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Private Equity Acquisitions of Franchisors

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I. Introduction

Private equity acquisitions of franchisors and large franchisees is a phenomenon that has transformed the franchising landscape over the past two decades. Berkshire Hathaway owns Dairy Queen, which it acquired in 1998. Trian Partners L.P. owns a controlling stake in Wendy's. Roark Capital affiliates now own the Dunkin, Arby's, Baskin-Robbins, Buffalo Wild Wings, Jimmy John's, Seattle's Best, Schlotzky's, Auntie Anne's Pretzels, Moe's Southwest Grill, Sonic and ServiceMaster Brands (among many others). TZP Group a few years ago acquired The Dwyer Group. And in the largest acquisition of a franchisor ever, a fund of the Blackstone Group acquired Hilton Worldwide, Inc. for approximately $25 billion in 2007[1]. While this trend has been growing for the last twenty years, it has grown exponentially during the last ten years – a trend driven by, among other factors, franchising's proven track record of success with high, steady, returns; the embrace of the franchise business model by Wall Street, the public markets and lenders; the rise of securitizations; a nearly zero interest rate environment; and, enormous pools of capital allocated by large pension funds, sovereign wealth funds, wealthy families and college endowments to private equity. Although there is increasingly more and more private equity activity in large multi-unit operators, this paper will focus on the private equity acquisition of entire franchise systems.

This paper provides an outline of the following key topics:

1. What are the goals of private equity investment in franchise companies?

2. How are acquisitions structured?

3. How is the pricing of acquisitions determined and when is the price paid?

4. What are the most essential franchise-related issues to be analyzed in due diligence?

5. Do acquisitions raise any disclosure issues?

II. Goals of Private Equity Investment in Franchise Companies

A. Typical Goals of Franchise M&A

Private equity acquisitions of franchisors are based on an array of sound and compelling determinants.

[1] Full disclosure: author Ms. Cohen's law firm served as franchise counsel in the Hilton transaction and in Trian's acquisition of a controlling interest in Wendy's.

First and foremost is the appeal of franchising as a business model. The franchise model requires a relatively modest capital investment on the part of the franchisor. While a franchisor must undoubtedly spend a significant amount of time, energy and capital developing its concept and franchise system, once the system reaches a critical mass, it generally requires less capital to operate over time. At the same time, a franchisee is generally required to pay its franchisor a set royalty (and other) fee, typically based on a percentage of its gross revenue, for a set period of time. Thus, a private equity buyer of a healthy franchise system is commonly able to operate the franchise company for deceasing costs while simultaneously achieving steady, recurring, long term revenues and predictable cash flow – characteristics particularly desirable to private equity investors.

In addition, although some private equity investors are interested in turning around mature franchise systems, the majority are interested in opportunities for growth and expansion. By way of example, a franchise system may have strong unit economics but a limited geographic footprint, and the franchisor may lack sufficient capital or access to capital to support an experienced franchises sales and development team. In this case, the ability of a private equity firm to buy the franchise system, hire the necessary management personnel and invest in a franchise sales infrastructure may allow the brand to focus on development and expansion into new territories. Multiplying strong unit economics with growing development enables the private equity firm to return increasing profit over time.

Further, private equity investors generally look for the ability of the acquired target to add significantly to the private equity firm's return on investment, achieved by increasing the target's EBITDA (earnings before interest, taxes, depreciation and amortization) once the acquisition price has been fully recouped. Indeed, often, the target's post-acquisition EBITDA will be enhanced through savings achieved following consolidation by the acquiror - - duplicative target senior management can be released and their compensation packages driven to the bottom line; duplicative facilities of the target (warehouses, distribution centers, regional offices, IT and the like) can likewise be eliminated at great cost savings; the combined purchasing power of the acquiror and the target can drive down the cost of critical products and services; and, where applicable, goods and services previously procured by the target's franchisees from third parties may, following the acquisition, be procured from the private equity concern's other holdings.

Likewise, many private equity investors have taken advantage of the benefits associated with a multi-brand franchise strategy, where a private equity fund owns an umbrella holding company, which owns several different franchise brands. By way of example, Lift Brands owns Snap Fitness, 9-Round, Yoga Fit, Steele Fitness, and Fitness on Demand, and Regis Corporation owns Supercuts, Jean Louis David, Vidal Sassoon, Regis Salons, MasterCuts, Trade Secret, SmartStyle, Cost Cutters and Hair Club for Men and Women. Similar to the point raised above, the back-office infrastructure (i.e., accounting, HR, legal and operations) needed to support one brand can often times support multiple brands. By sharing the various brands' overhead expenses, the holding company is able to drive down overhead costs, increase profit and create value.

It is also possible that multiple brands share synergies such as their target customers and target franchisee pool. A franchisor targeted for acquisition may offer complementary products or services to those already offered by one or more brands owned by the fund. Where this is the case, the holding company is able to save front end costs related to advertising/marketing, real estate and referrals based, in part, on economies of scale in purchasing power and other matters, while also potentially increasing revenues through the ability to service more than one customer need. Adding an additional franchise brand may also help the company grow and diversify throughout different geographic areas, as well as balance cyclical market rotations. In all, private equity investors see these sorts of strategic synergistic acquisitions as a tool to increase profits, drive value and ultimately achieve greater returns on their investments.

While franchise securitizations are not the subject of this paper, it is important to note the role that this method of financing has played in the proliferation of franchise acquisitions. In a whole business franchise securitization, the franchisor will securitize its future revenues (i.e., its royalties, company-owned outlet revenues and other sources of income) in order to raise debt at a relatively low interest rate. Whereas a franchisor raising money through traditional financing methods would typically need to satisfy an assortment of restrictive ongoing covenants in addition to a certain level of creditworthiness, in a securitization, such historical criteria are typically less important. Instead, the franchisor will isolate its future revenue stream from its operations and liabilities in order to become bankruptcy remote which, as a practical matter, generally offers more security to the bondholders. Because the financing is secured by the franchisor's future royalties and therefore theoretically involves less risk than a loan that is not backed by any such revenue or collateral, the franchisor is typically able to save a material amount of money in interest payments compared to traditional sources. As a result, the securitization financing allows the franchisor to pay a relatively low cost for growth. In addition, the securitization debt is portable, meaning that debt stays with the franchisor even upon a stock sale of the company (as discussed in Section III below), thereby facilitating the exit options available to the franchisor and its private equity investor upon a sale.

B. Impact of COVID-19

While the above factors have always been drivers of M&A activity in franchise companies, the COVID-19 pandemic has served as an additional catalyst. The pandemic has been an unprecedented event, causing severe economic disruption. However, time after time, history has demonstrated that periods of great economic disruption present the best investment opportunities.

Beginning in March of 2020, the revenues of many franchise systems seemingly disappeared overnight. This was particularly the case with many hotel brands, dine-in restaurants, gyms and spas. With little to no cash flow, if a business did not have sufficient reserves or access to emergency funds, its ability to remain open and operating was limited. For these businesses, private equity investment offered the opportunity to stay afloat and avoid bankruptcy. And for certain private equity firms, this unique period of economic disruption provided an opportunity to take a play out of Howard Buffet's book and "be greedy when others are fearful," particularly with respect to the franchise brands that were on healthy footing prior to the pandemic. Given the COVID-related consolidation of many brands, keen investors acted on the belief that the brands that survive will be able to dominate the market following the pandemic.

In stark contrast to the business sectors that were crushed by the pandemic, businesses in many other sectors - - such as small footprint QSR restaurants with a focus on delivery and take out, home repair and renovation businesses, home health care businesses, and others - - thrived. For these businesses, the pandemic served as a catalyst for growing interest and higher revenues. For private equity investors who think that the COVID-19 pandemic will forever reshape society, investing in these pandemic winners represented an opportunity to invest in brands best suited to dominate in the "new normal" future marketplace.

III. <u>How are Acquisitions Structured?</u>

There are various methods available to structure an M&A deal, each with its own particular benefits and detriments. While the acquisition of a franchise system involves many of the same business considerations as acquisitions in other sectors, it also involves many idiosyncrasies particular to the niche world of franchising and franchise law. Thus, while it is important that the buyer and seller consider each acquisition method with their respective legal, M&A, tax and accounting advisors in order to isolate the preferred structure, it is also important that advisors knowledgeable about the business, legal and regulatory framework of franchising be consulted. Through this holistic approach, analyzing all tax, liability, simplicity and franchise law and relationship considerations in tandem, the parties will be able to isolate the structure that works best for them.

With that in mind, the two most common methods of structuring an acquisition of a franchise company are stock/equity acquisitions and asset acquisitions. Each of these structures are described below.

A. Stock / Equity Acquisitions

A stock acquisition, where the buyer simply acquires all of the stock of the target company and continues to operate it as a going concern, is generally considered to be the most straight forward structure and is therefore by far the most common structure utilized. The benefits of this approach are several.

First, because the target company continues to operate in its current form, there are often less third-party consents and sign-offs needed in order to consummate the transaction. By way of example, while franchise, lease, vendor and other agreements sometimes provide that neither party may assign the agreement without the other party's prior consent, in a stock sale, this restriction is not triggered (unless the agreement has a change in control restriction, discussed below). Because the target company remains the applicable counterpart to the subject agreement, no such prior consent is necessary; as such, the parties can avoid the significant time and complications that may be associated with obtaining same.

Second, there are certain administrative simplicities. Unlike in an asset sale, where it is necessary for the buyer to hire and sometimes enter into employment contracts with the target company's employees, in a stock acquisition, the target company's employees can simply remain employed (if the buyer wants, of course) by the target company without any interruption in their operations.

Third, there are several franchise registration and disclosure related benefits of a stock acquisition. By way of example, while the target company's Franchise Disclosure Document may need to be amended to disclose the new ownership and control, the new board of directors (if any) and the new management (if any), that is it. The buyer will not need to capitalize a new entity, go through the significant time and expense of preparing new audited financial statements of such entity, and then conduct an analysis of whether there are any changes necessary in the target company's registration versus exemption strategy (i.e., whether previously secured exemptions from state franchise registration requirements based on the franchisor's net worth and experience continue to apply). Instead, the buyer may continue using the target company's existing financial statements (though, note that if the target company amends its Franchise Disclosure Document to disclose the change in ownership or control, or any other post-acquisition system changes, such that it will be required to file a post-effective amendment with the states in the middle of a renewal cycle, "stub" period unaudited financial statements will need to be produced and disclosed).

Lastly, there can be tax benefits associated with a stock sale, such as the avoidance of real estate transfer taxes, sales taxes and capital gains taxes. Notwithstanding this fact, there are a multitude of factors which may affect the tax implications of a particular transaction. It is therefore recommended that both the buyer and seller work with tax accountants and lawyers to achieve the desired result.

While often considered the simplest approach, a stock sale does still have is own set of particular complications and risk (though they are often considered relatively manageable). One of the most significant risks of a stock sale (for the buyer, at least) is the assumption of all of the target company's assets *and* liabilities that are not specifically excluded by the contract. A stock purchase agreement will typically include a schedule of all actual or alleged claims, litigation and liabilities, which are, of course, figured into the purchase price. However, it is possible that at the time of the sale, the target company is unaware of certain liabilities or that certain claims have not yet fully ripened. The buyer can usually mitigate this potential risk, however, by requiring the target company to: A. indemnify, defend and hold it harmless for any claims which are alleged after the closing of the stock purchase agreement but which are based on company operations prior to the closing; B. obtain and maintain insurance in sufficient limits to cover claims which may arise under the indemnification provision; and/or C. agree to a “hold back provision”, essentially allowing the buyer to hold back payment of a certain portion of the purchase price for a period of time in order to cover any such claims which may arise. We note, however, that in the current seller’s market - - where private equity funds are increasingly in competition to chase deals for growing franchise companies - - these historic risk mitigation tactics have been invoked less frequently.

B. Asset Acquisitions

Ironically, if the simplicity of a stock sale is its greatest advantage, the intricacy of an asset sale is its greatest advantage. As opposed to a stock sale, where, as described above, the buyer essentially steps into the shoes of the target company, acquiring the assets and liabilities and operates it as a going concern, in an asset sale, the buyer can identify which particular assets and liabilities (or no liabilities at all) it will acquire and, most importantly, which it will not. If the asset purchase agreement does not expressly state that a particular trademark, website domain, employee, vendor agreement, claim, company-owned outlet or otherwise is included in the sale, that trademark, website domain, employee, vendor agreement, claim, company-owned outlet or otherwise - - along with all the liabilities associated therewith - - remain with the target company. In addition to avoiding the acquisition of known liabilities, this approach also avoids the unintended acquisition of unknown or unripe liabilities. In this way, an asset sale is a much more targeted and controlled acquisition than a stock sale.

Along with this targeting, however, comes additional risks and complications. Because any assets not specifically stated in the asset purchase agreement are not acquired, it is crucial that deal counsel take great care to ensure that all assets intended to be acquired, whether tangible and/or intangible, are expressly included in the asset purchase agreement.

There are also a number of additional franchise-related hoops that a buyer will have to jump through in connection with an asset acquisition. Because the buyer is, by definition, a different business entity than the target company, it will need to: undergo the time and expense of preparing audited financial statements; likely complete a more in-depth revision of the brand’s Franchise Disclosure Document; and, file initial applications for state franchise and business opportunity registration or exemption, as applicable (which often take longer for the states to process than amendment applications, as would be the case in a stock purchase, as noted above). Completing these tasks will typically result in a longer franchise sales black-out period, during which time the franchisor will have to refrain from engaging in franchise sales activities (including, without limitation, entering into any renewal agreements, transfer agreements and the like).

C. Additional Acquisition Structures

While stock and asset acquisitions are the most common structures utilized for franchise acquisitions, we note that they are not the only structures possible. Additional structures include, by way of example but without limitation, tender offers (where a private equity fund will seek to acquire ownership of a public company by offering to buy out the shareholders at a certain per share price); minority investments (where the private equity firm will not acquire the entire brand but rather a non-controlling minority interest in the brand); and, mergers (where the private equity firm merge the target company into one of its existing brands, or more likely form a new subsidiary company to merge with the target company).

IV. How is the Pricing of Acquisitions Determined and When is the Price Paid?

Let us now address a critical issue in private equity acquisitions of franchisors – acquisition pricing. Before turning to the determinants at issue, we must emphasize that historically, the private equity acquiror would not pay the full purchase price up front. Instead, the private equity acquiror would initially acquire 70-80% of the franchisor's equity and then either purchase the balance later and/or permit the original equity owner to retain such balance and cash it in when the private equity concern exercises its exit option (generally through a subsequent sale of the franchisor or, if the franchisor is large enough, taking it public, in either event usually five to seven years following the initial acquisition).

There exists a universe of pricing models which private equity concerns may utilize in determining the ultimate purchase price they are willing to expend to accomplish the subject acquisition. Each has its own *raison d'etre* and legitimacy.

In certain instances, a percentage multiple of the target's gross revenues is utilized. In other settings, multiples of LTM (last twelve month) earnings per share. In the guest lodging segment, a key barometer of economic activity utilized is RevPAR (revenue per available room). Other times, multiples of the target's LTM cash flow is the basis around which a price is established. Infrequently, "book value" is employed. Comparable transactions can often prove a useful barometer. And "triangulation" of a number of these variables will frequently be used to ascertain purchase price.

But historically, the most common pricing determinant utilized in acquisitions (whether involving franchise companies or not) is a multiple of the target's LTM EBITDA. A target's EBITDA is viewed by many as the most accurate barometer of that target's true value, of what that target truly earned over the past twelve months.

Just what multiple EBITDA an acquiror is willing to pay is always a key subject of negotiation - - and will be affected by the economic climate. For example, in the heyday of the economic boom of the late 2010's, relatively rich deals priced at multiples of 6 (or even higher) times EBITDA were not uncommon. By contrast, throughout the COVID-

19 pandemic, EBITDA multiples of certain companies declined as risk taking and optimism diminished, such that EBITDA multiples of 4 – 4½ have been prevalent, whereas the EBITDA of other companies (such as growth franchise brands) have exponentially increased, sometimes even surpassing multiples in the teens. In very rough terms, the period of years it will take for an acquiror to recoup its investment in the target is equivalent to the EBITDA multiplier used. Thereafter, the target's EBITDA flows to the acquiror's bottom line. For example, roughly speaking, if a target's EBITDA is $10MM; the EBITDA multiple is four; and, the post-acquisition target's EBITDA remains constant over the coming four years, then simple mathematics reveals that it will take the acquiror four years of operating the target before the acquiror's purchase price is recouped and subsequent target EBITDA becomes pure profit to the acquiror.

Once the negotiation regarding precisely which EBITDA multiplier will be used to price the transaction has been completed, only half of the mission is accomplished. The other half consists of ascertaining precisely what the target's LTM EBITDA truly was and how it needs to be adjusted.

It may appear counterintuitive that this exercise needs to be engaged in. After all, especially with public company targets, EBITDA is easily derived from audited financial statements. But it is not as simple as that. Much investigation must go into just how the target computed its LTM EBITDA and what adjustments thereto need to be made to establish a transaction LTM EBITDA.

For example, the target may have capitalized certain repair and maintenance expenditures which more properly should have been classified as expenses (thereby reducing LTM EBITDA). Interest income from investments and operating cash balances are typically excluded when computing transaction EBITDA - - while interest income from operations will likely be included. The target's top tier management may deliberately be receiving compensation packages that are well above market (particularly where, in non-public company settings, management owns all or part of the target); in such circumstances, negotiation will frequently reduce this expense to the amount that the acquiror will be paying its management team to operate the target post-closing, thus increasing LTM EBITDA.

Also, to be "backed out" from a target's LTM EBITDA are one-time transactions which are non-recurring in nature and artificially inflate earnings. For example, if the target is a franchisor which in the last twelve months engaged in refranchising activity and thus sold company-owned units, the LTM EBITDA of the target should be diminished by the net sales price derived from that transaction. The same logic pertains when a multi-unit franchisee is the target and it, too, engaged in non-recurring transactions which will be viewed by the acquiror as artificially inflating LTM EBITDA.

Conversely, if the target itself expanded its operations (through acquisitions, the construction of new units or otherwise), then LTM EBITDA may be increased to recognize the conservatively estimated addition to the target's EBITDA which is not yet realized but will predictably flow from such activity. If the target has made significant charitable contributions, then justifiably it will want to have its LTM EBITDA increased by the amount of such contributions made over the past twelve months. If the target is a multi-unit franchisee in a network owned by its private equity acquiror, then the franchisee's LTM EBITDA is frequently increased by the amount of royalties it paid to its franchisor over the past twelve months.

Once transaction LTM EBITDA and the multiple to be applied thereto have been established, further steps must be undertaken before the ultimate purchase price is reached. The simplest step to address is the issue of the target's cash. Generally speaking, cash at closing is paid for dollar for dollar, but is increased or reduced to the extent that the net working capital of the target, at closing, is greater or less than zero. Further, it is often the case that the target's senior management team possesses "golden parachutes" which may or will be triggered by the transaction - - much discussion usually takes place regarding who will pay the cost of those "golden parachutes" (almost always it is the seller). The acquiror will almost always want to secure post-acquisition covenants not to compete from the target's seller as part of its purchase price. But it is frequently desirable not only to restrict the seller from competition, but its senior management as well. Again, much discussion will focus on what types of covenants not to compete senior management personnel will be required to enter into and who will pay the costs thereof.

The ultimate purchase price must be reduced by the amount of any debt which the acquiror will be assuming (including capital leases, bank indebtedness, non-compete payments, change of control payments, loans to or from officers or stockholders, amounts related to intercompany balances, obligations related to closed units, obligations related to severance and obligations related to the target's prior acquisitions). Conversely, any debt or severance obligations which are assumed or triggered following the acquisition and as a result of the acquiror's determinations are usually borne exclusively by the acquiror.

In certain sectors, an issue arises regarding income which will be received by the acquiror from the target's pre-closing economic activity. Particularly is this so in the real estate brokerage sector, where many months transpire between a target's entering into a multiplicity of listing agreements (when a home is put up for sale) and the time that commissions from those agreements are payable (the day the subject house sale is closed). In such circumstances, it is typical for the subject acquisition agreement to provide for the post-acquisition payment by the acquiror to the seller of the net income related to such pre-closing activity.

If the acquiror is purchasing the stock of the target, it may desire to join in an election with the target's parent pursuant to Section 338(h)(10) of the United States Internal Revenue Code, pursuant to which the transaction will be treated for federal income tax purposes as if the target had sold its assets to the acquiror and distributed the sale proceeds to the target's parent in a complete liquidation. Whether any additional purchase price will be paid for this election must be negotiated.

Once purchase price is determined and agreed to by the parties, still another crucial issue frequently remains - - the time of payment. The target will almost always want to receive full payment of the purchase price at closing. Many acquirors, however, desire to pay only part of the purchase price at closing, with the balance paid over a period of time thereafter. The acquiror's fear? That, whether due to the acquisition or otherwise, and for reasons either unbeknownst to or feared by the acquiror, the target's post-acquisition EBITDA will significantly decline. The target's senior management personnel may depart the post-acquisition enterprise *en masse*, thrusting the target into turmoil. Or the target's senior management may have known what the acquiror's management, even with due diligence, did not - - that the post-closing enterprise would suffer a significant EBITDA decline due to significantly waning customer demand for the product or service in question, the introduction of significant competition into the market or (in the case of a multiunit franchisee being acquired) brewing trouble in the subject franchised network (i.e., significant shrinkage of that network, inability of the franchisor to sustain prior levels of marketing and advertising, departure of key franchisor executives and the like).

Any or all of these factors may impel the acquiror to insist, as noted at the outset, that its purchase price be paid only in part at closing, with the balance due thereafter diminished or eliminated altogether if the target's post-closing economic performance falls below specified thresholds identified in the subject acquisition agreement. Such a proposal will frequently encounter great resistance. But if the price is right, perhaps not - - and, indeed, many target-sellers actively insist on participating (either up or down) in the post-acquisition performance of the target, or maintaining an equity interest in the target following the acquisition.

Complicating the pricing of international acquisitions are currency fluctuations and the specific manner of accounting for them, which must be carefully detailed in the subject letter of intent or pricing memo.

Notwithstanding the above-described historic pricing strategies, it should be noted that given the unique strength of the current private equity market for franchise acquisitions, growth brands have had increasing leverage to set aggressive deal terms. As such, it is not entirely uncommon at the present time to see certain private equity firms discounting, if not completely disregarding altogether, a target company's LTM EBITDA; instead, relying on pro forma / projected EBITDA at multiples never before imagined. These firms have taken the position that, because of the pandemic, a target company's LTM EBITDA does not accurately reflect the company's true value. As mentioned above, the current near zero percent interest rate and the relative surplus of investable cash in the market have been relevant factors in these more aggressive pricing strategies. So aggressive, in fact, that for the right brand, certain private equity firms have agreed to "walk away" deals, where they pay 100% of the purchase price up front, with no rollovers, contingencies, claw backs or other limitations.

V. What are the Most Essential Franchise-Related Issues to be Analyzed in Due Diligence?

1. Due Diligence by the Buyer

Critical to a successful private equity acquisition of a target franchise brand is franchise counsel's almost unique ability to ascertain and confirm just what the acquiror will ultimately be acquiring. That is where due diligence comes in.

While many laymen and lawyers are familiar with general concept of franchising, few are aware of the federal and state bodies of law governing franchise sales and operations, and even fewer are familiar with these laws. Even the most experienced M&A attorneys often possess little or no knowledge or experience regarding the structures and norms of franchising; how the creation and evolution of the target franchise network will impact the future profitability of that network; what impact franchisor-franchisee politics may or will have on the transaction; and, how to ascertain what impact the transaction itself will have on the subject network and its future profitability. Given this reality, it is crucial that seasoned franchise counsel experienced in franchise-related acquisition activity be engaged to ascertain (through due diligence) and confirm (through acquisition agreement representations, warranties and conditions to closing) certain facts, circumstances and assumptions that otherwise expert M&A counsel may be unfamiliar with.

A. The Franchise Disclosure Document

A target franchisor's most recent Franchise Disclosure Document provides a good starting point for this process. It highlights, among other important disclosures, who the franchisor is (Item 1), what the experience is of the management personnel running the company (Item 2), what litigation and bankruptcy the franchisor and its management are / have historically been involved in (Items 3 and 4), what fees the franchisor charges (Items 5 and 6), how big the franchise network is (Item 20) and an assessment of the franchisor's financial health (Item 21). These disclosures, while essential to understanding the franchise offering and the target franchisor's management of the franchise system, only provide half the picture.

By way of example, a prospective buyer may be pleased to learn upon review of Item 2 of a franchisor's Franchise Disclosure Document that its Chief Executive Officer has significant relevant experience; however, a review of the franchisor's Franchise Disclosure Document for multiple prior years may reveal that the company has had significant turn over in its executive management – a clear red flag deserving of further investigation by a buyer. Similarly, Item 20 of the franchisor's Franchise Disclosure Document may disclose a large franchise system and Item 6 may disclose an enticingly high royalty fee; however, it is possible that many of those outlets are on the verge of bankruptcy, are default of their payment obligations to the franchisor and/or have negotiated side deals with the franchisor for the right to pay a lesser royalty fee. Information disclosed in a franchisor's Franchise Disclosure Document can sometimes serve as window dressing on a much bleaker picture that is only discoverable through due diligence.

B. Compliance with Franchise Registration and Disclosure Laws

A key goal of conducting franchise due diligence is to determine whether and what types of potential liabilities may be hiding beneath the target company's surface. This is true of all M&A deals, but is especially relevant in franchise related acquisitions, where the lapse of a state franchise registration or the execution of a franchise agreement a day too soon could portend significant damages.

As such, a buyer should ask to see all state franchise or business opportunity registrations and exemptions, as applicable to determine whether they had ever lapsed. If they have, the buyer should inquire further to understand the cause of the lapse and to discover whether any franchise agreements were entered into or monies paid during those lapse periods (which inquiry should be further confirmed through review of the franchise agreements themselves). The buyer should also ensure that there is a signed Item 23 Franchise Disclosure Document Receipt for each signed franchise agreement entered into, and that the execution date of each such franchise agreement at least 14 calendar days after the date of such Receipts (or, if not, that there was an applicable exemption from disclosure or other factor weighing against any potential franchise disclosure violation).

Similarly, a buyer should ask to see copies of all franchise sales advertisements that have been disseminated and confirm whether: the information set forth on such advertisements comported with the information disclosed in the target company's Franchise Disclosure Document for the particular year in which the subject advertisement was disseminated (including with respect to the fees/costs disclosed in Items 5, 6 and 7, and the financial performance representation disclosed in Item 19); the information set forth on such advertisements included all mandatory disclaimers and omitted any and all prohibited language; and, all requisite state advertising filings were submitted to the applicable states prior to such dissemination.

D. Franchise Agreements / Development Agreements / Side Deals

Although the Franchise Disclosure Document summarizes many of the key concepts contained in a franchisor's franchise agreement and, as applicable, development agreement, it is just that, a summary. A review of the agreements themselves is necessary to fully understand the rights and obligations that the buyer is undertaking.

By way of brief example, some of the most important legal provisions that should be reviewed, outside of business/financial terms, are as follows:

1. <u>Assignment</u>. Most importantly, does the franchisor have the contractual right to assign the franchise agreement, delegate its

duties as "franchisor" to a third party and/or undergo a change in control? Or are there restrictions, limitations or conditions imposed that may complicate the anticipated transaction?

2. Indemnification. Is the target franchisor properly / sufficiently indemnified for potential issues that may arise? Or is the buyer acquiring assets without properly managed/mitigated risk?

3. Insurance. Does the franchise agreement mandate sufficient insurance policies and coverage limits, naming the franchisor and its affiliates as additional insureds? Does the franchisor have the right to obtain certificates of insurance evidencing same? If so, has the franchisor exercised its right to obtain such certificates for each outlet in order to confirm that the proper insurance is in place?

4. Term and Renewal. How long is the franchisee required / permitted to operate under the agreement? Pursuant to the term of the operative existing agreements, are there any imminent franchised unit expirations and/or closings? Can the buyer significantly update/modify the franchise offering and contractual rights set forth in the franchise agreement upon termination? Or will it be bound by the same older form of agreement?

While the terms of the franchise agreement, development agreement and other material agreements that franchisees are required to sign are disclosed in the Franchise Disclosure Document, it is important to keep in mind that those versions only reflect the franchisor's current forms being offered to new prospective franchisees. They do not, however, necessarily reflect the actual terms under which all existing franchisees are operating. Often, franchisors modify their form of agreements year over year to reflect changes in the franchise system, changes in the legal landscape, or otherwise. Therefore, it is important to review all operative signed franchise, development and other material agreements (and not just the most recent forms attached to the Franchise Disclosure Document).

One of the most important questions to discover is whether the private equity concern is purchasing the EBITDA it thinks it is. In this regard, there are a few key business-focused issues to consider:

First, as alluded to above, is the royalty disclosed in the franchisor's Franchise Disclosure Document the same royalty that its franchisees are actually paying? By way of example, it is possible that 99% of franchisees are operating under an older form of franchise agreement, where the designated royalty is half that of the current fee required of new franchisees. This could greatly impact the buyer's anticipated revenue.

Similarly, has the franchisor entered into any side deals with franchisees, agreeing to accept a lesser fee than contractually mandated? These deals are typically arranged at the outset of the relationship in the form of a negotiated addendum to the franchise agreement; however, they sometimes take the form of mid-term negotiated amendments, letter agreements or informal oral agreements subject to the parties' historic course of dealings. As such, it is vital to inspect all written documents memorializing the franchise arrangement as well as to interview all management personnel concerning the existence of any side deals not reduced to writing.

There are two different strategies that deal counsel follow in connection with this inspection and review.

The most in-depth and detailed approach to due diligence would be to follow the above guidance to the letter – that is, to review each and every operative agreement, including franchise agreements, development agreements and all addenda, amendments and side deals thereto, under which existing franchisees are operating. Although the best practice is for franchisors to incorporate any negotiated terms in an amendment or addendum to the agreement, franchisors sometimes modify the substance of the agreement itself. As such, without a document-by-document review, the buyer would be unable to ascertain/confirm the existence of such modifications.

However, this in-depth review is not always feasible and/or practical, given the scope of the proposed acquisition, timing of the proposed closing date, and a myriad of other issues that may be relevant. As such, buyers sometimes engage in a sort of "top level" due diligence review instead. That is, deal counsel can ask the target for every *form* of agreement that it has entered into, isolate the changes among the different forms, and require the target company to include a representation and warranty in the purchase and sale agreement, backed by sufficient indemnification and insurance requirements, that it so furnished the buyer with all relevant forms, that there have been no modifications in the text of the agreements itself and that the royalty figures disclosed have not been negotiated at all (or if they have, in a manner set forth on a schedule to the purchase and sale agreement). While this second strategy lacks the firsthand verification that is often desired during due diligence, it is often a sufficient method to accomplish the same goal.

D. Franchisee Population

It is the unseen third player at the table, the target's franchisee population, that distinguishes the acquisition of a franchise brand from the norm. The target's franchisees possess a plethora of weapons capable of - - if not defeating the proposed acquisition outright - - at least making it far more painful, expensive and cumbersome than would otherwise pertain, and perhaps as well making the acquisition far less profitable for the acquiror in the long run. Clearly, the target franchisees' proclivities, contracts and legal rights must carefully be taken into consideration and measured, both through due diligence (which will only partially satisfy the burden) and through other means.

The target company's business team, sometimes together with its franchise counsel, must thus conduct due diligence into an area that is radically amorphous and subjective - - "taking the temperature", as it were, of the target's franchisee population without that population ever being aware of the exercise. Will franchisees be radically opposed to the acquisition once it is announced, such that those of them whose franchise agreements will soon expire will determine not to renew? And even if they stay in the network, will franchisee combativeness result in a crippling stalemate by virtue of which the target franchise network will be unable to undergo modification to respond to changed customer demands, demographics, technology or new products/services? Will the post-acquisition franchisor be able to effectively communicate in a harmonious fashion with its own franchisees for the betterment of all? Or will the acquisition result in the exit of the franchisor's popular founder, such that post-acquisition communication will be stilted or even resentfully acrimonious?

However, franchisors are often hesitant to let franchisees know of a pending sale. This is especially true when the target company is public company. As such, franchisors often wait to tell franchisees about the transaction until after the deal is signed. Because of this, "taking the temperature" of the franchisee pool can be a very delicate task and buyers sometimes decide to interview management to obtain their insight into this matter, rather than reaching out to franchisees themselves.

E. Vendor Contracts

While sometimes omitted from the franchise specific portion of diligence, a review of the key systemwide vendor agreements should be conducted with an eye towards potential franchise implications. In particular, the following issues should be considered: is the target company permitted to transfer the agreement (as necessary with an asset acquisition) or undergo a change in ownership (as necessary with a stock acquisition); are the financial and other terms of such vendor agreements beneficial or would the buyer prefer to leave those liabilities with the target company (as would be possible under an asset acquisition) and negotiate its own terms; is the target company receiving rebates from franchisee purchases and if so, have those rebates been properly disclosed in the target company's franchise disclosure document and how will they be accounted for following the closing of the acquisition.

F. The Regulatory and Tax Environment in which the Target Operates

From a practical standpoint, one of the most important questions for a private equity investor to evaluate during the due diligence process is the regulatory and tax environment in which the target company operates.

By way of example, investors will want to discover whether the majority / a large portion of the target company's revenue is derived from businesses located in the State of California. California has one of the world's largest economies, so it may be natural to believe that it would represent a ripe environment for investing. However, California also has a greater degree of government regulation and a less consistent and less business-friendly judiciary (which tends to lean towards judicial activism, deciding cases on a case-by-case basis). Thus, where franchisors are named in lawsuits initiated by third parties against their franchisees (visa vi theories of joint employer liability, vicarious liability, etc.), it can be difficult for the franchisor obtain an early dismissal of the case. Further, California has recently enacted Assembly Bill 5 (known colloquially as “AB-5”) which (although is not the subject of this paper) has the potential to classify the employees of a franchisor’s franchisees as the employees of the franchisor itself. These regulatory risks, on top of its relatively high tax rate, are all factors which may affect costs of doing business and thereby impact the purchase price of an acquisition.

While we use California as an example of these sorts of risks, California is by no means alone. The regulations enacted in California are influencing the broader public discourse and other state and federal laws. Consider, by way of example, the Protecting the Right to Organize (PRO) Act that was recently passed by the United States House of Representatives (essentially federalizes California’s AB-5), as well as the frequent debates surrounding raising the federal minimum wage, corporate income taxes and capital gains taxes.

In addition, the use of executive orders in modern presidential politics - - and particularly, the risk of a president signing executive orders impacting labor laws, minimum wage, and classification of workers - - is a regulatory tool producing less predictive results that can be dangerous for investors seeking consistency and a short-term exit.

These issues and others can increase the costs and liabilities associated with operating a franchise system, thereby depressing the valuations. The investigation into these sorts of issues must be a crucial component of due diligence in order for a private equity investor to fully understand the current and projected value of a franchise target.

G. Is the Target Company a “Pure” Franchisor or also a Unit Operator?

While some franchise companies are “pure” franchisors - - meaning that they do not operate any outlets themselves or through their affiliates, they merely grant third parties a license to do so - - many franchisors also operate outlets. Operating outlets is not in it and of itself a problem; however, it is an important fact for the buyer to understand in order to evaluate potential risks and liabilities. By way of example, the capital expenditure and liability exposure of a restaurant operator can be much more significant than for a pure franchisor. An operator must expend significant time and effort, and incur significant costs, related to the constant maintenance and upkeep of its premises; must contend with increases in cost of labor and goods cutting into its bottom line; has direct liability for claims arising from its operation of the restaurant; and, is generally subject to the ups and downs of the economy. However, a pure franchisor need not confront these liabilities and costs.

H. COVID-19 Considerations

Depending on the business sector in which the target franchise system operates, where it is headquartered, and where its outlets are located, the pandemic likely caused significant disruptions from the status quo. Even where a private equity investor is comfortable assuming the (hopefully) temporary hit to revenues and is committed to weathering the (hopefully) temporary storm, it should nevertheless undergo diligence to understand just how the target company's business operations were affected. The answers to these inquiries will help the buyer fully appreciate the timeline to recovery and the administrative hurdles associated with accomplishing recovery – both of which, of course, may affect the price of the acquisition. By way of example, below is a list of due diligence inquiries that deal counsel would be wise to ask:

- Describe any operational changes since COVID-19 restrictions were enacted, including impact of social distancing restrictions on operations;
- Describe the impact of COVID-19 laws or regulations on the target company, its customers or vendors;
- Describe any supply chain risks, including confirmation of supply chain business continuity and existence of changes in shipments and key terms;
- Describe any distribution chain risks, including ability to ship products and existence of disruptions to distribution networks;
- Describe all workforce, health and safety policies and procedures, including accommodations the target company has implemented for employees;
- Advise whether the target company has received any complaints related to failure to provide safe working environment, and if so, what were they;
- Describe the target company's IT systems, including response to remote workforce and customer communications impact on cybersecurity measures and exposure;
- Describe the impact of travel restrictions on customer and vendor relationships; and,

- Describe the various termination rights and force majeure provisions in key customer and vendor contracts[2].

2. Pre-Sale Due Diligence by the Target Company

As highlighted above, there are many issues that a private equity investor is looking to discover during the due diligence process, whether to determine the appropriate purchase price of the target company or to confirm its plan to proceed with the acquisition. Some of these issues may be inherent in the target company's business model and not capable of cure; however, others may be entirely within the target company's ability to discover and fix. As such, it is recommended that approximately six to twelve months prior to going to market, the target company conduct its own internal due diligence review. This internal review will help the company lay the foundation for a future sale and maximize the proceeds of any such future sale.

By way of an example, a review of the target company's franchise files may reveal that the company does not have a signed franchise agreement in place for each franchised outlet. While this would most certainly be discovered in the buyer's due diligence and could represent a serious red flag, it is an issue that may be easily cleaned up by the seller in advance. Similarly, a seller may discover certain unpaid invoices and disgruntled systemwide vendors. Instead of waiting for this issue to be discovered during the buyer's due diligence, the seller can proactively take steps to resolve it in advance. Also, a seller may realize that it has been lax at policing the use of its trademark, and that there are copycat brands using its intellectual property without authorization. Again, this is an issue that would surely represent a red flag to a potential buyer and possibly decease the purchase price or slow down the transaction (if the buyer decided to move forward at all). However, it is also an issue that the seller can take steps to proactively address, whether it be through sending cease and desist letters, negotiating a limited consent agreement, or otherwise.

A company that is proactively looking for potential issues is far more likely to be able to discover and resolve them than a company that keeps its proverbial head buried in the sand and waits until a small issue boils over to a large and uncurable issue. This is true for all companies but is especially relevant in the context of a franchise sale, where the target company's ability to receive a clean bill of health can drastically increase its valuation and sale price.

VI. Do Acquisitions Raise any Disclosure Issues?

The decision of when to tell franchisees of a prospective acquisition is one that would likely have little significance to an attorney unfamiliar with franchise laws; however, it is arguably one of the most sensitive issues to be considered by the target company. Although the buyer may desire to call franchisees to conduct due diligence on the franchise system and existing management (as discussed above), the target company is typically quite reluctant to permit such contact, lest risk a leak of the

[2] https://www.manningfulton.com/news/client-alert-covid-19-and-the-current-ma-landscape-part-ii/

potential transaction and spooking current and prospective franchisees. However, as discussed below, the target company will have to disclose this information at some point, and while the buyer often has very little to do with the franchisees prior to the transaction closing, this disclosure is best coordinated with the buyer (since, ultimately, violations of franchise and other laws committed by the target company during the sale process could result in contingent liability of the buyer).

In particular, a franchisor has an obligation to disclose in its Franchise Disclosure Document all facts that a reasonable investor would consider material, and there is perhaps no fact more material to a prospective franchisee than who, exactly, is the franchisor. Therefore, when a target company is considering a sale, the most cautious approach would be to immediately cease all franchise sales activities.

However, that is not always practical from a business standpoint and parties often want to continue operating the company to continue generating revenue and to not alert existing franchisees unnecessarily when there is no guarantee that a deal will be finally consummated. Some franchisors do not cease franchise sales until there is a signed letter of intent (i.e., when it seems more certain that the parties have committed to the sale) and others do not cease franchise sales until there is an actual signed binding purchase and sale agreement (though waiting this long may invite franchisee claims for fraudulent inducement, in the event those who signed franchise agreements in a short period prior to the sale are unhappy with the buyer and/or the change). Ultimately, there is no bright line rule as to when these sales are required to stop. The decision typically involves an analysis of the facts on the ground, including the following:

> "• whether the buyer is a financial sponsor or a strategic acquirer;
>
> • whether key management will likely change;
>
> • whether the buyer has a franchise system or other business that will compete with or sell supplies to franchises of the selling system;
>
> • the level of risk of sales violation claims the parties are willing to take and which party bears the cost of a claim or a rescission right;
>
> • the number of franchise sales that suspension or amendment will delay or affect;
>
> • the location of the expected sale, e.g. whether in a non-registration state, a registration state, or a state with a general materiality component to required disclosures;
>
> • the length of time expected after the signing of the LOI prior to the execution of a definitive agreement, and how difficult

suspending sales will be from a business and competitive standpoint;

• the risk of creating an expectation with the prospect that the deal will close when it may not;

• the level of concern that deal communication will raise among existing franchisees and the impact disclosure may have on the franchisee relationships and the activities of any franchise associations or councils;

• the buyer's desires with respect to suspending sales when considered against the purchase price and the desire to maintain a "hot" concept that is growing rapidly;

• the number of franchisees who need to renew during any "going dark" period to avoid expiration;

• when the company is prepared to make the transaction public and, if either the buyer or seller is a publicly traded company, the requirements of securities laws and regulations regarding the disclosure of material, non-public information; and

• other factors related to the nature of the target company and deal specifics."[3]

It is also important to keep in mind that cessation of franchise activities not only applies to agreements with new prospects, but also to any successor agreements entered into with existing franchisees upon expiration and/or a new franchise agreement entered into in connection with a transfer. If possible, the selling franchisor should try to simply extend existing agreements, rather than entering into new successor agreements, and similarly simply approve of a franchise transfer, rather than requiring the transferee to enter into a new agreement with the franchisor (though, depending upon whether the buyer believes the target franchisor's existing franchise agreement is satisfactory or in need of significant improvement, the latter may be more desirable). However, if not possible or desirable, there may ways for the franchisor to continue engaging in such activities (depending on the seller's and the buyer's appetite for risk), such as the use of a supplemental disclosure letter to disclose the intended sale and/or offering franchise recession to franchisees who signed a franchise agreement during this period (though, we note, offering recession (i.e., making the franchisee whole as if it never acquired the franchise to begin with) can be a very expense decision, fraught with potential regulatory and other liabilities, and whether it is used required a fact-specific analysis of the potential risks versus rewards).

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[3] *See* Brian Balconi, Richard Morey and Mike Weinberg, *Basics Track: Franchise-Related Mergers & Acquisitions,* in IFA 52nd ANNUAL LEGAL SYMPOSIUM, (2019)

Upon the closing of the transaction, the target company will have to cease all franchise sales (if it hadn't ceased already previously), amend its Franchise Disclosure Document to disclose the transaction and the new ownership and control, as well as any other Items that may require changes as a result of the sale (by way of example, any change in management or any other franchise systems owned by the buyer would have to be disclosed) and file post-effective amendments in those registration and business opportunity states where required.

Then, once the Franchise Disclosure Document has been updated, issued and registered or exempted from registration in the states where required, in addition to resuming new franchise sales activities, it is also recommended that the newly acquired target company re-disclose all "pipeline" prospective franchisees (i.e., those prospective franchisees who were previously disclosed with a Franchise Disclosure Document but who have not yet signed a binding agreement with the franchisor).

VII. Conclusion

Private equity activity in the franchise space has been heating up for years, was super charged by the COVID-19 pandemic and - - unless there is a significant change in the regulatory and/or tax environment - - is unlikely to slow down any time in the near future. When structured correctly, franchise acquisitions can offer a win-win-win proposition for all three players: the buyer, the seller and the silent third party in the room - the franchisees. While all M&A transactions require a great deal of planning and diligence, as described in this paper, transactions involving franchise systems involve their own unique set of challenges and considerations. Therefore, to ensure that the parties reap the intended benefits of the transaction, and that the transaction is completed and rolled out with as little post-closing disruption as possible, franchise counsel should be closely involved in the process from start to finish.