final assessments for the past 5 years.

8.4 Schedule of all statute of limitations waivers or extensions with respect to any U.S., state, local and foreign tax return or report agreed to by the Company and an explanation of the duration thereof and reasons therefor for the past 5 years.

8.5 Schedule of states, localities, foreign countries and other jurisdictions in which income or other taxes were paid by the Company and the nature and amount of taxes paid in each jurisdiction for the past 5 years.

8.6 Schedule of all federal, state, local or foreign tax audits conducted to which the Company has knowledge (completed or pending) and brief description of all adjustments made as a result of the audits for the past 5 years.

8.7 All tax sharing, tax indemnification or similar agreements by which the Company allocates tax liabilities or benefits with any other person for the past 5 years.

9. **Litigation and Compliance Matters**

9.1 A list and description of, and the pleadings or similar documents related to, each pending, threatened and concluded material written claim to the Company threatening to initiate a proceeding unless a dispute is resolved, litigation, arbitration or other proceeding or investigation relating to the Company, or any of the
directors, managers, members of the board of managers or officers of the Company, of a judicial, regulatory or administrative nature for the past 5 years (hereinafter collectively referred to as “Litigation”), including the following matters:

(a) general civil and commercial Litigation;
(b) condemnation;
(c) the health and safety of workers, including workers' compensation matters;
(d) the health and safety of clients and other persons;
(e) employment discrimination;
(f) Litigation with any of the Company's present or prior franchisees;
(g) government contracts and licenses;
(h) congressional, administrative or criminal Litigation;
(i) indictments of the Company or any of their directors, managers, members of its board of managers, officers or employees;
(j) alleged violations of environmental laws or regulations or laws or regulations regarding the health and safety of others; and
(k) alleged violations of any tax laws, rules or regulations.

For each such Litigation, provide a description of the amount of damages or other relief sought, the status of the Litigation, the amount of insurance coverage applicable, whether any insurer has disclaimed coverage with respect thereto, the court or tribunal in which such Litigation is pending and whether any claim for punitive or exemplary damages has been made.

9.3 All consent decrees, judgments, other decrees or orders, arbitration awards, settlement agreements and other agreements to which the Company is a party or beneficiary or is bound, requiring or prohibiting any future activities for the past 5 years.

9.4 All correspondence with, reports of or to, filings with, or other material information with respect to any other administrative or regulatory bodies which regulate a material portion of the business of the Company for the past 5 years.
9.5 All responses by Company counsel to auditors’ requests for information concerning contingent liabilities for the past 5 years.

9.6 Statements or reports given by the Company to, and notices, complaints or similar documents given to the Company by, any federal, state, local or foreign governmental agency or authority involving any violation or alleged violation of laws or regulations, or any investigation thereof for the past 5 years.

10. **Governmental Regulations and Filings**

10.1 Except as otherwise requested herein, all material reports filed and material correspondence with any U.S., state, local or foreign regulatory agency, including the Equal Employment Opportunity Commission, Housing and Urban Development, Department of Justice and Federal Communications Commission relating to the Company and any state, local or foreign counterparts thereof for the past 5 years.

10.2 All currently existing material governmental, regulatory and administrative permits and licenses of the Company.

10.3 Material information and documents relating to the Company’s compliance with U.S., state, local and foreign laws and regulations, including actual information requests, and potentially responsible party letters or actual claims addressed to the Company from any governmental or administrative agency for the past 5 years in the Company’s possession.

10.4 Except as otherwise requested herein, a schedule of all material governmental permits, licenses, certificates, consents, approvals, authorizations and registrations necessary or useful for the current and projected operations and business of the Company, and necessary for the Company to avoid a violation of applicable law.

11. **Insurance**

11.1 All insurance policies covering the Company or its properties (and all binders and certificates related thereto) and a schedule indicating the insurer, types of coverage (including whether the policy is an “occurrence” or “claims made” policy), limits of liability, annual premiums, amount of premiums prepaid or unpaid from prior years and the amounts of deductible and/or self-insured retention in effect with respect to the Company.

11.2 All key-person life insurance policies relating to any Company employee.
### 11. Description of Insurance Programs

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<td>11.3 A description of any self-insurance, fronting, risk-retention or captive insurance program of the Company, and all actuarial studies related thereto.</td>
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<td>11.4 A description of the Company's insurance claims history, including the date of claim, nature of loss and payment or reserve for the past 5 years.</td>
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<td>11.5 All correspondence and information relating to any insurer's declining coverage or reserving rights with respect to a pending claim, or aggregating related claims of, or with respect to, the Company for the past 5 years.</td>
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<td>11.6 A description of any claims or lawsuits pending or contemplated with respect to the Company's insurance coverage for the past 5 years.</td>
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<td>11.7 Any analysis of the Company's insurance program or requirements by an insurance broker, agent or consultant or by in-house risk-management staff for the past 5 years.</td>
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### 12. Affiliate Transactions

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<td>12.1 A brief description of each circumstance where any Owner, director, manager, member of the board of managers, officer or employee, or affiliated entity or member of the family of same, as applicable, of the Company, owns any property used in or related to the business or operations of the Company or is a party or beneficiary to any contract with the Company or otherwise in respect of the Company.</td>
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<td>12.2 A statement of the amounts and other essential terms of any indebtedness or other obligations of or to the Company to or from any Owner, officer, director, manager, member of the board of managers or other managing authority, employee, or other affiliate of the Company.</td>
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### 13. Franchise Matters

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<td>13.1 A list of all franchise agreements to which the Company is a party (collectively, together with all ancillary agreements related thereto, the &quot;Franchise Agreements&quot;), including for each Franchise Agreement (i) the name, address and telephone number of each and every subfranchisee, area developer, franchisee, licensee, master licensee, or master franchisee (any of which is hereinafter referred to as a &quot;Franchisee&quot;), and (ii) the effective dates and expiration dates.</td>
</tr>
</tbody>
</table>
13.2 A copy of the current form Franchise Agreement used by the Company and copies of any and all previous from Franchise Agreements used by the Company

13.3 All agreements with Franchisees other than on the Company’s current or previous form Franchise Agreements

13.4 All area development agreements or similar agreements

13.5 All marketing and advertising agreements between the Company and its Franchisees

13.6 All material correspondence between the Company and its Franchisees relating to any disputes between the parties

13.7 All FDD’s, disclosure documents or agreements filed in the preceding three (3)-year period with any foreign or domestic, governmental administrative or regulatory agency or otherwise used by the Company in connection with the offer, sale and operation of Franchises in any jurisdiction (domestic or international).

13.8 All written agreements with independent sales representatives, contractors, brokers or consultants under which the Company has authorized any person to sell or promote Franchises on behalf of the Company or agreed to rebate or share amounts receivable under any Franchise Agreement

14. **Miscellaneous**

14.1 Describe all commitments to finders or brokers.

14.2 All closing binders (if any) for any recent significant transactions involving the Company (e.g., financings, reorganizations, recapitalizations, acquisitions, etc.).

14.3 All recent analyses or appraisals of the Company or its business or assets prepared by investment bankers, engineers, management consultants, accountants, appraisers or others, including marketing studies, financial analyses, appraisals of property, plant and equipment, and other reports.
Exhibit C:

Sample Closing Checklist

ABC CORPORATION
SIGNING & CLOSING CHECKLIST

KEY INFORMATION; DEFINED TERMS

| Signing Date: | July [ ], 2010 |
| Stock Purchase Agreement: | STOCK PURCHASE AGREEMENT (the “Purchase Agreement”), dated as of July [ ], 2010, by and among ABC, Corporation, a Delaware corporation (“Purchaser”), Target, Inc., a Colorado corporation (the “Company”), the shareholders of the Company party thereto (collectively, “Sellers”), and John Doe, as Sellers’ Agent (the “Sellers’ Agent”). All section references in this Signing & Closing Checklist are to sections of the Purchase Agreement. All capitalized terms not otherwise defined herein have the meanings ascribed to them in the Purchase Agreement. |

<p>| Parties &amp; Advisors: | Purchaser: ABC, Corporation |
| | Company: Target, Inc. |
| | F&amp;B: Faegre &amp; Benson LLP, counsel to Purchaser |
| | 123: Smith and Smith, PLLC, counsel to the Company and Sellers |
| | Sellers’ Agent: Joe Doe as Sellers’ Agent |
| | JD: Joe Doe |
| | BS: Bob Smith |
| | GJ: George Jones |</p>
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<tr>
<th>Document / Action</th>
<th>Responsible Party</th>
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<tr>
<td><strong>I PRE-SIGNING ACTIONS</strong></td>
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<tr>
<td><strong>A. PURCHASER</strong></td>
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<tr>
<td>1. DUE DILIGENCE</td>
<td>Purchaser, F&amp;B</td>
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<tr>
<td>2. LIEN SEARCHES</td>
<td>Purchaser, F&amp;B</td>
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<tr>
<td>3. RESOLUTIONS OF THE BOARD OF PURCHASER</td>
<td>Purchaser, F&amp;B</td>
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<td><strong>B. COMPANY</strong></td>
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<tr>
<td>1. RESOLUTIONS OF THE BOARD OF THE COMPANY</td>
<td>Company, S&amp;S</td>
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<td><strong>II SIGNING DOCUMENTS</strong></td>
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<tr>
<td><strong>A. PURCHASE AGREEMENT AND EXHIBITS/SCHEDULES</strong></td>
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<tr>
<td>1. PURCHASE AGREEMENT</td>
<td>All</td>
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<tr>
<td>2. EXHIBIT A – FORM OF COMPANY COUNSEL LEGAL OPINION</td>
<td>Company, S&amp;S</td>
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<tr>
<td>3. EXHIBIT B – FORM OF NON-COMPETE AGREEMENT</td>
<td>Purchaser, F&amp;B, Company, S&amp;S, JD, BS, GJ</td>
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<tr>
<td>4. SCHEDULE 1 (COMPANY CAPITAL STOCK)</td>
<td>Company</td>
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<td>5. SCHEDULE 10.1 (SPECIAL INDEMNIFICATION ITEMS)</td>
<td>Purchaser, Company</td>
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<td>6. DISCLOSURE SCHEDULE</td>
<td>Company, S&amp;S</td>
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<td><strong>III. PRE-CLOSING ITEMS</strong></td>
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<td>1. DRAFT WORKING CAPITAL STATEMENT&lt;sup&gt;1&lt;/sup&gt;</td>
<td>Company, Purchaser</td>
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<tr>
<td>2. WORKING CAPITAL STATEMENT&lt;sup&gt;2&lt;/sup&gt;</td>
<td>Company, Purchaser</td>
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<td>3. FUNDS FLOW MEMORANDUM</td>
<td>Company, Purchaser, S&amp;S, F&amp;B</td>
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<td><strong>IV. CLOSING DELIVERIES / ACTIONS OF COMPANY</strong></td>
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<tr>
<td>1. TRANSFER OF LIFE INSURANCE POLICIES</td>
<td>Company, JD, BS, GJ</td>
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<sup>1</sup> To be delivered to Purchaser no fewer than two Business Days prior to the Closing.

<sup>2</sup> To be delivered to Purchaser on the day prior to the Closing.
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<tr>
<th>Document / Action</th>
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<td>2. OFFICER’S CERTIFICATE OF THE COMPANY</td>
<td>Company, S&amp;S</td>
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<td>- fulfillment of conditions in section 8.3(a)</td>
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<td>- authorizing resolutions</td>
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<td>- Company Articles and Company Bylaws</td>
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<td>- incumbency</td>
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<td>3. THIRD PARTY CONSENTS</td>
<td>Company, S&amp;S</td>
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<td>4. PAYOFF LETTERS</td>
<td>Company, S&amp;S</td>
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<td>5. LEGAL OPINION FOR THE COMPANY</td>
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<td>6. GOOD STANDING CERTIFICATES</td>
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<td>- Target Sub (CO)</td>
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<td>7. RESIGNATION LETTERS FROM EACH DIRECTOR AND OFFICER OF:</td>
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<td>- Company</td>
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<td>- Target Sub</td>
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<td>8. EVIDENCE OF TERMINATION OF COMPANY 401(K) PLAN</td>
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<td>- board resolutions</td>
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<td>- notice to plan administrator</td>
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<td>9. FIRPTA CERTIFICATE AND AUTHORIZATION FORM</td>
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<td>10. LANDLORD ESTOPPEL CERTIFICATES</td>
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<td>- Englewood, CO lease</td>
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<td>- Knoxville, TN lease</td>
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<td>11. NON-COMPETE AGREEMENTS</td>
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<td>12. EMPLOYMENT OFFER LETTERS</td>
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<td>- Stacy Zerr</td>
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<td>13. CLOSING BALANCE SHEET</td>
<td>Company, Purchaser</td>
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<td>14. EVIDENCE OF PAYMENT OF TRANSACTION EXPENSES BY THE COMPANY</td>
<td>Company</td>
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<tr>
<td>15. LIST OF EMPLOYEES, IF ANY, TERMINATED FOR NON-COMPLIANCE WITH APPLICABLE LAW (IMMIGRATION)</td>
<td>Company, S&amp;S</td>
<td></td>
</tr>
<tr>
<td>16. TERMINATION OF ALL TAX-SHARING AGREEMENTS</td>
<td>Company, S&amp;S</td>
<td></td>
</tr>
</tbody>
</table>

**V. CLOSING DELIVERIES / ACTIONS OF SELLERS**

1. OFFICER’S CERTIFICATE OF SELLERS
   - fulfillment of conditions in Section 8.3(a)
   - authorizing resolutions
   - Company Articles and Company Bylaws
   - incumbency
   Sellers’ Agent, S&S

2. COMPANY CERTIFICATES, DULY ENDORSED OR ACCOMPANIED BY AN ASSIGNMENT SEPARATE FROM CERTIFICATE
   JD, BS, GJ, S&S

**VI. CLOSING DELIVERIES / ACTIONS OF PURCHASER**

1. OFFICER’S CERTIFICATE OF PURCHASER CERTIFYING FULFILLMENT OF THE CONDITIONS IN SECTION 8.2(A)
   Purchaser, F&B
<table>
<thead>
<tr>
<th>Document / Action</th>
<th>Responsible Party</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. NON-COMPETE AGREEMENTS</td>
<td>Purchaser, F&amp;B, Company, S&amp;S, JD, BS, GJ</td>
<td>At Closing</td>
</tr>
<tr>
<td>- JD</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- BS</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- GJ</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. EMPLOYMENT OFFER LETTERS</td>
<td>Purchaser, Company, JD, BS, GJ and other employees</td>
<td></td>
</tr>
<tr>
<td>4. CLOSING AMOUNT PAID TO SELLERS</td>
<td>Purchaser</td>
<td></td>
</tr>
</tbody>
</table>

### VII. POST CLOSING

<table>
<thead>
<tr>
<th>Document / Action</th>
<th>Responsible Party</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. RELEASE OF INDEMNIFICATION HOLDBACK AMOUNT³</td>
<td>Purchaser</td>
<td></td>
</tr>
<tr>
<td>2. APPOINTMENT OF DIRECTORS AND OFFICERS OF COMPANY AND TARGET SUB</td>
<td>Purchaser, F&amp;B</td>
<td></td>
</tr>
<tr>
<td>3. SUN TRUST LIEN RELEASES</td>
<td>Purchaser, F&amp;B</td>
<td></td>
</tr>
<tr>
<td>- UCCs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- PTO and other IP filings</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

³ See Section 10.1(c) of the Purchase Agreement for release dates.
Victoria T. Blackwell

Victoria is Senior Vice President, General Counsel and Secretary of Papa Murphy's International, LLC franchisor of the Papa Murphy's Take 'N' Bake Pizza stores. Victoria has been with Papa Murphy's since 2001 and handles all legal matters for the company including litigation, franchising, corporate compliance, intellectual property, franchise compliance and contract negotiation. Papa Murphy's recently completed a merger acquisition with private equity investors, the second such event since 2004.

Victoria is a past speaker at the Franchise Forum, IFA Legal Symposium, and is a recent contributor to the new ABA Franchise Compliance Manual.

Kevin P. Hein

Kevin is a partner in the Faegre & Benson Denver office. He focuses his practice on a wide range of legal issues facing franchise and restaurant companies, including state and federal disclosure issues, compliance with state relationship laws, franchise sales compliance, restaurant development, mergers and acquisitions, corporate counseling, and dispute resolution.

Kevin represents franchise companies in the full scope of matters, including state and federal disclosure issues, compliance with state relationship laws, dispute resolution, franchise sales compliance, bankruptcy matters, real estate, mergers and acquisitions, and general corporate issues.

In the area of restaurant development, Kevin assists startup and established restaurants and restaurant companies in corporate formation, real estate acquisition and development, leasing issues, corporate financing activities, mergers and acquisitions, dispute resolution, and general corporate issues.

Kevin is recognized consistently for legal excellence by organizations such as The Best Lawyers in America - Franchise Law, International Who's Who of Franchise Lawyers, Super Lawyers, and as a Franchise Times - Legal Eagle. Kevin serves on the International Franchise Association's Supplier Forum Advisory Board, previously served as the Young Lawyers Division Liaison to the American Bar Association Forum on Franchising, and is the founder of the Colorado Bar Association Subsection on Franchise Law. Kevin has published several articles on franchise-related topics and has spoken at numerous regional and national franchise and restaurant-related conferences.

Kevin is a graduate of Colorado State University and the Georgetown University Law Center.