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Positioning for a Strategic Transaction: Getting Your House in Order

Joel R. Buckberg

Shareholder

Baker, Donelson, Bearman, Caldwell & Berkowitz, PC
Nashville, TN

Amy Cheng

Partner

Cheng Cohen LLC
Chicago, IL

Aziz Hashim

CEO

NRD Capital Management, LLC
Atlanta, Georgia

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I. INTRODUCTION

Whether a franchise system is still owned by the founder, owned by a private equity company or otherwise, the exit strategy of such owner typically involves some kind of strategic transaction. Such transaction may involve the sale of all of the assets, sale of all of the ownership interest in the franchisor, or some other structure that may continue to involve the founder post-closing. All of these transactions require months—if not years— of planning. The likelihood of consummating a transaction often depends on the planning and organization that take place long before a potential buyer enters the picture. This article will address some of the financial, business and legal considerations that a franchisor should be prepared to address when positioning for a strategic transaction.

Our paper addresses the business and certain legal aspects of positioning a franchisor for what comes next – a sale or strategic transaction.

II. TIMING: WHY SELL NOW

The first question for an owner of a franchise system is when is the right time to sell or generate liquidity? Timing of a transaction may significantly impact the multiple for which the enterprise will be sold. Ideally, the consideration of this inflection point in the brand's life occurs well in advance of the date when the transaction needs to or should occur. For example, companies that intend to engage in an initial public offering of securities transition their financial management from minimizing taxable income through aggressive use of salaries, bonus and expense shifting for owner benefits to maximizing after tax earnings, at least two and perhaps three fiscal years in advance, so the financial statements in the prospectus show strong margins and earnings growth. The same consideration applies to franchisors, where the selling price or equity valuation is driven by earnings before interest, taxes, depreciation, and amortization (EBITDA), and its directional trend.

a. Capital

Before an owner decides to sell some or all of its ownership interest in a franchise system, such owner should calculate the effective return on its invested capital. If the franchise system needs more capital in order to grow, how much additional capital will be necessary in order to provide adequate resources to management? Is third party financing an option to obtain this capital? If not, some kind of strategic transaction may be required to generate liquidity to grow the enterprise. Understanding the rate of return and the amount of capital necessary is necessary in order to identify the type of strategic transaction that the owner desires and, therefore, identify buyer(s) that may be interested in such transaction.

b. Management

Owners should also assess the strengths and weaknesses of the current management team. This is important for several reasons. First, if the company is selling to a sophisticated buyer, will this team be able to earn the confidence of the buyer during the diligence and negotiation process? Not only can the management team impact the

likelihood of consummating a transaction, but the team could also impact the ultimate purchase price. Second, if the purpose of the transaction is to generate liquidity rather than to transition the business to the buyer, will some or all of the current management team be able to fulfill the forward business plan? Do they have the proper skills to move the brand forward in the current environment? Finally, if the seller may receive a post-closing earnout subject to meeting certain financial targets, the likelihood of getting that earnout may depend on the management team.

If the company faces a liquidity issue, it may not be able to attract the right talent until it has capital to invest in the team. If it uses its limited resources to hire a management team prior to a transaction, the management may require significant compensation in connection with a change of control. Further, what if the buyer has its own management team and would only consummate a transaction subject to termination of certain executives in connection with the closing, which would result in the payment of significant severance amounts? While there's no playbook for a seller to follow, simply understanding the strengths and weaknesses of the management team will put the company in a better position as it considers a strategic transaction.

If the company is seeking liquidity but not selling, the strength of an existing founder to continue future growth will be attractive to many buyers. Whether that founder is a skilled CEO or has good relationships with franchisees, a buyer may require the founder to continue to be an active member of the executive team. Such buyers may offer a premium if they can lock in that founder into a long-term employment agreement. Some may also be willing to let the founder keep a percentage of the ownership going forward.

If the founder remains part of the team post-closing but gives up control of the company, the toughest part of the transaction is often negotiating the rights of such founder. It would be beneficial to all parties, if the founder is mentally prepared to give up that control. Further, the founder should articulate early on if he/she desires to retain certain areas of control. Negotiating rights and obligations of such founder is often one of the trickiest parts of the transaction. Having fulsome internal discussion on this subject well in advance of the articulation of the founder's intentions on a continuing role in the enterprise can prevent the issue from surfacing later on in the process and sidetracking or killing the transaction.

c. Technology

Whether the existing technology of the franchise system is one that will enable the franchisees to operate effectively and the franchisor to have visibility into their operations may impact the attractiveness of a system to a buyer. If the system is outdated and requires significant future investment by either the franchisees or the franchisor, a seller will need to take that into consideration when determining the purchase price. Further, if the franchisor has no visibility into franchisees' financials, a buyer may not be able to effectively evaluate the financial health of the franchise system.

d. Supply Chain

A franchisor's future revenue depends on the ability of the franchisees to continue to offer services and products. This means there must not be supply chain disruptions. Or if there are, the franchisor has found alternative suppliers to minimize interruptions. A company that has locked up a supply chain and has the ability to manage any supply disruptions may be able to leverage scale for optimum pricing.

e. Competition

In making the decision as to whether and when to sell a franchise system, the seller must consider existing and future competition. Is the competitive landscape going to change as to increase or decrease the value? If the concept is unique yet has great potential to grow, the seller may receive a higher value now than five years from now when there is a lot of competition. Therefore, it may be better to sell a system with thirty units now when there is not any competition, then to sell a system with eighty units three years later when there are a lot of other similar franchise systems. From this perspective, bigger may not always be better.

f. Liquidity Event

If a private equity company or similar company with investors owns the company, then part of the timing consideration is whether a liquidity event would be meaningful to the investors. What were the investor expectations and what kind of return on investment would this require? To the extent a private equity company is expecting investors to invest in future funds, then the amount of return on investment may determine whether they will invest in future funds. This may mean that, even if the management is ready to sell, it cannot sell unless it believes it can get a price that it needs to meet investor expectations.

III. PREPARING FOR A TRANSACTION – RIGOROUS SELF-EXAMINATION

An effort to engage in a sale or a strategic transaction must be rooted in a rigorous, candid and honest self-examination of the franchise organization, the brand and the markets for franchisees and customers. The examination is often outsourced to financial or business consultants or investment bankers who are experts in evaluating strategic alternatives for businesses. The consultants should provide complete and insightful answers to augment the owner/management knowledge about the business. No outsider will know the business as well as the owner/management, but their objectivity and market knowledge will be invaluable in answering important questions about strategic options.

Compared to other retail-oriented businesses, whether B2B or B2C, franchise brands operate in two separate markets– the market for the franchises of retail outlets, and the consumer market for the brand's product or services. Any analysis must evaluate potential and competitiveness for both markets. One significant benefit in the franchise world is the availability of competitors' franchise disclosure documents ("FDDs") to provide information about all of the topics covered in an FDD. Of particular interest would be Items 5 (initial fees), 6 (on-going fees), 7 (estimated costs to open), 8 (supply chain

and related revenues), 10 (financing), 11 (services, training and technology), 12 (territory and channel management), 19 (financial performance representations), 20 (outlet census and expected growth in Table 5), and 21 (financial statements).

Many companies start their assessment with a “SWOT” analysis:

SWOT analysis was invented in the 1960s by a management consultant named Albert Humphrey at the Stanford Research Institute. Previously, corporate planning had not met with much success. Fortune 500 companies needed a way to produce long-term planning that was executable and reasonable. Humphrey and his research team proposed the SWOT model to bring accountability and objectivity to the planning process, and it has been popular ever since.

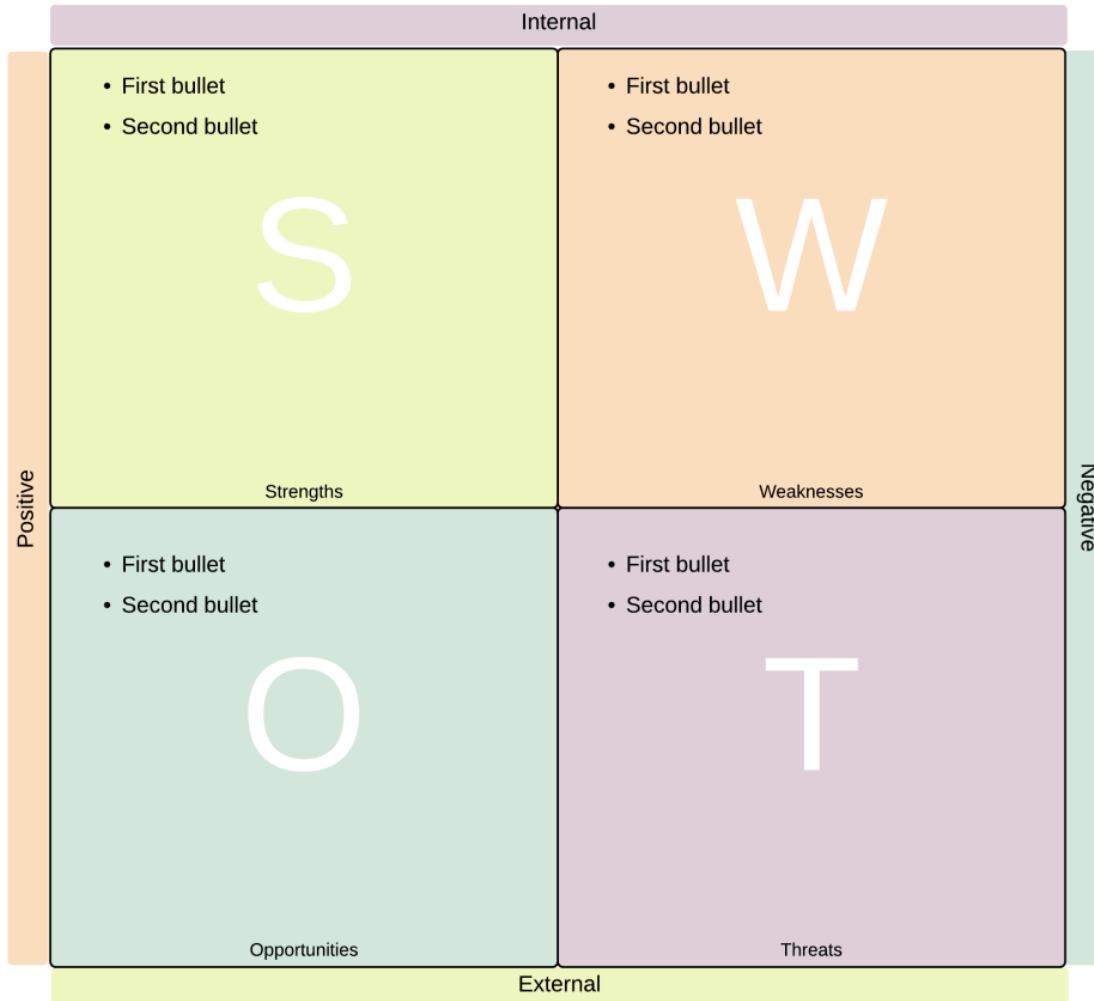
Albert Humphrey advocated performing SWOT analysis on specific criteria, such as products, process, customers, distribution, finance, and administration.¹

SWOT stands for Strength, Weakness, Opportunity, Threat. This analysis grid is often used to organize the presentation and enhance understanding of the findings.²

¹ <https://www.lucidchart.com/pages/what-is-swot-analysis>; viewed on January 29, 2023

² *Ibid.*

SWOT Analysis Template



For a franchisor, a SWOT analysis should be used for both the franchise market and the consumer market. For each market, consider the internal factors first. These factors should include:

Experience and capability of the management team

Finances of the franchisor and the ability to finance infrastructure in anticipation of growth

Human Resource talent evaluation throughout the organization

Technology and tangible resources sufficiency

Backlog of signed outlets under development and probability of successful completion and opening

Growth potential based on existing outlets, outlets under development, and existing territorial commitments, exclusivity and channel potential

The analysis moves to externalities that affect both markets:

State of the general economy and the willingness of customers to buy in varying economic conditions

Demographics and psychographics of customers

Competition and perceived standing of the organization with franchisees and customers

Regulatory changes and governmental intervention in the market

Armed with the SWOT analysis, the franchisor's owner/management group has the option of a deeper dive to decide what changes will be the most effective to achieve the organization's goals. Typical areas of focus would be the following:

a. Franchise Sales and Development.

Examination of the lead generation and development, sales process, closing and developing outlets after signing. The analysis would include trends and changes in all key metrics to identify easy fixes and those changes which will require access to more investment and resources than are currently available for that purpose. Early-stage franchisors may collect responses to inquiries from the consumer website to generate leads or use more expensive lead generation vendors because they do not have the capital to support in-house resources. In either case, the cost of a qualified lead may be sufficiently high as to justify cost reducing investments.

Has the pace of sales activity and outlet openings slowed, and if so, to what is the slowing pace attributable? The open territories/markets identified by the franchisor as opportunities for growth need sales and support resources. If competitors populate open markets with their outlets first in the best locations, then outlet growth opportunities in those markets will be less attractive, non-existent, or more expensive. The larger owner/management question is whether the organization's design and talent have the capability to achieve the brand's growth potential, or whether the organization has maximized its growth potential realization at the current growth rate and pace of openings.

Another growth inflection point occurs when the franchise sales function shifts from outsourced shared salespeople to a dedicated, in-house staff. Franchisors often engage outsourced franchise sales groups or franchise brokers at an early growth phase, but those resources are often relatively expensive in terms of upfront fee sharing and perhaps royalty fee sharing. But switching requires cash outlays in advance to hire, train and field an in-house sales force. The savings from reducing the costs incurred for each franchise sale will be realized over time, but the start-up/set-up costs must be expended before sales occur and the associated initial fee cash is harvested. Add relocation, equipment, travel, remote office and other overhead expenses to the mix and the investment required increases exponentially. Management for this sales force, who usually command relatively high levels of compensation and benefits, add another layer of execution complexity and cost. Owners/management face hard choices in deciding whether to

implement such a dramatic organizational change, whether existing resources are allocated or new resources are obtained. The uncertainty of the amount and the timing of the return on this sales force investment will often argue against debt financing for such a purpose.

b. Compliance Culture.

Early-stage franchisors observe varying degrees of formality with respect to documentation of franchise transactions. Resources devoted to administrative functions, and the sophistication of employees or consultants managing administrative functions, can lag the resource allocation to non-administrative functions. A priority focus of buyer/partner diligence will be how well each franchise transaction was documented, and how well any inflection points in the relationship are documented after completion of the initial franchise sale transaction. This concept appears to be elementary and simple, but in practice, not all organizations demonstrate the same dedication to recordkeeping and chasing down the last signature for every agreement. Conversion of closing from using manual or wet signatures to electronic signatures should address the initial transaction details sufficiently, as there is usually substantial attention paid by franchisor and franchisee to FDD-connected documents.

But what about the on-going relationship with the franchisees? What is the platform for recording interactions that may have legal significance? Does the franchisor's desire for a collegial and non-confrontational relationship with franchisees cause it to shirk or shy away from the administrative responsibilities of a franchisor? An extreme example of laxity in administration is the case of *Schwartz v. Rent A Wreck of America, Incorporated*, 468 FedAppx. 238, CCH Bus. Fran. Guide ¶ 14,782 (4th Cir. 2012), in which a series of transactions involving corporate acquisitions and later divestitures left a founder and former franchisee in business at the original location in Los Angeles, California, operating under what was disclosed in Item 1 of the 2001 and 2002 editions of the Uniform Franchise Offering Circular of the franchisor as a "royalty-free agreement." The franchisee never signed a franchise agreement for that location. It was listed in the franchisor's Item 20 as a franchised location for several years and was listed on the franchisor's website as an authorized location. The Fourth Circuit called the relationship between the franchisee and the franchisor "somewhat unorthodox." The franchisee did not abide by the brand standards, but the franchisor took no action. When the franchisor put itself up for sale, the putative franchisee sued to challenge the sale, and the franchisor brought its own action seeking to clarify the status of the relationship. The case went to trial in 2010, and the jury reached a majority verdict to find that a course of dealing resulted in an implied franchise agreement with an exclusive territory of West Los Angeles for the rest of the franchisee's natural life covering the primary and a secondary brand of the franchise. The franchisee was not subject to the same obligations as a franchisee using the franchisor's standard franchise agreement, yet was entitled to the same benefits or services provided to a conventional franchisee.

The Fourth Circuit reviewed the jury findings and affirmed the finding of an implied contract. The record at trial supported the finding with evidence that the franchisor treated the franchisee as it would have others, and the Uniform Franchise Offering Circular Item

1 and Item 20 disclosures supported the finding as well. The franchisor's conduct in treating the non-contract franchisee as one would a contracted franchisee undermined its arguments about the validity of the arrangement. The jury findings on the exclusive territory were vacated under California's prohibition against restraints of trade³. The Court also reversed on the issue of whether the franchisee could enjoy the benefits of the franchise unless it fulfills the same obligations as other franchisees.⁴

c. Technology.

The utilization of and investment in technology is a point of great contention and stress for franchisors. As the level of sophistication and complexity of the business grows, a point is reached where off-the-shelf systems are inadequate for the franchisor's information technology needs. Because investment precedes revenue generation from new technology, financing the technology refresh at the franchisor level must be creatively pursued. The cost of a technology refresh, or the realization that the franchisor does not have the organizational wherewithal to pursue and execute a technology refresh, is often a catalyst for a strategic transaction. Leverage of existing technology in use by another franchisor offers an attractive alternative that can reduce costs on both the acquirer and the acquired. Funding for operations, development and support can be shared over a larger number of outlets, or support services enhanced by the larger revenue pool. When the brands can share retail customer facing and franchisee facing technology, while maintaining brand identity and differentiation, consumer and franchisee choice and facilitation of transactions can be enhanced. Ultimately, the brands are more competitive with others in the same marketplace.

For example, such technology platform sharing has been common in the hotel industry since the early 1990's when the large, multi-brand hotel companies began to form and operate common reservations, guest loyalty and hotel property management systems. Guests benefit from the opportunity to book a reservation efficiently in whatever level of hotel they prefer – from economy to luxury, while the cost of a common technology platform that is opaque to the guest is shared among thousands of franchisees.

d. Back Office Support Functions.

As brands grow in the number of their outlets and geographic spread, support becomes more difficult to execute. Organizational support for a larger franchise base requires more people, even if there is a deliberate increase in the number of outlets supported by each support representative. For each number of direct support providers added, a new step in the cost of operating the business occurs. The conventional wisdom about step cost businesses is that incremental revenue from new sources does not

³ CA. Bus. & Prof. Code Sec. 16660.

⁴ The franchisor and franchisee continued their litigation war through a second trial, and the franchisor filed a bankruptcy case in Delaware that was dismissed as a bad faith filing. *In Re Rent-A-Wreck of America, Inc.*, 580 B.R. 364, 65 Bankr.Ct.Dec. 74 (U.S.B.C. D. DE. 2018).

increase overhead costs proportionally, thereby increasing profit by a relatively high percentage of incremental revenue.

e. Market Segmentation.

The segmentation of markets by price, service, product or customer provides opportunities for franchise systems to grow laterally or through channels besides retail outlets. The rights reserved in the territorial clauses of franchise agreements and development agreements, as well as the disclosures in Item 12 of the franchisor's historical FDD's, and commitments made to franchise advisory councils, should be the focus of clear-eyed analysis about segments and channels that are closed because of legal obligations, disclosure language, policy or disclosure ambiguity. Diligence in this area should extend to advisory council agendas, minutes, and presentations, as well as franchise convention and franchisee communications on the issues of market management. If the CEO stood in front of the convention and said, "We will never package and sell in Big Box stores," then the lore of the brand may preclude such a direction for the franchise brand. At the very least, the franchisee discontent will be substantial if new owners decide to proceed in a direction contrary to past commitments and statements, even if those are not legally binding.

The other term marketers use in this context is "cannibalization," which vividly describes the impact of aggressive pursuit of new markets that adversely impact sales of existing outlets.

f. Leverage of a Larger Organization.

A frequently expressed reason for combining forces is the creation of multi-brand leverage for spreading the cost of marketing, technology development and implementation and harnessing outlet buying power to lower costs of goods and services for the combined franchise systems' outlets. Both Hilton and Marriott each have over 15 hotel brands.⁵ These franchisors' Items 1, 8 and 12 disclosures demonstrate the scale of larger organizations that can leverage resources, harness buying power for goods and services, and spread the costs of infrastructure over a larger number of brands and outlets. For genres where buying power scale can reduce the cost of goods for franchisees, the combination with a larger system can produce bottom line results for franchisees, if there are no corresponding increases in fees, commissions or rebates that would drive up prices to franchisees to prior levels. If cost reduction or price stabilization for franchisees can drive growth and success for franchisees, then the opportunity will be appreciated by the constituents that are most affected. Conversely, if a sale or event will lose a competitive advantage in supply chain, then the resistance to such a transaction may become fierce and potentially threatening to the transaction.

Another potential leverage advantage is consolidation of franchise sales forces that will allow the salespersons to offer and sell additional brands to existing franchisees

⁵ The 2022 Hilton FDD lists 19 brands being franchised. The 2022 Marriott FDD lists 24 brands being franchised.

and new franchisees. The target brand may be a better match for the skills, resources and talents of a franchise prospect than the legacy brand. There will be dilution of focus and less dedication of effort to an individual brand, which is a tradeoff for a larger sales force and more resources devoted to selling franchises. Multi-brand sales forces generally organize around complementary brand clusters so a prospective franchisee looking at a genre or class of franchise will be able to connect with a salesperson assigned to the desired market. If the target brand needs a dedicated sales force and its prospects are not interest in the more than one brand in the portfolio, then this factor is not germane to the seller's consideration.

g. System Culture.

Each franchise system is inculcated with its own culture and ethos, drawn from the founders, the business model, the training and support functions, the common experience of franchisees in operating their outlets and adherence of the franchisor and the franchisees to the written policies and procedures of the brand. For example, do employees at franchised locations follow the brand directives regarding greetings of customers on arrival and delivery of purchased goods and services according to the brand's service standards? Is the customer experience consistent from outlet to outlet, or is the customer experience equivalent to the famous "Forrest Gump" metaphor about the box of chocolates – "you never know what you are going to get" when you order from the outlet?

A franchise system without a strong culture of brand loyalty, consistent service levels and customer experience will not command the same value as a franchise system that demonstrates those attributes. An owner/management team must first assess the brand's and system's culture – again, at both market levels: franchisor/franchisee and outlet/customer. There are some simple diligence tasks for counsel that can assist in this assessment.

Franchise systems measure quality assurance and customer perceptions of quality. Brands have standards, and standards assessments and inspections are routinely performed by brand staff, mystery shoppers or third-party vendors. The franchisor has likely litigated a standards failure, either to compel compliance or to terminate a franchise. What did the litigation reveal about the brand culture and system? A clear-eyed review of the discovery, evidence and pleadings in that case, and any expert testimony available, may provide a pathway to recognition of improvement opportunities.

Another area for examination is the record of granting standards waivers and other dispensations to franchisees who are or would like to be non-compliant with brand standards. A brand that operates with a significant number of waivers has trouble maintaining consistency as a brand. It runs the risk of being perceived by potential acquirers as just a collection of outlets sharing certain operating expenses. Reducing or eliminating waivers or arranging for departure of outlets and franchisees that will not or cannot operate in standards compliance will in the long run enhance brand value. But in the short run, the loss of revenue from these outlets will adversely affect financial performance. The challenge for the owner/management team is to promote brand

standards compliance, eliminate or curtail standards waivers, and reduce the variability of outlet compliance with brand standards.

Financial and reporting compliance culture forms a key component of diligence and preparation. Do franchisees report information needed to calculate or confirm their franchise fees as and when required? Do they pay their recurring and episodic fees on time? These simple questions will be among the first asked by a prospective acquirer.

Any guest of a hotel, many restaurant customers, and other customers who provide email information will be solicited to provide feedback on the experience. There are well known companies in the “customer experience management” industry like Medallia and J.D. Power who solicit and manage this customer feedback. These collection tools provide rich data to examine and assess customer perceptions of the brand. It behooves any franchisor to analyze such data in preparing for (and pitching) a strategic transaction.

h. Changing the Culture.

A franchise brand’s culture cannot be changed by fiat or on the whim of the brand’s owner. Culture shifts require persuasion, time and candor in answering the question of “what’s in it for me.” Franchisees have been sensitized about signals of a pending strategic transaction, particularly when a benign practice or course of dealing becomes the target of an effort to modify, end or restructure in a way that will benefit the bottom line of the franchisor. An example of this would be when development process deadlines that are only casually observed become the object of more focus and attention, resulting in the first time a late developing outlet may have its franchise agreement terminated for failure to start construction or renovation on time. A potential buyer looks hard at the quality of the development pipeline and expects overdue developers to be motivated to complete development, or lose the market.

Changing the culture of a franchise organization is akin to steering a large ship. There are two principles of navigation that also apply to these cultural shifts and are usefully borrowed for the context of a cultural change. The first concept is called “transfer” and it means the distance a vessel moves horizontally at any point in the turn, measured 90 degrees from the original course. The second concept is called “advance,” meaning the distance surged by the vessel forward after the turn has been initiated.⁶

To complete the analogy for a franchise brand, the “transfer” is the relative change intended to be implemented, and how far from the original conditions must the brand travel to achieve the new course. The “advance” is how long in time or how many transactions or events under the changed culture must occur before the change is complete. The bigger the transfer, the longer is the advance. The ability to execute a 90

⁶ <https://www.marineinsight.com/naval-architecture/different-types-of-manoevres-of-a-vessel/>; viewed on February 24, 2023.

degree or 180-degree transfer turn with little or no advance is rare, so the franchisor needs to plan for the likely implementation delay for any cultural change.

The cultural change issue is the subject of a number of litigated cases. Some of the cases involve what some franchisee lawyers call the “lore” of a franchise relationship – oral representations or practices on which franchisees allege they justifiably rely that were made and repeated by the franchisor to form material terms of the bargain between a franchisor and its franchisees. A topic of candid assessment for the franchisor’s executive staff is whether the franchisor’s practices and customs vary materially or consistently from the area or franchise agreement forms. If the answers are “we never enforce that,” or “we always give twice the amount of time as the franchise agreement says,” the franchisor should consider an exceptions report in diligence materials, or act promptly to rehabilitate the original performance requirement embodied in the agreement forms.

The concept of a course of dealing becomes a powerful tool against the party seeking to change the course. “A course of dealing is a sequence of conduct concerning previous transactions between the parties to a particular transaction that is fairly to be regarded as establishing a common basis of understanding for interpreting their expressions and other conduct.” *Jonibach Management Trust, v. Wartburg Enterprises, Inc.*, 136 F.Supp.3d 792; 2015 WL 5734420; Bus. Fr. Guide ¶15,621 (S.D. TX. 2015). The *Jonibach* case involved an oral distribution agreement between a South African manufacturer of plastic infant seats sold to retailers in the United States. The court held that the Uniform Commercial Code (“UCC”) governed the distribution arrangement because the sale of goods was the dominant purpose of the arrangement.⁷ If a franchise involves a product distribution business, the UCC will likely apply to the franchise agreement. Because the *Jonibach* arrangement was purely oral, there was no guidance from a writing and the parties were left with evidence from the communications and actions of the relationship over its term. An unsigned franchise agreement is essentially an oral contract, and the disclosed terms may or may not provide guidance as to what the parties agreed for the contract terms.

In evaluating the culture of the brand and franchise system, particularly when the franchise involves the distribution of branded goods instead of a business format program, the UCC becomes a significant factor in determining whether the parties have a contract that is not necessarily the franchise agreement. Consider how the UCC looks at the factors to decide if a contract exists under Section 2.204:

A contract for sale of goods may be made in any manner sufficient to show agreement, including conduct by both parties which recognizes the existence of such a contract.

⁷ 136 F. Supp. 3d 792, at 810. The Court cites with approval the language of *East Hill Marine, Inc. v. Rinker Boat Co., Inc.*, 229 S.W.3d 813, 818 (Tex.App.-Fort Worth 2007): “the overwhelming majority of jurisdictions that have considered the question have concluded that distributorship agreements are subject to the UCC. We will follow the majority rule in holding that the dominant factor or essence of each of the alleged agreements was a contract for the sale of goods, and thus each was subject to the UCC.

An agreement sufficient to constitute a contract for sale may be found even though the moment of its making is undetermined.

Even though one or more terms are left open a contract for sale does not fail for indefiniteness if the parties intended to make a contract and there is a reasonably certain basis for giving an appropriate remedy.

The UCC sets a low bar for a contract. The contract law of a franchisor's or a franchisee's state may follow the UCC closely, even in non-UCC cases such as a services contract. Most significantly, the general principle for interpreting the term of oral contracts also applies, which is that in the absence of an agreement as to the term, the contract is terminable at will by either party after a reasonable time,⁸ and after giving the non-terminating party reasonable notice.⁹ But what is a reasonable time and reasonable notice? There is little predictability to that answer:

“What constitutes a reasonable notice of termination will vary in accordance with the facts and circumstances of each case” and is a fact question for the jury. *Id.* In *Coburn Supply Co., Inc. v. Kohler Co.*, 342 F.3d 372, 376 (5th Cir.2003), the appellate court opined, “While no Texas case squarely addresses the issue of reasonable notification in the sale of goods context, the cases on this issue outside of our jurisdiction uniformly hold, even in the context of an exclusive distributor relationship, that reasonable notification calls for such notification as will give the other party reasonable time to seek a substitute agreement (citations omitted).” Thus, damages for a breach-of-contract claim are based on whether the terminating party gave reasonable notice to the other party. *Id.* at 375¹⁰”

The statute of frauds that requires some contracts to be in writing has exceptions. The UCC Statute of Frauds appears in Section 2.201 and requires all contracts for the sale of goods over \$500 to be in writing,¹¹ with certain exceptions for incomplete or defective writings, partial performance, payment, as between merchants, or specially manufactured goods. The general statute of frauds in most states has an even lower bar in the context of a franchise agreement or relationship, namely, a contract that cannot be performed within one year.¹² Because the stream of written communication between a

⁸ UCC Sec. 2.309(b) provides: “Where the contract provides for successive performance but is indefinite in duration it is valid for a reasonable time but unless agreed may be terminated at any time by either party.”

⁹ 138 F. Supp. 3d 792, at 812.

¹⁰ *Ibid.*

¹¹ UCC 2.201(a): (a) Except as otherwise provided in this section a contract for the sale of goods for the price of \$500 or more is not enforceable by way of action or defense unless there is some writing sufficient to indicate that a contract for sale has been made between the parties and signed by the party against whom enforcement is sought or by his authorized agent or broker.

¹² V.T.C.A. Bus & C. Sec 26.01: (a) A promise or agreement described in Subsection (b) of this section is not enforceable unless the promise or agreement, or a memorandum of it, is (1) in writing; and (2) signed by the person to be charged with the promise or agreement or by someone lawfully authorized to sign for

franchisor and its franchisees is constant and continuous, the writing requirement can be met by some form of written acknowledgment by the party against whom enforcement is sought.

In the context of preparing for a sale/strategic transaction, the buyer/investor will want to understand whether there is a risk of the unknown – a contract that will not be interpreted as it is written because a course of dealing or communication with persons of authority has created an implied contract or modification that is undocumented and not well understood. What about the practices observed by the franchisor target in dealing with franchisees? Are they consistent with the agreement forms and good business practice, widely inconsistent, or only applied selectively to franchisees based on some unarticulated criteria?

Consider the case of *LaGuardia Associates and Field Associates v. Holiday Hospitality Franchising, Inc.*, 92 F.Supp.2d 119 (E.D.N.Y. 2000), in which a long-standing practice of allowing the franchisees to pay monthly franchise fees 60 days late without penalty or declaring a default was sought to be curtailed, and the franchise was terminated for monetary default, based on late payment. The franchise agreement was governed by Tennessee law, but the Delaware entity franchisor's headquarters had moved to Georgia, so the court refused to honor the choice of law and applied New York law instead. The opinion includes an extensive discussion of the franchise relationship and merits reading for those managers and their counsel seeking to change franchise system management practices. After a long exposition on relationship laws, unconscionability, and unequal bargaining power, one stunning statement from the Court arguably reached toward a New York relationship law limitation of franchisor conduct, even without a New York statute to the same effect.

Despite the fact that New York's statute does not by its express terms cover termination of franchises, its general tenor bespeaks a state policy to prevent overreaching in the franchise relationship.¹³

While the Court in *LaGuardia Associates* followed New York law and found that no implied modification of the franchise agreement occurred, choosing to honor New York law that enforces written modification clauses, it did find that the franchisor's conduct in delaying enforcement of the "pay on time" clause constituted a waiver of enforcement of that clause. The franchisor had given a notice of default but failed to terminate for ten months after giving the notice. The franchisees eventually caught up their fee arrearages and became current on the account. The Court observed: "Having permitted plaintiffs to become addicted to payment delays, Holiday could not simply cut them off cold turkey."¹⁴ The Court then fashioned a remedy that allowed the franchisees until May to pay fees

him. The one-year language provides: (b)(6) an agreement which is not to be performed within one year from the date of making the agreement.

¹³ 192 F.Supp.2d 119, at125-127.

¹⁴ 92 S.Supp.2d 119 at 130.

accrued through March 1, but then required the franchisee to pay on time for the April revenues with the fees due May 15, and for all months thereafter.

A more recent case in the same court distinguished *LaGuardia Associates* as an equitable result and declined to create a New York relationship law from whole cloth. See *Tow Services International, Inc. v. Tampa Bay Marine Towing & Service, Inc.*, 2022 WL 5122728 (E.D.N.Y. 2022). That case involved a transfer gone awry but merits consideration as it does find that under New York law, and the New York Franchise Act, a franchise can arise through implicit agreement.

One area where the franchise system's relationship culture and compliance culture meet and potentially clash is whether the franchisor enforces its jurisdiction and venue provisions outside states where local jurisdiction and venue are required by law or as a condition of registration, or it allows franchisees to bring actions locally and does not defend its forum selection clause. The track record on this score should be examined and unless there are tactical reasons in particular situations that argue for litigation where the franchise is located, such as witness availability or locally sensitive issues, should be enforced as written and disclosed. The potential expense and disparate results from multiple jurisdictions deciding similar issues in enforcing the franchise agreement is a controllable risk a buyer or strategic partner may be unwilling to assume.

i. Diligence Facilitation.

To make its own decisions and to facilitate diligence by a buyer/strategic partner, what records should a franchisor compile or create? The counterparty will focus on the current status of the brand, how that status was achieved and attained, and whether the brand is well positioned for either energetic growth or sustained cash flow with slower but steady growth after the transaction. If the buyer/strategic partner is already a participant in the same industry, it will be able to cut to the heart of the business more quickly and need less time to understand the franchise genre and competitive landscape. Compilation records to be created might include the following:

- Library of Franchise Disclosure Documents and Redlines for annual changes
- Registration state comment letters
- Compilation of Negotiated Changes to Franchise and Area Agreements
 - Frequently changed provisions and form special stipulations
 - Royalty Rate or Formula Changes
- Compilation of Territorial Restrictions and Closed/Open markets
 - List of exceptions and negotiated exclusive territories
 - Non-traditional venue exclusions and exceptions
- Development Process Status Reports for Area and Franchise Agreements
 - Approval process status for sites and leases
 - Delinquency deficiency list
 - Designs, plans and specifications status
 - Supply chain backlog issues
 - Projected Opening Dates

- List of On Schedule and Off Schedule Area Development Agreements
 - Actions taken to clarify status and deadlines
- Key Performance Indicator (“KPIs”) Program for Outlets
 - Current KPI Report
 - Analysis of leading and lagging KPI’s
 - Outlier Follow Up Plan
 - Track Record Report
 - Franchisee Performance Improvement Plans Status Reports
 - What do the field representatives know and don’t write in the reports?
- Pending Standards Updates and Deadlines
 - List of waivers, exceptions, deferrals
- Non-Performance Report – outlets not in compliance and actions taken to resolve
 - Late Standard Reports
 - Deadlines for Action
 - Standards waivers and exceptions, sunset dates on waivers
- Default Report – default notices issued, and default not cured, within cure period
 - Cure Plans (payment and performance), extensions and status
- Termination Report – outlets eligible for termination and terminated this fiscal year
 - Reinstatement Possibility
 - Enforcement Status

j. Assignment Rights and Change of Control Consequences.

Although a review of Item 17(j) of each FDD is a starting point for this issue, the franchisor should review any negotiated changes to its assignment rights and any change of control limitations that may have been added to any franchise agreement. These restrictions may have been added through a restriction on the identity or status of a buyer or strategic partner and may take the form of a springing termination right, triggered if a certain buyer/investor becomes the owner or a significant part of the ownership of a franchisor.

The same review and analysis should be directed toward key supplier contracts and other major contracts such as mission critical software licenses, leases, advertising, sales and marketing contracts and other contracts on which the franchisor relies to perform its services and distribute goods for resale to franchisees.

k. Internal Controls on Compliance at Key Process Points.

One area of immediate interest that is relatively easy to repair is whether the franchisor’s administrative workflow for new transactions incorporates checks and balances to assure compliance with the timing of disclosure requirements, and the good cause termination or notice requirements under state and Federal franchise disclosure and relationship laws. Does the franchisor use check lists and has it assigned someone

besides the application coordinator processing the file to check at key points in the process to assure compliance with applicable laws? Whether or not the franchisor's auditors comment on the internal controls, the franchisor will need to demonstrate a consistent, coherent process in which the gatekeeper is not compensated if he or she looks the other way and allows a process-defective file to be converted into a franchise sale. Although appropriate process oversight is generally part of a well-run, well-intentioned franchisor, fast growth franchisors may elect to skip this step in organizational design, relying instead on the compliance training received by the administrative staff, or legal counsel to assure regulatory compliance. After the sale is too late, so the checks and reviews must occur before each sale is consummated. Rescission is very expensive to pursue, and voluntary self-disclosure to regulators, is not financially or emotionally beneficial. More on this topic appears in the next section of this paper ("Legal/Regulatory").

I. Financial House in Order – Internal Controls.

Every audit report is accompanied by the auditor's cover report to management in which the audited entity's internal controls are assessed. The accounting for a franchise business is somewhat more complex because it relies in some measure on the quality of information submitted by franchisees to calculate franchise fees and ultimately, franchisor revenues. The buyer/strategic partner will request the management letters along with the audits, and then inquire about the steps taken to address all of the deficiencies noted in the management letter. To the extent that any deficiencies carry over from one audit to the next audit, those would be of greatest concern.

To assure the accuracy of franchisee-reported information, franchisors are expected to have some form of verification, either through an internal audit performed by franchisor or contract personnel, or by direct data access and polling of franchisee point of sale and accounting systems. This function is very important with respect to franchises that involve cash transactions at retail. It assures a buyer or strategic partner that accounting is timely, accurate and complete, with no underreporting of revenue. As the saying goes, "trust but verify."

A prospective buyer/strategic partner will also inquire about, and the franchisor should be prepared to demonstrate, that it has adequate information about and takes appropriate action to assure compliance in other sensitive legal areas, such as income, withholding, sales and property tax reporting and compliance, human resource compliance with employment law governing the franchisor's workforce, and compliance with leases and other material contracts. This control element involves robust and thorough monitoring of performance obligations on both parties, and percolating information up to the decisionmakers in the ordinary course of business. In a small, flat organization, these functions may be overlooked or consolidated in a small group of employees who are assigned more duties than can be successfully performed in a timely manner.

m. Quality of Earnings

An important part of pricing for the sell side and the buy side is the confidence of each side respectively in the quality of current earnings and the continuity and predictability of future earnings for the franchisor. The accounting and consulting professions have created a commonly used reporting vehicle available to both sides to address this critical need.¹⁵

A Quality of Earnings report, also called a QOE or QofE report, helps a buyer or investor understand the historic earnings and forward-looking performance of the business through rigorous financial analysis. QOE reports are one of the two most important components of due diligence when buying a company (the other being legal diligence). QOE reports go beyond the face of the target's balance sheet and profit and loss statement – they challenge the underlying data through rigorous testing and management interviews to assess accuracy of forecasts and the risk of external and internal factors having a negative impact on earnings. Franchises lend themselves to QOE analysis because each franchise agreement has a defined payment scheme, a history of performance, and a finite term. The likelihood of renewal can be determined based on historical rates of renewal, and the constraints of post-term non-competition covenants. Future earnings tie to disclosed development and franchise agreements, with a track record establishing a probability of opening for franchise agreements that have been signed but the outlet has not yet opened. Franchise companies present reduced uncertainty of future earnings compared with other methods of retail business operations. Externalities face all businesses, but the presence of competitor Franchise Disclosure Documents reduces the guess work about competitive market factors.

A QOE report is like taking a used car to the mechanic before buying it. Even if the “check engine” light is not on, that does not mean you can assume the car is in good working order. Businesses are no different – strong financial statements can often mask risks or material inaccuracies under the surface. A QOE report is designed to detect those risks and inaccuracies.

A QOE report will differ by who is requesting the information: the buyer or the seller. Sellers order a Quality of Earnings report before soliciting buyers to uncover any problems that might disrupt the transaction or affect the price. Think of a home inspection ordered by a homeowner before listing the house in which they live, so all of the big and small items on that inspection report can be resolved or deferred with a plan or allowance, or factor into the listing price of the home. In addition to uncovering potential problems with future earnings forecasts, a sell-side report will help the seller understand the business from the perspective of a potential buyer/investor. In either case, the additional perspective enables the seller to address or remedy any pitfalls ahead of the transaction or develop a strategy to be implemented after the transaction.

¹⁵ This material is drawn from <https://cfoshare.org/blog/what-is-quality-of-earnings/>, viewed on January 27, 2023.

A buy-side QOE report provides more details around the business's net income and EBITDA¹⁶ to help the buyer determine whether the business is worth the price asked, and if not, what would be the price for the business according to the corrected QOE analysis. For example, the report evaluates the recurring nature of the franchisor's operations and cash flows, potential over-statements of inventory, and the quality of the assets and liabilities of the business. Buyers use the results of a QOE report to feel confident in their acquisition, negotiate better terms of sale, create plans and allowances/reserves for dealing with or walk away from a deal with problems that affect the business that cannot readily be resolved.

A franchisor's audited financial statements focus on historical transactions, with appropriate attention to contingencies and events that may occur in the future, with management responsible for compliance with GAAP¹⁷ accounting standards. Audits are prepared under the guidance of generally accepted auditing standards¹⁸, whereas Quality of Earnings reports focus on the franchisor's earnings history and potential. What factors influenced earnings in the past, and what factors will influence earnings in the future? Financial audits do not address the outlook of the franchisor—a Quality of Earnings Report does.

The type of analysis performed by the QOE consultant should be relevant to the franchisor's industry and business model. Examples of findings include:

- Unusual financial trends and variances
- Significant and/or unusual accounting policies that affected earnings such as:
 - Changes in accounting methods
 - Changes in accounting principles
 - Changes in accounting policies
 - Changes in accounting practices or procedures
- Unusual or nonrecurring items of income or expense
- Transactions with related parties
- Inability to prove cash impact from accrued items
- Sales concentrations and/or backlog risk
- Analysis of inventory reserves and allowances
- Reviews of account reconciliations, account aging, and composition

¹⁶ Earnings Before Interest, Taxes, Depreciation and Amortization in common accounting terms. The measure represents a rough approximation of operating cash flow from a business.

¹⁷ "GAAP" refers Generally Accepted Accounting Principles in the United States.

¹⁸ "GAAS" are promulgated by the Auditing Standards Board of the American Institute of Certified Public Accountants. <https://us.aicpa.org/research/standards/auditattest/asb.html>; AU-C Section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*. <https://us.aicpa.org/content/dam/aicpa/research/standards/auditattest/downloadabledocuments/au-c-00200.pdf>

IV. LEGAL/REGULATORY

A seller of a franchise company should anticipate that any prospective buyer will conduct due diligence prior to consummating the transaction. Some of the initial diligence may be done before a price is negotiated, and some buyers will reserve the right to continue to conduct diligence even after signing a definitive agreement, including financial diligence, business diligence, and legal diligence. The bottom line, a seller in a strategic transaction must anticipate that its legal compliance will be carefully reviewed. Therefore, it must be prepared to provide evidence of compliance with various areas of the business that are subject to regulatory compliance.

Further, a seller will have to make specific representations and warranties in the purchase agreement, including franchise specific representations and warranties. In order to be able to make those representations and warranties, a franchisor must have good records upon which it may rely. When getting its house in order, a franchisor should examine these following areas of its legal compliance.

a. FDD Compliance

The FTC Rule¹⁹ requires franchisors to provide a prospective franchisee with a franchise disclosure document (“FDD”) at least fourteen calendar days prior to the earlier of the franchisee’s execution of a franchise agreement or payment of any monetary consideration. State franchise laws impose similar disclosure requirements. When a franchise company considers entering into a strategic transaction, the company should anticipate that it will need to provide evidence of compliance and be prepared to make representations that it has complied with all federal and state disclosure requirements. Therefore, mere delivery of the FDD is not sufficient. The company must be able to produce an Item 23 receipt for each transaction over the previous three years, by law (and ideally, going back to inception) that evidences compliance. Many franchise companies struggle with the record keeping that is necessary in order to be able to quickly produce these receipts. Remember that just having a receipt is not sufficient. The receipt needs to be signed by the franchisee, must be dated at least fourteen calendar days prior to the earlier of the franchisee’s execution of a franchise agreement or payment of any monetary consideration, and must identify applicable franchise sellers.²⁰

Gathering all of the Item 23 receipts can be a very tedious process unless a franchisor has a filing system in place. However, the last thing a franchisor anticipating a strategic transaction will want to spend time and money doing is to audit its own files to make sure that it can make a compliance with law representation. Therefore, it should consider tracking this compliance with some database and/or have outside counsel conduct periodic audits. Sellers should anticipate that a buyer will assume the franchisor failed to comply unless it can provide evidence of compliance.

¹⁹ 16 C.F.R. Part 436 (2017), Disclosure Requirements and Prohibitions Concerning Franchising.

²⁰ 16 C.F.R. § 436.2(a) (2017).

b. Trademarks

The most important asset of any franchise system is probably the principal trademark or service mark (for brevity here, we will simply use the terms “trademark” or “mark”). Without a trademark, there would be no franchise. It is the name and mark of a system that makes it a “system.” It is the mark and the brand that attracts customers to the franchised locations, and in turn attracts the franchisees. Therefore, a franchise company should take all actions to maintain the registration of each principal mark with the United States Patent and Trademark Office. The company should also conduct periodic trademark searches to identify any infringing uses of the mark or, more importantly, any prior uses. No buyer will be interested in paying a premium for any brand that has infringers devaluing the brand. Many franchisors establish affiliates to hold trademark registrations and other intellectual property, and then license the use of those marks to themselves or directly to franchisees. Where this is the case, make sure that the structure of the organization is such that it can be easily conveyed to a buyer in a transaction. The company should also consider tax implications of any such structure in the event of a sale.

c. Litigation History

There are several critical reasons a buyer would want to understand a franchisor’s litigation history. First, a franchisor’s failure to disclose in compliance with the FTC Rule and applicable state law might entitle franchisees who were furnished with deficient FDDs a right to damages or rescission, at least in those states with registration and disclosure laws.²¹

Second, the type and number of actions to which a franchisor has been a party is often a good indicator of the health and culture of the system as a whole and of the quality of the franchisor-franchisee relationships in that system. For example, a franchisor’s repeated resort to litigation to collect unpaid royalties suggests historical laxity in collections or enforcement practices. In the worst case, those practices might give rise to a counterclaim or defense of waiver. A multiplicity of lawsuits focusing on or complaining of a common practice or of the actions of a particular salesperson could raise a red flag and trigger further inquiry into the challenged practice or the activities of that salesperson. On the other hand, a franchisor that brings a strategic action against a franchisee to protect the system may be helping the system in the long run. Therefore, litigation is not always bad.

²¹ There are 15 states with their own version of a franchise disclosure statute: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. See, CAL. CORP. CODE §§ 31000-516; HAW. REV. STAT. §§ 482E-1 to 12; 815 ILL. COMP. STAT. 705/1 to 44; Ind. Code Ann. §§23-2-2.5-0.5 to 51; MD. BUS. REG. §§ 14-201 to 233; MICH. COMP. LAWS §§ 445.1501- 1546; MINN. STAT. §§ 80C.01-30; N.Y. Gen. Bus. Law §§ 680-695; N.D. CENT. CODE ANN §§ 51-19-01 to 18; Or. Rev. Stat. §§ 650.005-480; R.I. Gen. Laws §19-28.1-1 to 34; S.D. CODIFIED LAWS § 37-5B-1 to 53; 21 VA. ADMIN. CODE 5-110-10 to 95; WASH. REV. CODE § 19.100.010-940; WIS. STAT. § 553.01-78.

Third, the buyer would review the franchisor's litigation history and portfolio of current litigation to understand anticipated litigation expenses going forward and to test whether the seller's revenues allow for adequate legal budgeting. Who is litigation counsel, what is counsel's experience or expertise in representing franchisors, what rates are charged, how has the franchisor leveraged its volume of litigation to drive rates down, and what internal activities might be outsourced and vice versa? The buyer will also want to consider how effectively the franchisor has anticipated and managed litigation, as reflected in the accuracy of its annual budgeting over recent years.

That assessment may be used to evaluate litigation-related representations and warranties and consider appropriate means of securing those, such as indemnities, holdbacks, and escrows.

Therefore, a franchisor that anticipates entering into a strategic transaction in the near future should consider not only FDD disclosure, but also the picture that the litigation matters may paint for a prospective buyer/partner. Further, a seller should consider the potential impact of current litigation and litigation history on not only the purchase price but timing of payment of such purchase price, including potential holdbacks and escrows.

d. Item 19

Franchisors interested in a strategic transaction exit should take into consideration various factors when deciding whether to make financial performance representations²² ("FPRs") in Item 19 of their FDD. Importantly, if the seller elects to make FPRs, it should be aware of how a potential buyer is likely to use that information. Prospective buyers are likely to take special care to ensure the franchisor's Item 19 complies with the requirements of the FTC Franchise Rule²³ given that FPRs are often the subject of disputes between franchisors and franchisees. A buyer may also use the unit level financial performance information for an insight into the historical financial health of the franchisor and its franchised units. The Item 19 disclosure, or the absence of an Item 19, may be material for the buyer to evaluate future growth expectations for the system.

Further, a buyer is likely to compare the FPRs to data provided separately throughout the course of due diligence and analyze the "reasonable basis" of the FPRs, the key driver for evaluating any FPR.²⁴ Omissions in information supporting the FPRs, as well as sampling issues and inaccurate bases or assumptions for representations

²² 16 C.F.R. § 436.1(e) (2008). "**Financial performance representation** means any representation, including any oral, written, or visual representation, to a prospective franchisee, including a representation in the general media, that states, expressly or by implication, a specific level or range of actual or potential sales, income, gross profits, or net profits. The term includes a chart, table, or mathematical calculation that shows possible results based on a combination of variables."

²³ 16 C.F.R. §§ 436.5(s) (2008).

²⁴ 16 C.F.R. §§ 436.5(s)(3), 436.9(c) (2008).

made, can signal potential issues of concern about an FPR's "reasonable basis" and could negatively impact the terms of a potential sale.²⁵

In addition to these Item 19 considerations, a seller should ensure that its development team understands the importance of complying with the FTC Rule and not making illegal FPRs. While diligence efforts by the buyer may not uncover illegal FPRs, a seller's post-closing liability exposure often hinges on whether illegal FPRs were made to existing franchisees. Often, a seller does not have control over decisions of the franchisor post-closing. Therefore, the buyer could implement certain system changes that franchisees may not welcome. FPR violations often only surface when franchisees are unhappy. If these violations surface, a seller may have indemnity obligations relating to such violations requiring such seller to forfeit some of the money it received at the closing. Therefore, it is important that franchisors planning for an exit minimize such post-closing exposure by ensuring that its development team does not make illegal FPRs during the sales process.

e. Franchise Agreement

A buyer's due diligence will likely include a substantive review of forms franchise agreements over an appropriate look-back period, as well as any actual franchise agreements that have been significantly negotiated.

Sellers should be aware that a buyer's review of the standard form of the franchise agreements is likely to focus on key terms with respect to both the franchisor and franchisee's rights, restrictions, and obligations, as well as changes to the key terms over the years. These key terms to be reviewed and evaluated often include the following:

Territorial Protection. If a seller has granted franchisees territorial exclusivity, a buyer may evaluate the scope of that protection to determine whether and to what extent it will affect anticipated or potential growth of units or other distribution channels. If a potential buyer is a strategic buyer that owns other franchise concepts in the same industry, these territorial rights may prevent a strategic buyer from being able to purchase the company.

Reservation of Rights. In reviewing the franchise agreements, a buyer will likely analyze the nature and breadth of the license granted in the franchise agreement and the exceptions and reservations delineated for the franchisor. This may include, for example, whether the franchisor has reserved rights as to its ability to sell to customers in any protected territory and with respect to potential future markets and alternative channels of distribution, such as internet sales, captive markets, other retailers, and national accounts (if applicable). This will almost certainly be taken into consideration in the valuation of the company.

Sellers should be sure to avoid any inconsistencies between the disclosures in their disclosure document and the franchise agreement. It is important that the rights

²⁵ 16 C.F.R. §§ 436.5(s)(1) (2008).

granted to each franchisee are consistent to avoid blurring the rights granted to different franchisees.

Special Deals or Addenda to Franchise Agreements. A seller of a franchise company should be aware that the less uniform the signed franchise agreements in its system, the more review a buyer will likely undertake in its due diligence. Administration costs associated with different franchise agreements alone could impact the valuation, and, more importantly, negotiated addenda could materially impact the franchisor's right to receive revenue or could impose obligations on the franchisor that a buyer would view as material to any valuation assessment. Finally, a seller should be prepared to disclose all negotiated changes from the standard form of franchise agreement. If not, it will have to go through the arduous task of identifying those variances at the time of diligence. A buyer may also require a seller to schedule all variances to the form agreement attached to the franchise disclosure document at the time the franchisee signed the agreement. Depending on the size of the system, this also could be an extremely time-consuming and expensive task.

Additionally, a seller preparing the sale of a franchise system will want to ensure that any negotiated changes to the standard form franchise agreements do not run afoul of franchise sales and disclosure laws. Under some state statutes, negotiated changes to a franchise agreement require compliance with negotiated change rules.²⁶ It may be wise to eliminate these "one-off" deals in anticipation of a sale in favor of the standard, then-current form franchise agreement at renewal when a sale is anticipated.

Sellers should also be aware of how any other, less obvious amendments to the terms of its franchise agreements may impact a potential sale. For example, did the franchisor promise economic assistance as part of the roll out of a new POS system, or did it indicate it would forgive prior defaults in a "new day" communication regarding system or monetary requirements? It is important that a seller keep track of these kinds of communications to avoid making any potential misrepresentations as part of the sale.

Implementing System Changes. The degree to which the franchise agreements allow the franchisor to implement necessary changes over time is critical. For example, does the franchise agreement incorporate or supplement the operations manual (broadly defined to include other manuals and standard implementing documentation) and permit the franchisor to unilaterally modify it? Also, do the franchise agreements permit the franchisor to modify and change the system trademarks with new trademarks? Have the manuals and other data been updated regularly? And does the franchise agreement expressly require franchisees to update and remodel their outlets periodically? These are all rights that a buyer would like to have when it evaluates the franchise system. A

²⁶ See Ca. Corp. Code §31109.1 (requiring a franchisor to register material changes of negotiated franchise sales). Other than in California, franchisors and franchisees have the right to negotiate changes to the franchise agreement prior to sale without the need to register the amendment with state regulatory agencies unless the changes are repeated in multiple franchise sales such that the changes constitute an amendment to the franchise offering.

franchisor without agreements that retain these rights may limit its pool of potential buyers, particularly private equity buyers that plan to aggressively grow the company.

V. CONCLUSION

A founder or franchisor's ownership considers the growth prospects for the brand and the organization, then decides some element or component necessary to maximize brand potential and enterprise value isn't present or isn't present in sufficient quantity or quality. What action should the owner undertake? Our paper discusses a range of more obvious and less obvious actions and considerations that the owner may pursue, explore and discard. Two factors are almost certain to apply: the process won't be instantaneous, and the process won't be inexpensive in terms of professional fees and internal resource allocation. Whether the owner ultimately sells or creates a partnership to jointly own the enterprise may not be known at the inception. We submit that the exercise itself has value and merit, as would any rigorous process of self-examination and prioritization. The journey always starts with the first step.....

Author Biographies

Joel R. Buckberg

Joel Buckberg is a shareholder in Baker Donelson's Nashville office, where he is a member of the Corporate Group and heads the Firm's franchising and hospitality practices. Mr. Buckberg counsels clients on corporate and asset transactions and operations, particularly in hospitality, franchising and distribution, including strategic planning and transactions, financing, mergers and acquisitions, system policy and practice development, regulatory compliance and contract system drafting. Prior to joining Baker Donelson, Mr. Buckberg was Executive Vice President and Deputy General Counsel of Cendant Corporation, General Counsel of Days Inns of America, and was engaged in private practice in Atlanta, Georgia and Houston, Texas.

Mr. Buckberg has been a speaker at events and meetings sponsored by the American Bar Association, the International Franchise Association, the Tennessee Hospitality and Tourism Association, the New Jersey Bar Association, and other continuing legal education programs. He is the author of numerous articles and book chapters on franchising, hospitality, and distribution topics. He was a practice group chair at Baker Donelson and the chief administrative lawyer for Cendant. He is rated AV by Martindale Hubbell, and has been selected as a *Best Lawyer in America* in Franchising and Hospitality and a Legal Eagle by Franchise Times magazine.

Mr. Buckberg served on the Board of Trustees of The Immune Deficiency Foundation. He has been a member of the United States Coast Guard Auxiliary since 2010.

Amy Cheng

Amy Cheng is the Co-founder and Managing Partner at Cheng Cohen LLC. She concentrates her practice in domestic and international commercial transactions, general corporate, and franchise, licensing and distribution law. She represents franchisors on the structuring and operation of their franchise programs through all phases of domestic and international development. Amy has extensive experience in structuring complex franchise, licensing and distribution relationships and in regulatory compliance. Her experience includes advising clients in connection with complex issues arising from the ownership of multiple brands, non-traditional opportunities, system restructuring and brand acquisition.

Amy's commercial transactional practice includes counseling clients on mergers and acquisitions, complex commercial relationships, strategic business alliances and joint ventures. Amy's unique combination of corporate and franchise experience provides clients with comprehensive legal services to expand their franchise portfolio. Her experience includes representing private equity in acquiring and selling franchise companies of all sizes and in a myriad of industries.

For her work in the field of franchise law, Amy has been named a "Legal Eagle" by the Franchise Times, recognized by Who's Who Legal, Leading Lawyers, Chambers and Partners and selected by her peers for inclusion in The Best Lawyers of America®. She was selected as The Best Lawyers' 2014 Chicago Franchise Law "Lawyer of the Year". In 2018, Amy was recognized as one of Crain's Chicago Notable Women Lawyers.

Amy serves as a member of the Franchise Advisory Board for the Illinois Attorney General and is an active member of the International Franchise Association, speaking frequently at the International Franchise Association's Annual Convention and Legal Symposium. She has also served as the Past Chair of the International Franchise Association's Annual Legal Symposium and currently is the Vice Chair of the Supplier Forum Advisory Board. In 2016, the International Franchise Association's Women's Franchise Committee bestowed Amy with the Crystal Compass Award. In 2020, Amy was honored with the International Franchise Association's Bonnie LeVine Award.

Aziz Hashim

Aziz Hashim is recognized as a leader in franchising and the study of unit-level economics. He is the Founder and Managing Partner of NRD Capital.

Founded in 2014, NRD Capital is a private capital firm headquartered in Atlanta which occupies a unique niche in middle-market investing. NRD offers a suite of capital solutions that invest in franchise companies and technologies both domestically and globally.

Aziz, an electrical engineer by education, has over 30 years of deep franchise operating experience starting as a restaurant employee while in high school and through his college years to becoming one of the largest multi-brand franchisees and then launching NRD by bringing together investors around a common purpose to invest in brands which create value with a strong ethical premise of helping operators be profitable at the unit level. NRD capital was among the first non-venture capital providers to technology companies by recognizing the need for solutions to improve unit-level economics in an industry which has previously been a slow adopter of technology.

Aziz remains deeply committed to creating impact by leveraging the franchise business model to create financial independence for families; particularly under-served segments who are often on the front line of retail business but rarely get an opportunity to own a business. Through the "Own It!" model created by Aziz, employees have a pathway to business ownership. Aziz and his wife endowed a faculty position at the Cecil B. Day School of Hospitality at Georgia State University for the Study of Franchise Entrepreneurship in 2014. Aziz serves on several boards including The Carter Center Board of Councilors. Additionally, Aziz previously served as Chairman of the Board of Directors for the International Franchise Association (IFA), representing the franchise industry. He has also served as Chairman of the Multi-unit Franchisee Conference (MUFC) - being the only franchise leader to serve as Chairman of both sides of the franchise business model. In 2017, Aziz created the NRD Foundation to support non-profit and for-profit international organizations that create entrepreneurs, foster financial independence, and power academic research focused on franchise entrepreneurship.

The Nation's Restaurant News has recognized Mr. Hashim as one of the "50 most powerful leaders" in the Foodservice Industry. He is often published and quoted in prestigious franchise industry publications as well as The Wall Street Journal, Entrepreneur, Forbes, The Globe and Mail in Canada, and The Washington Post, and has guest lectured at several educational institutions including Harvard University, Emory University, and Georgia State University.