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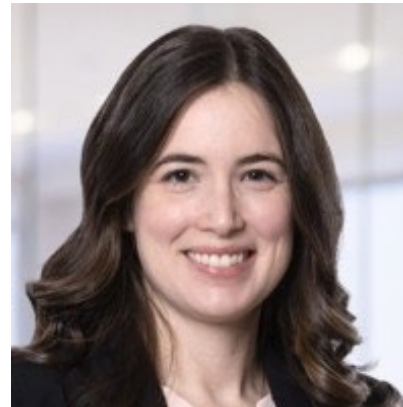
Challenges After Acquiring and Managing a New Brand

Speakers

David J. Kaufmann, Esq.
Kaufmann Gildin & Robbins LLP
New York, New York

Melanie Parker
BELFOR Franchise Group
Nashville, Tennessee/Lansing, Michigan

Moderator: **Jarina Duffy, Esq.**
Saxton & Stump
Malvern, Pennsylvania



Sold! Examples of purchased systems:

- Roark Capital Group now owns:
 - Arby's; Dunkin'; Baskin Robbins; Buffalo Wild Wings; Carl's Jr.; Hardee's; Sonic; ServiceMaster; The Cheesecake Factory; and Jimmy John's (among many others).
- YUM! Brands, Inc., now owns:
 - Taco Bell; Pizza Hut; and The Habit Burger Grill.
- IHG Hotels & Resorts now owns:
 - the Kimpton Hotel network, adding to its portfolio of 12 brands (including Holiday Inn, Holiday Inn Express, Crowne Plaza, InterContinental, Vignette and voco).
- ServiceMaster now owns:
 - Two Men and a Truck; Merry Maids; AmeriSpec Inspection Services; TruGreen Companies; and Terminix (among others).



What do these purchases have in common?

The purchasing franchisor or parent company now must manage multiple franchise systems in a way that enhances profitability and avoids business or legal pitfalls.



Expanding Vertically or Horizontally?

- Are you acquiring a competitor?
- What is a competitor?
 - Consider markets, market appeal, services, customers, etc.
- What is a complementary service or business?
- How can the new brand help the existing brand?
- And vice versa?



Spilling the Beans: An Effective Communications Strategy

- What information is shared and when?
- How to spread the message to franchisees
- How to spread the message to the public
- How to spread the message to internal employees
- Managing the optics from the franchisee's point of view
- Encourage cross-brand relationships



When is a Franchisor Required to tell Franchisees?

- *Basic v. Levinson*, 485 U.S. 224 (1988).
 - Before this case, the rule was to disclose the existence of the transaction when a formal written agreement or LOI was signed.
 - After this case, no particular event or factor short of closing the transaction need be either necessary or sufficient by itself to render merger discussions material... (M)ateriality depends on the significance the reasonable investor would place on the withheld or misrepresented information.
 - This could mean disclosing either after or before an LOI.



Factors and issues to consider...

1. How certain is it that the transaction will be finalized?
2. Will any internal staff changes be made? If so, when?
3. Will the franchisees be affected negatively by the transaction (e.g. if the acquiring brand is a competitor and will possibly encroach on their territories)?
4. Will the customer base of the existing franchise system be affected by the transaction?
5. Will prices for products/services increase or decrease?
6. Will customers lose any benefits, services, loyalty/rewards accounts or anything else associated with the existing franchise brand?
7. Will the existing franchisees need to expend money to re-brand or otherwise comply with post-transaction needs?



Communication with Franchisees

- Prioritize BOTH sets of franchisees.
- If franchisees are upset by the acquisition, they can – in some limited circumstances – block it.
- Blockbuster Video announced it was acquiring a competitor, Major Video, with plans to convert the units to Blockbusters.
 - But a Major Video master franchisee sought and obtained an injunction because the acquisition would prevent him from selling Major Video franchises.
 - RESULT: Blockbuster paid \$6,000,000 for the master franchisee to drop the suit and have the preliminary injunction vacated.



Lessons?

- Use the due diligence period to critically scrub the target franchise system's franchisee population.
- Ascertain the politics of the franchisor-franchisee relationship and whether it is friendly or hostile.
- Determine what franchisee rights may or will be impinged by the transaction (and how such impingement may be avoided or alleviated).
- Figure out how to anticipate and address franchisee concerns with and reactions to the transaction.



Would you tell your franchisees about the new franchise system...

- Once the LOI is signed?
- On the date of closing?
- On the date you issue the amended FDD?
- At your next franchisee annual conference?
- Other ideas?



Putting Pen to Paper: Disclosure Obligations

- The transaction may be a “material change.”
 - Any change to the franchisor or in the franchise itself that is likely to have a significant financial impact on, or which is likely to influence the decision-making process of, a franchisee or prospective franchisee.
- Material change would then require an amendment to the FDD and, potentially, amendment filings in the registration states.



Issues to Consider re: Materiality:

1. Whether management from the existing franchise system will stay in place or whether management from the new franchise system will be incorporated.
2. Whether the existing franchise system already owns other franchise systems.
3. Whether the two brands will co-exist and be offered as one franchise system to new prospective franchisees.
4. Whether the brands will stay separate, but prospects will be given the opportunity to purchase a co-branded franchise.
5. The size of the existing franchise system as compared to the size of the purchased system.
6. Whether there will be new affiliates that will provide products and/or services to existing franchisees.
7. Whether the existing franchisees will pay fees to affiliate entities that have been added to the overall corporate structure.
8. Whether the franchisor entity will survive the merger or be subsumed into a new entity.
9. Whether the transaction results in additional debt and/or reduction in cash flow of the franchisor entity.
10. Whether the transaction will cause supply chain issues or disruptions in providing products or services to existing franchisees.



States with their own ideas about materiality:

- Hawaii, Indiana, Maryland, Minnesota, New York and Wisconsin have their own definitions of material change.
- Examples of what they may consider a material change:
 - New product line.
 - Termination of a certain % of franchisees.
 - Adverse financial development involving the franchisor or its parent company.
 - Change in franchise fees.
 - Significant change in requirements re: approved suppliers.
 - Change in control of the franchisor.



Required State Amendment Filings

- Promptly: California, Maryland, Michigan, New York, North Dakota, and Rhode Island.
- Upon the occurrence: Hawaii, Virginia and Washington,
- Within 30 days: Indiana, Minnesota and Wisconsin.
- Quarterly: Illinois and South Dakota.



Potential Uproar from Franchisees: Encroachment

Market saturation:

- An optimal number of retail locations in a given market.

Market undersaturation:

- A number of retail locations in a given market that is insufficient to serve the consuming public's demand for the products or services.

Market oversaturation:

- A number of retail locations in a given market that is too high and results in less than optimal unit revenues and profits.



Potential Uproar from Franchisees: Encroachment

- Refers to market oversaturation, frequently in the context of one or more franchised units suffering (or claiming to suffer) diminished revenues and/or profits as a consequence of additional company-owned or franchised units of the same brand being placed in close proximity.



Potential Causes of Action from Franchisees:

- Breach of contract.
- Breach of the implied covenant of good faith and fair dealing.
- Common law fraud.
- Violation of federal/state franchise laws/regulations.
- Violation of federal and state antitrust laws.



Helpful Franchise Agreement Provisions

Reservation of Rights

- to market, offer and sell products and services that are similar to the products and services offered by the franchised business under a different trademark or trademarks at any location, within or outside the franchisee's territory.
- to acquire, merge with, or otherwise affiliate with, and after that own and operate, and franchise or license others to own and operate, any business of any kind, including, without limitation, any business that offers products or services the same as or similar to the franchised business (but under different marks), within or outside the franchisee's territory.
- to use the franchisor's intellectual property, trademarks and franchise system, and license others to use the intellectual property, trademarks and franchise system, to engage in any other activities not expressly prohibited in the franchise agreement.



Helpful Franchise Agreement Provisions

Grant and Territory that is trademark specific

- The Franchise Agreement grants you the right to operate a [NAME OF BRAND] franchised business only within the "Territory" defined in the Franchise Agreement.
- Franchisor grants and franchisee accepts the right and obligation for the term and any renewal term:
 - (i) to develop and open the franchised business within the "Territory";
 - (ii) to adopt and use the franchise system in the operation of the franchised business; and
 - (iii) to adopt and use the "Intellectual Property" (including, but not limited to the franchisor's trademarks), and only in connection with the sale of food and beverage products that have been designated by Franchisor.



Helpful Franchise Agreement Provisions

Franchisor's Right to Transfer

- This franchise agreement is fully transferable by Franchisor and will inure to the benefit of any transferee or other legal successor to our interests herein.



Helpful Franchise Agreement Provisions

Franchisor's Right to Modify the Marks

- If it becomes advisable at any time in franchisor's sole discretion to modify or discontinue the use of any trademark and/or use one (1) or more additional or substitute names or trademarks, then franchisee must comply with franchisor's direction no later than ten (10) days after franchisee has received notice.
- Franchisor will not be liable to franchisee for any expenses, losses, or damages franchisee sustains as the result of any such addition, modification, substitution, or discontinuance of a trademark, and franchisee must not commence or join in any litigation or other proceeding against franchisor for any such expenses, losses, or damages.



Helpful Franchise Agreement Provisions

Franchisor's Right to Modify the Offered Products or Services

- Franchisee acknowledges that every component of the franchise system is important to Franchisor and to the operation of the franchised business as a [NAME OF BRAND] franchise. Franchisor has the right to modify the franchise system at any time.
- At Franchisor's request, Franchisee shall refurbish, up-grade, and/or remodel the franchised business, at Franchisee's expense, to conform to the building design, trade dress, and color schemes in a manner consistent with the then current image for new franchises and in accordance with any descriptions set forth in the operations manual. Such refurbishment may include, without limitation, structural changes, installation of new equipment, remodeling, redecoration, and modifications to existing improvements.



Co-Branding

Benefits:

- Gaining market share and expanding the customer base.
- Sharing operational functions.
- Reducing investment/operational costs.
- Leveraging the power of each brand.
- Maximizing marketing and advertising dollars.
- Increasing sales and revenue for each brand.

Consider:

- Market for the products/services.
- Customer base.
- Demand for combined product/service.
- Physical logistics of placing two sets of products in one location.
- Logistics of providing two sets of services from one franchisee.



What Else to Share:

- Third party services: legal, accounting, auditing, bookkeeping, marketing, and promotional services.
- Supply chain: inventory sourcing, supplies, and equipment.
 - Potentially from a new affiliate!



What to Keep Separated:

- Training team
- Management team
- FDDs



Thank you for attending!

David J. Kaufmann

Founding Member and
Senior Partner

Kaufmann Gildin & Robbins LLP
(212) 705-0810

dkaufmann@kaufmanngildin.com

Melanie Parker

Senior Vice President

Legal and Franchise Administration
BELFOR Franchise Group

(615) 806-8115

melanie.parker@belfrangroup.com

Jarina D. Duffy

Senior Counsel

Saxton & Stump

(484) 218-9204

JDD@saxtonstump.com

