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New and Recurring Issues in Franchise Brand Acquisitions

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Introduction

2021 and the first few months of 2022 witnessed a substantial and increasingly seller-friendly pace of transactions involving the buying and selling of franchise systems due to strategic opportunities caused by changing markets, available capital from private equity, and various other forces. At the same time, franchise brand acquisition deals now require additional layers of consideration to deal with new and emergent issues, such as COVID-19, quickly changing economics and markets, domestic and global political events, and others. This paper discusses these current issues as well as recurring issues, such as the logistics and considerations that buyers confront when they acquire and own multiple (often competing) franchise brands, post-closing integration issues for multi-brand systems, territorial issues, contractual alignment, relationship management, resource allocation, and more.

1. Current state of transactions - buying and selling franchise systems

a. The seller's market

Recent years have seen a marked increase in seller-friendly deal terms. For instance, there has been a jump in the percentage of deals that expressly state that the representations and warranties do not survive the closing (not counting the "fundamental" representations). Whereas in 2018-2019's private target mergers and acquisitions (M&A) deal points study conducted by the American Bar Association (ABA), only 14% of deals had an express no-survival provision, in 2020-2021 33% of deals had such a provision, and another 43% had survival periods of 12 months or less.[1] As another example, more "Material Adverse Effect" qualifiers have become prevalent over time, regarding representations and warranties being brought down to the closing.

As yet another example of more seller-friendly deal terms in the current market, according to the most recent private target M&A deal points study conducted by the ABA, anti-sandbagging provisions have become less common over time, and silence in regard to sandbagging has now become prevalent in almost 70% of deals.[2] While each deal is unique, a multitude

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[1] Private Target Mergers & Acquisitions Deal Points Study (including transactions from 2020 and Q1 2021), a project of the M&A Market Trends Subcommittee of the Mergers & Acquisitions Committee of the American Bar Association's Business Law Section, published Dec. 30, 2021. Such study examined 123 deal agreements in 2020, across a wide variety of industries, involving private targets. For further discussion regarding the basics of survival periods of representations and warranties in the franchise M&A context, see, e.g., Amy Cheng and Fredric A. Cohen, A Road Map to Due Diligence in the Acquisition of Franchise Companies, FRANCHISE LAW JOURNAL, Summer 2008.

[2] A "sandbagging" provision (sometimes referred to as a "pro-sandbagging" provision) in an acquisition agreement (asset purchase agreement, stock purchase agreement, or merger agreement) essentially states that even if the buyer was aware of an issue prior to closing - whether it be the target's non-

of other legal terms throughout acquisition agreements, such as knowledge qualifiers and materiality qualifiers, have also been typically been affected in recent years by the overall trend of a seller's market.

Valuations are currently trending relatively high (discussed further below) but whether that will continue is anybody's guess. Many significant players in this field (such as Matthew Frankel, the managing partner of Levine Leichtman Capital Partners, one of the most active private equity firms in the franchise M&A space) have voiced the opinion that they believe this will continue in 2022.[3]

b. **Changes in economic environment and markets**

Various macroeconomic trends at any given moment affect the M&A environment in franchising as in other sectors of the economy. As of the time of this writing, interest rates are increasing rapidly as the U.S. Federal Reserve has been raising its benchmark federal-funds rate in recent months and plans to do so several more times this year in a relatively aggressive fashion. However, as of now interest rates are still at (historically speaking) relatively low levels.[4] Inflation (especially in the cost of fuel and energy generally, but also in many other areas, including commodities and finished goods of all sorts) over the past year or more has risen at rates not seen in several decades[5], creating a double-edged sword by increasing both costs of doing business and revenues from the same. Consumer demand appears to be relatively strong overall, helping restaurants (a major area within the franchise realm), guest lodging, and various other chain businesses in the franchise space recover sales volume. Over the past year, investment bankers and M&A law firms have generally reported being extremely busy handling deal volume generally, including in key sectors for franchising, such as the restaurant / fast-casual dining sector.[6]

Franchising as a whole appears to be well on the road to recovery after the shock of COVID-19 (the novel coronavirus), though there is not yet sufficient data to determine if we are "out of the woods." According to FRANData's "FRANchise Performance Index" 2021 Forecast, by the end of calendar

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compliance with applicable laws, a breach of a customer contract, or other breach of a representation, warranty or covenant - it could decide to complete the acquisition, and subsequently make claim against, or "sandbag," the seller under the agreement. An "anti-sandbagging" provision, as the name suggests, prohibits the buyer from sandbagging or seeking post-closing recourse regarding matters which the buyer knew about at or prior to closing.

[3] Beth Ewen, Four Dealmakers Predict Franchise M&A Outlook for 2022, FRANCHISE TIMES, Jan. 21, 2022.

[4] Nick Timiraos, Fed Raises Interest Rates for First Time Since 2018, The Wall St. Journal, March 17, 2022.

[5] Torry, Harriet, and Anthony DeBarros, Omicron, Inflation Drive down U.S. Growth Outlook, The Wall St. Journal, Jan. 16, 2022.

[6] See, e.g., Why Restaurant M&A Activity is Spiking After Pandemic Lull, Restaurant Dive, July 21, 2021. Increasing M&A activity in the restaurant franchise sector has been happening not only with respect to whole franchise brands, but also with respect to multi-unit operators within those systems. See Lisa Jennings, M&A Activity Heats Up for Franchise Operators, Nation's Restaurant News, Jan. 21, 2022.

year 2020 the franchising field had already recovered as much as half of the initial losses incurred when COVID-19 became a pandemic, and all of the eight business lines studied in the IFA's 2021 "Economic Outlook for Franchising" report were expected to continue with sustained growth; and indeed, in the IFA's 2022 "Economic Outlook for Franchising" report, such forecasts seemed to play out. While certain types of brands and subsectors have grown more than others during the last couple of years – for example, those that have adapted to the COVID era by expanding pickup or express formats, "ghost kitchens" and/or "dark stores" (where applicable), or simply seem to be "hot" areas (such as personal services) – the overall economic picture appears optimistic.

c. **Strategic opportunities**

Franchisors and strategic buyers have been quite actively consolidating in many areas of the franchise space, a trend that continued to accelerate over the last few years especially. For example, in 2021 and in 2022 thus far, the following are some of the myriad notable strategic acquisitions, both in the bulge bracket and middle-market: Restaurant Brands International (the parent company of Burger King, Tim Hortons and Popeyes) acquired the Firehouse Subs brand; BBQ Holdings added brands to its growing roster, as did Fat Brands; BurgerFi acquired Anthony's Coal-Fired Pizza & Wings as part of a strategy to become a multi-brand platform; Jack in the Box acquired Del Taco Restaurants; Planet Fitness acquired Sunshine Fitness; Unleashed Brands acquired Premier Martial Arts; and many, many more. So it is that consolidation (or perhaps a better word would be conglomeration) in certain sectors of the franchise industry continues through strategic acquisitions.

d. **Private equity**

Private equity firms continue to acquire franchise brands at a swift pace and exercise a great deal of influence on M&A activity in general. This trend is many years in the making at this point[7], and seems to be continuing to accelerate. With "dry powder" funds that they need to deploy (often being required to do so within a short number of years after raising funds from their limited partners), franchising continues be an attractive target base for private equity funds. Franchise brands offer private equity funds a relatively predictable return on investment through a proven business model, often involving relatively low levels of required capital, which is sometimes not available elsewhere. Further, they offer the ability to enhance synergies by adding complementary brands, know-how or service lines to a private equity fund's existing brand holdings; sometimes the ability to eliminate competition of brands they already own, through acquisition; and

[7] See Ritwik Donde and Darrell Johnson, PE Buys Into Franchising: From Unicorns to Warhorses, M&A is on the Rise, MULTI-UNIT FRANCHISEE MAGAZINE, Issue 1, 2020.

sometimes, obtaining another brand that multi-unit franchisees of their existing brands can invest in. These, among many other reasons, are why private equity funds have increasingly plowed into the franchise M&A space and seem to be doing so at an accelerating pace.

Beyond the usual types of private equity players such as KKR investment group (which, for example, in 2021 acquired the Neighborly home-service umbrella franchisor -- comprised of roughly two dozen brands) and Roark Capital (owner of Focus Brands and Inspire Brands and which, in the past year, acquired several more franchise brands), family offices employing professional management teams and/or investment banking advisors have also gotten more involved in franchise brand acquisitions recently. Family offices, more focused on inter-generational wealth transfer and typically having a longer time frame in mind for their investments, are sometimes more willing and able to look at smaller investments such as acquiring multi-unit franchisees rather than necessarily acquiring entire brands; and, they are sometimes willing to take more time to exercise due diligence in finding those particular investment(s) that will be a good long-term fit for their needs.[8]

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, in the first couple of years of the COVID-19 pandemic, EBITDA multiples declined as risk taking and optimism diminished, such that EBITDA multiples of 4 – 4½ have been prevalent. But historically high valuations have since returned as higher average multiples generally prevail in the M&A industry today. On the other hand, some have predicted that valuations will cool as 2022 proceeds, with inflation and interest rates rising (bringing up the cost of capital to would-be acquirors).

Private equity firms often desire to keep at least some of the existing key management of the acquired franchise brand on as employees for a period of years after the acquisition, for purposes of continuity and know-how regarding running the brand. Often, the private equity firm will negotiate "rollover" deals whereby management of the acquired franchisor reinvest some of the cash they otherwise would have received in the acquisition, as shares of the new business going forward – the notion being to make sure their interests and incentives are aligned to optimize performance of the brand going forward.

2. **New and emergent issues**

[8] See Laura Michaels, What Family Offices Want in their Franchise Investment, FRANCHISE TIMES, Jan. 23, 2020, updated Oct. 13, 2020, available at https://www.franchisetimes.com/franchise_finance/what-family-offices-want-in-their-franchise-investment/article_224a2523-f9cc-5f27-9414-2a5741567fd1.html.

a. **COVID-19, Variants, Subvariants and More**

Since 2020 when COVID-19 first struck globally and became a pandemic, deal terms have varied widely in addressing it and pandemic-like situations that may arise in the future. In the latest ABA private target deal points study (not limited to the franchise space), approximately one third of deals examined had a COVID-19 standalone representation in them. Otherwise, the legal terms of deals were all over the place in terms of COVID-19 being addressed and if so, how; there was no standard or common term to address COVID-19 discernible in this regard.

Some have noted that in franchise systems whose founders have worked hard for many years to grow the system, and who have struggled particularly during the COVID pandemic to navigate its challenges, those types of founders may be thinking of retiring earlier than they otherwise would, or may otherwise be looking for an exit so they can work on something else. The nature of enterprise founders often being that they simultaneously have many business ideas or other projects churning in their minds at all times, the grueling experience of the pandemic may have led many of them to think of "retiring" earlier than they otherwise would.

In other words, many executive teams are tired – tired from dealing with not only the pandemic, but the labor and supply shortages and disruptions of the last year, which in some ways are related to the pandemic. To the extent that tiredness is a trend coming out of COVID-19, combined with a "fear of missing out" if the economy enters into another downturn soon, this may drive further deal volume in the franchise space, as founders and entrepreneurs look to sell out and obtain some liquidity from the personal wealth they have built within their franchise brands over the years.

Operators, investors, and lenders are paying attention to what brands are doing well, which ones weathered the pandemic (so far) or have even thrived during it, which operators are outperforming their peers, and the availability of capital. Those brands that did well during the pandemic are in a position to command a higher premium upon sale – much like those brands that did well during the "Great Recession" that commenced in 2008 were in a position to command a higher premium in the years after that crisis.

With what seems like constant news about new infection risks related to the omicron variant, the emergence of its subvariants, the industry is coming to the realization that Covid and the surrounding uncertainty related to the virus (or, if not coronavirus, another pandemic disrupting economic activity) will continue to factor into business and acquisition risk planning for some time. But that realization does not seem to be slowing down M&A activity in franchising.

On top of everything else, franchisors must also worry about the relatively new guidance provided by NASAA during the pandemic, concerning item 19 financial performance representations and addressing COVID-19 adequately. An acquiror of a franchise brand will want to examine closely how that has been done by the target over the last couple of years and whether it has faced challenges or objections from disgruntled franchisees who felt that the financial performance representations they were provided were misleading in this regard.

b. **Russia and Ukraine War**

While it is perhaps too soon to reach conclusions about how the Russia-Ukraine war which began in February and, as of the time of this writing, is ongoing, will affect acquisition deals in the franchise sector, it will likely cause parties to revisit what is already extremely common language within most every M&A agreement's "Material Adverse Effect" provision, concerning "Acts of War" or "military actions." A target company will typically want to limit the extent to which "acts of war" or "military actions" are included as triggers for a "Material Adverse Effect" giving the buyer a potential "out" from closing on the deal. The target will typically press for such matters to only possibly be deemed to have a Material Adverse Effect to the extent that they have a disproportionate effect on the target's business or operations.

Always 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; the war in Ukraine and its repercussions not only for the Russian Ruble but for currencies in the entire region may further complicate franchise M&A deals, particularly for systems that operate in Eastern Europe.

As much of the world has placed heavy blame and condemnation on Russia for its invasion of Ukraine, including various global companies with store chains shutting down their operations in Russia (perhaps most famously in the franchise arena, McDonald's), doing so is problematic for some brands given the nature of the franchise model.[9] If a franchisee in Russia is properly following the system licensed to them and bears no responsibility for the acts of its government / military in Ukraine, can it be shut down due to these geo-political issues? Should it be? For some franchise brands (including some household names such as Burger King and Marriott), the

[9] See CNN Business, Here are the companies pulling back from Russia, https://www.cnn.com/2022/03/02/business/companies-pulling-back-russia-ukraine-war-intl-hnk/index.html, downloaded April 9, 2022 (when last updated April 5, 2022)

restrictions in their existing franchise contractual arrangements are reportedly causing them to be unable to shut down or suspend operations in Russia even if they want to do so.[10] Applied to the franchise M&A context, any contemplated deals involving target brands with franchised outlets in Russia will by necessity require a careful examination of those franchise agreements to determine what, if any, authority the franchisor has with respect to taking such a step.

In deals where outlets in Russia play a large role in the target brand's system as a whole, some deals will be put on hold until the war (and the uncertainty surrounding it) subside.[11] Indeed, the war in Ukraine appears to have exacerbated market volatility, the rising cost of energy which was already jumping, and dislocation of global supply chains which were already facing major delays before the war started. In this context, it appears that cross-border M&A activity as a whole -- not specifically regarding franchising, and not specifically regarding deals involving eastern Europe -- had a significant reduction in the first quarter of 2022, dropping 29% as compared to its rapid pace in 2021. Some argue this is a result of the Russia-Ukraine war.[12]

c. **"#MeToo"**

#MeToo has become known in recent years as a social movement against, and ongoing public conversation concerning, sexual abuse and sexual harassment, where people publicize allegations of sex crimes and/or demand policy change and accountability in both public and private organizations. It is associated with a number of high-profile resignations, investigations, terminations, and/or lawsuits involving corporate executives.

The "Me Too" movement has had an effect on acquisition deals generally. According to the most recent ABA private target deal points study, 37% of the deals examined in 2020-2021 included a "Me Too" representation of some sort – in essence, a representation that the target company has not been a party to a settlement agreement regarding allegations of sexual harassment or misconduct, and/or that there have been no allegations of

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[10] See Michael Race, The Western Brands Unable to Leave Russia, BBC News, March 16, 2022 (downloaded from bbc.com, April 9, 2022).

[11] Richard Henderson, M&A in jeopardy as Ukraine war chills deals, FINANCIAL REVIEW, April 11, 2022; Kristin Broughton, Some Companies Put M&A on Hold Amid Russian War on Ukraine, THE WALL ST. JOURNAL, April 1, 2022; Dinesh Nair and Ruth David, European Deals Worth $300 Billion Left Exposed by War in Ukraine, BLOOMBERG, March 3, 2022; Luisa Beltran, Global M&A Fell 29% in the First Quarter, BARRON'S, March 31, 2022; Charlie Konchie, M&A slumps as war in Ukraine rattles dealmakers, CITY A.M., March 3, 2022.

[12] See, e.g., Abirban Sen and Pamela Barbaglia, Global M&A Hits the Skids as Ukraine War Saps Confidence, Reuters, March 31, 2022.

sexual harassment or misconduct at the target company. Such a clause typically includes knowledge qualifiers, though not always.[13]

However, it remains to be seen whether the use of a “Me Too” clause in M&A agreements will become ubiquitous; if so, whether it is a form of reactive M&A growth uniquely rooted in a movement driven by women that will continue to endure rather than be a temporary response to a one-off event; whether such a clause will become a permanent addition to M&A boilerplate legal provisions; and, whether such changes to legal terms will ultimately have a discernible effect on either the valuation of brands or on their management and human resource practices.[14]

d. **Joint Employer**

While the risk of a franchisor being deemed legally to be the “joint employer” of its franchisees’ employees and/or the employer of its franchisees is hardly new (cases, government agency positions, and proposed legislation in this regard has been an ongoing issue for at least the past seven years), at least one very recent case has shown yet again that the outcome of such legal allegations may be highly specific to the particular franchised brand’s practices, as viewed by the particular court examining them.

A recent case involving 7-Eleven, Inc.[15] illustrates this point, although the ultimate outcome is yet to be determined. The seven-member Massachusetts Supreme Judicial Court (SJC) unanimously held in March of this year, in the case of *Patel v. 7-Eleven*, that a state law governing the classification of workers could apply to franchise relationships because it does not conflict with the U.S. Federal Trade Commission rule governing franchising.[16]

The *Patel* decision arose from a reference from the U.S. Court of Appeals for the First Circuit, which certified the question to be determined by the SJC as follows: “Whether the three-prong test for independent contractor status set forth in the [Massachusetts independent contractor statute] applies to the relationship between a franchisor and its franchisee, where the franchisor must also comply with the FTC Franchise Rule. [8 F.4th 26 (1st Cir. 2021)].” In the federal lawsuit, 7-Eleven franchisees filed a class action claiming that 7-Eleven misclassified them as independent contractors rather

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[13] See Bloomberg Law Analysis: #MeToo Reps Becoming M&A Market Standard, June 25, 2019, available at https://news.bloomberglaw.com/bloomberg-law-analysis/analysis-metoo-reps-becoming-m-a-market-standard

[14] For further discussion, see Anna Windemuth, The #MeToo Movement Migrates to M&A Boilerplate, The Yale Law Journal, Vol. 129, No. 2 (Nov. 2019).

[15] Disclosure: the law firm of one of the authors of this paper (David B. Ramsey) serves as franchise counsel to 7-Eleven, Inc. but was not involved with the subject litigation.

[16] Patel v. 7-Eleven Inc., 489 Mass. 356, 183 N.E. 3d 398 (Massachusetts Supreme Judicial Court, Case No. SJC-13166, decision issued March 24, 2022).

than as employees in violation of the Massachusetts Independent Contractor Law and other labor laws. The U.S. District Court for the District of Massachusetts granted summary judgment to franchisor 7-Eleven (485 F. Supp. 3d 299 (D. Mass. 2020)) and the franchisees appealed. In considering the appeal, the U.S. Court of Appeals noted that the Massachusetts Supreme Judicial Court had yet to analyze the interactions between Massachusetts' Independent Contractor Law (ICL) and the FTC Franchise Rule (which 7-Eleven's counsel suggested to the District Court preempted the ICL), leading the court to "… consider the most prudent approach to be to give the [Supreme Judicial Court] the first opportunity to weigh in on this issue."

For a bit of key background: the Massachusetts Independent Contractor Law at issue in the *Patel* case is virtually identical to a similar law in California, called AB-5 (Assembly Bill 5) and the California labor laws which resulted as a consequence of passage of that bill. In short, the Massachusetts Independent Contractor Law poses a three-prong test to determine whether a relationship is that of employer-employee or that of independent contractors. Under this three prong test, commonly referred to as the "ABC test," an individual may be deemed an independent contractor only if the alleged employer can rebut the presumption of employment by establishing, by a preponderance of the evidence, each of the following elements: (a) the independent contractor is free from control and direction in connection with the performance of the services; (b) the service performed by the independent contractor is outside the usual course of business of the putative employer; and (c) the independent contractor is customarily engaged in an independently established trade, occupation, profession or business of the same nature as that involved in the service he/she is performing. If any one of these criteria is not shown, the Massachusetts Independent Contractor Law directs that the individual is an employee.

The SJC noted the gravity of the issue, since classification as an "employee" generally entitles an individual to timely payment of wages, holiday and vacation pay; a minimum wage; overtime pay; a private right of action to enforce these rights; the ability to recover attorneys' fees; and, liquidated damages (treble damages for lost wages and other benefits).

Noting that the certifying court (the First Circuit) observed that there is an inherent conflict between prong "A" (control) of the Massachusetts Independent Contractor Statute, on the one hand, and the FTC Franchise Rule, on the other, with the federal court believing that compliance with the latter would potentially make every franchisee an employee, the SJC entirely rebuffed the First Circuit's perceived conflict—in fact, outright rejecting it—holding that "[c]ompliance with [the FTC Franchise Rule's] disclosure requirements does not mandate that a franchisor exercise any particular degree of control over a franchisee."

While expressing no opinion as to how the Massachusetts Independent Contractor Law's "ABC test" applies to the federal case, the SJC did conclude "… that the Independent Contractor Statute applies to the franchisor-franchisee relationship and is not in conflict with the franchisor's disclosure obligations set forth in the FTC Franchise Rule." Although the court sent the case back to the U.S. Federal Court for the 1st Circuit to apply its decision, so the ultimate outcome of the case is still uncertain, and the outcome may turn out to be highly fact-specific, it nonetheless underscores that dealing with such uncertainty will continue to be part of franchise M&A due diligence and risk assessment for years to come. Acquirors doing due diligence on target brands, and target brands preparing themselves for sale, need to examine the franchisor's brand standards, operations manuals, and daily practices with an eye toward whether a court might reasonably conclude that they exert more control than necessary to protect and promote the brand and trademarks, and whether joint employer risk may result. This will be part of a more general assessment of litigation risks in any franchise brand acquisition, including potential liability for disclosure violations and general compliance with franchise laws, rules and regulations.

e. **Cybersecurity**

According to the most recent ABA private target deal points study, in the 2020-2021 sample, approximately 67% of deals included an express representation regarding cybersecurity. The representations appear to have grown in complexity over time, according to the study.

Cybersecurity is an especially significant concern in franchising M&A, because the very nature of franchising makes it an attractive target for cybercriminals. With multiple locations, franchisors need to invest in excellent data protection systems and cybersecurity to ensure franchise agreements are adhered to. Cybersecurity protection is also essential to decrease potential liability for accessing the franchise system – whether it is through database hacking (franchisors often share databases with their franchisees in one network), malware, viruses, phishing scams, insecure passwords (a long-ignored concern in franchise systems, particularly businesses that by their nature involve a high amount of turnover of employees, who may or may not change passwords frequently as they should), or other channels.[17] Some case law exists for the proposition that franchisors may possibly be held liable in certain situations (depending on

[17] For more detail on this subject, see, e.g., David B. Ramsey, Cyber-Security for Franchisors: Protecting the Brand While Avoiding Vicarious Liability, Business Law Today (published by the American Bar Association), July 2016.

the circumstances), or otherwise face negative consequences (including, of course, damage to their brand reputation) for cybersecurity breaches at or data practices of franchised locations.[18] As such, cybersecurity will continue to be given increasing attention in franchise M&A due diligence processes as part of the risk assessment.

f. **R&W Insurance**

The above-described seller-friendly trend of having a lack of survival of representations and warranties, and the concomitant restrictions on indemnification for breaches of representations or warranties, have occurred at the same time as the use of representation & warranty insurance policies has become quite commonplace in M&A deals. Whereas it already was included in over 50% of deals in the 2018-2019 private target deal points study, in 2020-2021 that figure jumped to 66% of deals. Such insurance policies, typically purchased by the buyer in an M&A acquisition, put the buyer's attorney in an intriguing position. On the one hand, of course, the buyer's attorney seeks to advise their client as honestly and forthrightly as possible about any downsides, risks, gaps or other concerns that are uncovered in due diligence on a target. On the other hand, the buyer's insurer in regard to representations and warranties will often ask to review the due diligence memorandum produced by the buyer's attorney, and interview such attorney about such concerns, possibly then excluding any significant matters or risks uncovered by the buyer's counsel, from the R&W insurance policy – to the detriment of the buyer. This situation tends to put some pressure on the buyer's counsel to be honest but not overly alarmist in regard to diligence findings. It is, however, increasingly the norm. The R&W insurer will typically be conducting its underwriting of the risk of the deal in a short timeframe, sometimes no more than a few days. Therefore, the R&W insurer often relies on the buyer's franchise counsel's diligence memorandum, due diligence review, and calls with franchise counsel in order to be able to move forward quickly and bind a policy.

[18] See, e.g., Michael Peterson, et al v. Aaron's, Inc., et al., U.S. District Court, N.D. Georgia, CCH Business Franchise Guide ¶15,562, (Jun. 4, 2015) (franchisor was held liable for breach of consumer privacy by its franchisees); FTC v. Wyndham Worldwide Corporation, et al., U.S. Dis Ct, D. New Jersey, CCH Business Franchise Guide ¶15,249, 10 F. Supp. 3D602, (Apr. 7, 2014) (franchisor was alleged to be liable for technology practices of franchisees, in this case data security breaches; consent order reached in which franchisor must maintain certain standards for payment card data security).

3. **Recurring issues**

a. **The high-level questions: why, how, and whether to do the deal**

Perhaps the most important recurring questions that any franchise brand buyer or seller must answer for themselves are: Why do the Deal? How to do the deal? And, ultimately, whether to "pull the trigger" and execute the deal or not?

If one is the owner of (and perhaps also the founder or chief executive of) a franchise brand, the initial question is why to put your brand out in the market for sale. There is much more than one possible, and good, answer to this. But understanding what the answer is, will determine various other factors such as the timing, and possibly even the pricing and terms, of the deal. If you are the founder, are you looking to liquidate some of the value you have built up in the brand over a course of years, in order to use those funds for personal purposes? Are you looking to stay on in the business or to exit? Regardless of who the seller is, are they looking for a buyer because they want to grow the brand but need a backer with deeper pockets and access to more capital? Or perhaps they would like a strategic competitor to acquire them in order to gain further market advantage going forward, to benefit both the competitor's brands and one's own brand?

If one if looking to acquire a franchise brand, understanding why is also key, not only at the outset but throughout the process. Some answers to this question are not the greatest. Is it "growth just for the sake of growth"? Whether executives admit it (to themselves?) or not, sometimes executives seem to have exactly that mindset. Wiser than that is the approach of thinking through the long-term goals of one's enterprise and how an acquisition of a particular franchised brand would (or would not) further those goals. Some franchisors of multi-brand companies are looking to acquire additional brands that are complementary to, but not directly competitive with, their existing brand holdings. Others quite consciously, even purposefully, acquire brands that compete in the exact same space, under different names and slightly different models, but largely overlapping and directly competing with each other. Still other multi-brand franchise system owners seek out acquisitions of brands that fit within the larger socially conscious purpose of their umbrella of brands – such as certain fitness, health, and wellness brands – and are only looking to acquire brands that will further that larger mission.

Whether one is a buyer or a seller of a franchised brand, thinking carefully and long-term about what pricing makes sense, and over what time period, is a crucial exercise. Does the price make sense for all parties? In this regard, a prospective acquiror must consider what time frame they have in mind for growing the brand they seek to acquire, whether that time frame is realistic, and what their ultimate goal will be after that objective is reached. For example, as discussed above, private equity acquirors typically have a certain time frame in mind for their acquisition investment, including an exit plan some years down the line after they have made improvements to and grown the acquired brand network. What is the timeframe required to really expand the brand being examined and "take it to scale" and does that jive with the acquiror's financial planning?

Depending on the answer to that for any particular target brand, it will largely answer the question of whether a brand acquisition makes sense for a particular acquiror.

Next is the question of how. This is largely a question for sellers who have never sold a franchised brand before, but to some extent it also comes into play for buyers of franchised brands who may not have done it before or who may be entering into unexplored areas of the market. Obtaining key, experienced advisors in such an endeavor is key on either side. Investment bankers, broker teams specializing in franchise M&A deals, and legal and accounting franchise advisors will often form a core team around which plans for a purchase or sale can efficiently and effectively be strategized. The "how" will include questions such as how to put a brand on the market; how to find and reach the right partners and prospective buyers; how to structure the sale process (e.g., an auction process? One-on-one negotiations? Whether to enter into exclusivity, no-shop, go-shop or other arrangements) to yield the most beneficial result; how to plan for due diligence processes (business, tax, legal, operational, and otherwise); how to secure financing sources, and many other questions can most efficiently be handled, without monopolizing the time of one's executives, by bringing in experienced advisors who have a sense of the "pulse" of the current market. Then there are the "how" questions relating to post-transaction challenges of integrating one brand with others – issues with the new leadership team; change management; shared services; shared strategy and processes; differences between cultures of different systems; and the legal requirements pertaining to FDD updates and coordination – all of these require a strong level of commitment or time and energy in order to have a successful outcome.

Ultimately, one must also have discipline in making the final decision – yes or no – on whether to proceed with a particular franchise brand acquisition or not. All the advisors in the world cannot answer this question for the executives – and it is important that they not pretend or attempt to do so. Disciplined, wise executives will retain the ability and leeway with all their internal constituencies to say "no" to a deal and not let mere inertia pull it forward, as deals can sometimes take on a life of their own, with deal teams on each side working feverishly to attend to all aspects of the (prospective) deal. But until the signatures of both sides are released, nothing is final. One must retain at all times the ability, and the willingness, to step back and assess whether the deal presented is, after all, the deal initially imagined and more importantly, a deal that makes sense. Of course, executives will look to their advisors for input on this – and in this regard, franchise legal counsel should play a central role. Executives often look primarily to their in-house counsel (assuming they have one). In-house counsel will typically seek input from franchise lawyers who have worked on many deals in the recent past and can provide a comparative perspective and insight into what the marketplace looks like in the given point in time. In this regard, franchise brands and their acquirors looks to franchise legal counsel not just for legal advice but to be a strategic advisor as well – and the most successful and useful legal counsel will deliver on that point. It is imperative for a franchise lawyer advising on an M&A deal to not just raise issues, problems, and risks, but to help find the solutions if there are any to be had. Some level of risk is inevitable in almost any franchise brand acquisition, as a franchise brand is never perfect in every respect. A useful franchise lawyer helps a client assess whether the remaining risks are acceptable to take on or not, and why, from a pragmatic standpoint.

b. **Stock deal vs. asset deal**

We will not recite here the many factors pertinent to one of the basic, initial decisions inherent in any M&A deal – whether in the franchise context or not – of whether the acquiror should acquire ownership via stock / equity in the target company, or via purchasing substantially all of its assets. For detail on this key question, we refer readers to any number of articles published on the subject, including excellent ones published by some of the IFA's members.[19] Many considerations go into that structural decision, involving among other things the extent of potential assumed liability, simplicity of transfer, tax, and the ability of the buyer to more easily cherry-pick, in an asset deal, which assets and which employees it wishes to take on. We will note that, in the current market environment, given the relatively low levels of unemployment and the high level of competition for talented managers, the relative simplicity of an equity deal in terms of assuming the employment relationships with the target's existing managers may be of particular salience to buyers at the moment. The decision of doing an equity or an asset deal will often be made by sophisticated large buyers in connection with their general corporate / M&A and tax counsel, but it is important for specialist franchise counsel to be well versed in the basic "pros" and "cons" of each option, and of course to bear in mind the mechanism for transferring ownership when reviewing the existing franchise agreements and other documentation to be able to spot any issues in the extant documents.

c. **Disclosure regarding the pending acquisition of a franchise system**

The question has long been discussed (and not all franchise lawyers have the same answer): At what point in time must a franchisor whose brand is to be acquired, disclose the planned acquisition? For decades the issue has been debated, on and off. As a practical matter, a franchisor's and their franchise counsel's position on it is not really known until tested in the pressure situation of a deal.

We note that federal and state franchise registration and disclosure laws had their genesis in, and were modelled after, the federal securities laws. Courts determining franchise disclosure disputes and/or construing the provisions of franchise registration/disclosure statutes frequently cite and rely upon their securities law analogues.

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[19] See, e.g., Basics Track: Franchise-Related Mergers and Acquisitions, by Michael R. Daigle et al., International Franchise Association 54th Annual Legal Symposium, May 4-6, 2021, Washington, DC.; Mark A. Kirsch and Charlene York, Who You Gonna Call: The Role of Franchise Lawyers in Mergers & Acquisitions, American Bar Association 43rd Annual Forum on Franchising, Oct. 27-30, 2020 (which notably includes, as Appendix A thereto, a bibliography of franchise M&A publications that also explore this subject); and, P. Thao Le et al., Basics Track: Franchise-Related Mergers and Acquisitions, International Franchise Association 52nd Annual Legal Symposium, May 5-7, 2019, Washington, DC.

The U.S. Supreme Court discussed this present issue in the securities law context in the case of Basic Inc. v. Levinson et al., 485 U.S. 224 (1988). Specifically: when must disclosure of planned merger or acquisition activity be forthcoming? The Court correctly noted that, until its decision, the applicable standard was that preliminary merger discussions "...do not become material until an 'agreement-in-principle' as to the price and structure of the transaction has been reached between the would-be merger partners". Before then, went the old doctrine, "...information concerning any negotiations not yet at the agreement-in-principle stage could be withheld or even misrepresented".

However, the U.S. Supreme Court in <u>Basic</u> swept away this "bright line" test for disclosure, substituting therefor the following far more flexible and somewhat subjective standard, depending on the facts of the particular case to determine whether materiality of the transaction is triggered or not, in the eyes of “the significance the reasonable investor would place on the withheld or misrepresented information.” That ruling, though from many decades ago, is important in franchising because in franchising, there is no law, rule, or regulation addressing the precise issue of when disclosure of planned merger or acquisition activity needs to be made to prospective franchisees. Given that the law governing securities disclosure is the antecedent of the law governing franchise disclosure; the fact that courts customarily refer to securities law precedent when construing the application of franchise laws and/or resolving franchise-related disputes; and, the risks associated with one day being deemed not to have complied with the federal and state laws governing franchise disclosure, the U.S. Supreme Court's decision in <u>Basic</u> is an important precedent on this issue.

Among other things, <u>Basic</u> tells us that when the urge to merge or acquire is sincere, waiting until the execution of a letter of intent or similar preliminary agreement before making disclosure about the deal in the target’s Franchise Disclosure Document (FDD) may not be an adequate approach. Many times, an agreement to merge, acquire or be acquired is reached on a handshake, with board presentations and approval, document preparation and execution, and public announcements to follow. In such circumstances, the U.S. Supreme Court's decision in <u>Basic</u> would seem to compel disclosure of the possibly forthcoming transaction as soon as each party thereto has subjectively determined to proceed with same, despite the lack of any written agreement in furtherance thereof or the possibility that, ultimately, the transaction may not proceed. Subjective determinations are difficult to ascertain but, as the Supreme Court noted in <u>Basic</u>, are almost always reflected by objective criteria.

What does this mean in practice? First, if a company's board of directors has determined to proceed with the negotiation and execution of a letter of intent embodying merger or acquisition terms orally agreed to, then the "subjective determination" threshold will have been crossed. Similarly, as the Supreme Court noted in <u>Basic</u>, if investment bankers are retained to carry out the transaction, even though it is not yet memorialized, then disclosure should likely be forthcoming. Moreover, per <u>Basic</u>, the size and scope of the proposed merger or acquisition transaction -- and its impact on prospective and existing franchisees -- needs to be taken into account (the greater the magnitude, the earlier disclosure may have to be forthcoming). Naturally, the execution of any writing memorializing the proposed transaction will likely trigger disclosure.

However, having stated all the above, each case should be examined with franchise counsel in light of the circumstances of the case, as well as case law and precedents in the applicable jurisdictions. We refer readers to recent presentations at the IFA Legal Symposium which explore this subject in more depth. For example, one must also consider the seminal cases on related questions such as whether a fraud action may be asserted against a franchisor which fails to apprise its existing franchisees of its plans to sell out to a third party (see, e.g., Vaughn v. General Foods, 797 F.2d 1403 (7^{th} Cir. 1986), cert denied 497 U.S. 1087 (1987)) and in general, when disclosure about planned M&A activity must be made to existing franchisees.[20]

Though it may depend on particularities of the circumstances in each case, it is generally prudent and ideal for a franchisor engaging in franchise sales activity with existing franchisees -- whether such activity takes the form of franchise renewal, modification, extension or the grant of additional franchises -- to treat those franchisees as if they were "prospective franchisees", following that paradigm for when disclosure about the deal is required. While not all target franchisors take this approach, nor do all acquirors push for it (since, after all, no one desires to disrupt or temporarily halt franchise sales while amended FDD disclosures are registered in the requisite states), it is likely the best approach to take from the standpoint of prudence and minimizing liability.

d. **Logistics of acquiring multiple (often competing) franchise brands: assessing and seeking "buy-in" from existing franchisees**

In franchise-related mergers and acquisitions, there is always another set of players at the table -- figuratively, but not usually literally. The views of these third parties are often unknown, yet they have many tools at their disposal capable of, if not defeating the proposed acquisition, at least making it far more painful, expensive and cumbersome than would otherwise be the case. These third parties are, of course, the franchisees of either the acquiring and/or target franchise system. Due to the breadth of legal and economic weapons they have to challenge or even defeat proposed merger or acquisition activity -- ranging from royalty strikes to lawsuits and/or public announcements meant to instill fear in any participating lender -- these franchisees' attitudes and legal rights must carefully be considered against the forces motivating the proposed transaction for a rational "risk/reward" analysis.

Franchisees can be and have been instrumental in either advancing or defeating proposed merger or acquisition activity in franchise M&A deals. Whether it was a franchisee's procurement of a preliminary injunction blocking the acquisition of one franchised video rental chain by another, or the franchisee population of a fast food chain being pitched by both participants in a hostile takeover (and allying with the ultimate victor, which was not a coincidence), franchisees have -- in a non-public fashion -- frequently advanced or defeated planned merger or acquisition activity, and will continue to do so.

[20] For more detailed discussion of this and related case law, see, e.g., P. Thao Le et al. (supra note 17).

Therefore, to perform any rational risk/reward analysis of proposed franchise-related merger or acquisition activity, the legal rights, temperaments and predilections of the franchisees of the affected franchising entity(ies) must be taken into account. This is why it is imperative that franchise counsel ensure that their clients' franchise agreements contain explicit, expansive and conclusive language presaging and ordaining future merger or acquisition activity.

Furthermore, an acquiror of a franchised brand, acting in cooperation with the target’s management, should attempt to investigate how enthusiastic (or not) the target’s franchise population will be to an acquisition of the system; whether opposition can be expected from certain quarters and if so, how much and due to what concerns; and the like. Attention must be paid to how many franchise agreements in the target’s system are going to expire in the near future, and whether those franchisees are likely to be put off by the acquisition such that they may choose not to renew; and even if they do renew, how likely they are to be combative with the franchisor versus proceeding in a spirit of cooperation, growth, and mutual improvement. While doing such an investigation informally will by its nature yield only limited definitive insight, it can nonetheless provide key clues for the acquiror as to what to expect after closing.

e. **Post-closing integration issues for multi-brand systems**

Some acquirors wish to convert some or all franchisees of the acquired system to another brand that the acquiror already owns. However, unless there is franchise agreement language expressly authorizing the franchisor to make systemic modifications to its system -- including change of concept, authorized product/services, names, trademarks, service marks, interior/exterior fixturization and advertising philosophy/methods -- a planned merger or acquisition contemplating the "conversion" of the target company's franchisees may be contractually prohibited (or at least, limited). It is therefore essential that the acquiror’s business team confer openly with its franchise counsel about its post-acquisition intentions in this regard.

The existing franchise agreements must be analyzed with a view toward contractual, statutory and other legal rights that the franchisees may have in regard to changes in the franchise system. Did the franchisor covenant not to itself operate, or license to others to operate, competing operations within the territory of its franchisees? Did the franchisor not expressly reserve the right to change the name of the brand it was franchising? Points like this can make all the difference in whether conversion is difficult (if not impossible) and must be looked out for in the due diligence process.

An acquiror that already owns one brand and wishes its newly acquired brand to use the same software (thus benefiting from greater economies of scale, among other things), must consider the risks of imposing changes on the newly acquired system. Existing franchisees of the acquired system might feel that they are adversely affected by the changes, leading them to explore and bring legal claims. For example, they might claim a breach of contract if any newly imposed system changes are not clearly authorized under the franchise agreements they executed. Other potential claims depend on the circumstances, such as claims of a breach of the implied covenant of good faith and fair dealing which is inherent in every contract in the United States; unfair competition (for example, if franchisees are forced to share advantageous business aspects or confidential information of their system with units of another system that competes with them); violation of certain states' franchise relationship laws (for example, if they refuse to comply with the new system owner's changes and are terminated as a result); violation of antitrust laws (for example, if the franchisees are forced to adopt new pricing by the acquiror of their system); or other potential causes of action.

Sometimes an acquiror seeks to differentiate competing franchise brands it owns in the same space by having its franchise sellers favor one brand over the other – that is, present one as being higher end and the other, lower end, in order to foster a differentiated image in the market. Of course, if that is not based on objective fact, or if such a differentiation is engineered by the owner of the two systems after the acquisition, then the franchisees of the "lower end" labeled system might well object to such imagery or related policis as hurting their business.

Then there is the less tangible, but no less important, issue of culture. Franchisees are part of a particular brand and system. But in some types of franchise systems, such as real estate brokerage services, they also often build their own personal brand within that structure. Sometimes those franchisees are the most passionate and even among the best performing. But when a new ultimate owner of the brand comes along, they might not fit within the new owner's plans for the acquired brand. While this is less of a legal issue than a political and psychological one, an acquiring franchisor would be wise to take steps to minimize the sense of devaluation that franchisees of the acquired system may feel. Communication about the importance of their role in the system going forward is key. And many of the acquired system's franchisees may wonder, what are the plans of the acquiror? Why are they acquiring multiple brands? If a long-term goal or theory, other than just making more money, can be communicated to all constituents (ideally pertaining to better serving the ultimate consumer of the brand's products or services), that can make all the difference in obtaining the trust from existing franchisees that can otherwise be elusive to even the most well-intentioned acquirors. As conglomeration of brands results in larger and larger collective groups of franchise brands, it may become challenging for management executives to maintain this personal communication with all existing franchisees. Leveraging the latest multi-media communication technologies is part of the solution to that. In addition, careful provision of training to, guidance to, and solicitation of constant feedback from, the field representatives to interact with franchisees on a frequent basis is also key to surmounting the logistical challenges of post-acquisition integration.[21]

f. **Territorial issues**

[21] For some further discussion about these integration issues, with examples from particular franchise brands, see Nate Hopper, Franchises Keep Buying Up Other Franchises. Here's Why the Big Area Getting Bigger, ENTREPRENEUR, Oct. 6, 2021.

Even when the franchise agreement(s) at issue are seemingly clear that no territorial exclusivity is conferred upon franchisees, still great caution must be exercised -- for the courts have, in certain such circumstances, deployed the "implied covenant of good faith and fair dealing" to find territorial protections where the contracts at issue ostensibly afforded none. Given the clear and unequivocal language of many franchise agreements with regard to territorial exclusivity; the silence of most such agreements with regard to future merger or acquisition activity; the amorphous "implied covenant of good faith and fair dealing" doctrine; and, the case law recited and analyzed below, it is frequently the case that -- unless adequate measures are taken to deflect and/or compensate territorial encroached, economically threatened or otherwise oppositional franchisees -- these franchisees can, and often will, commence litigation seeking to enjoin (both preliminarily and permanently) the contemplated merger or acquisition. The causes of action such complaining franchisees might advance include the following, among others:

1. Breach of contract;
2. Breach of the implied covenant of good faith and fair dealing;
3. Violation of antitrust laws;
4. Violation of applicable state franchise disclosure laws;
5. Common law fraud;
6. Violation of applicable state franchise relationship laws;
7. Breach of fiduciary duty; and
8. Violation of securities laws.

Depending on the causes of action advanced, recoveries by aggrieved franchisees can range from and include: injunctions; rescission; contract damages; tort damages; attorneys' fees; and, punitive damages. If certain antitrust statutes (such as the Sherman Act) or state laws affecting franchising (such as the Texas Deceptive Trade Practices Act) are involved, then treble damages might even be sought by franchisees as well. Add to this damage exposure, naturally, the costs of defense of such franchise litigation, which can range anywhere from $100,000 for the simplest lawsuit to many millions of dollars for more complex legal challenges initiated by complaining franchisees. The salience of this issue thus becomes clear.

Aggrieved franchisees can also undertake another course of action which could prove even more dangerous and harmful to the franchisor and its brand, to wit: the filing of complaints with state franchise authorities, who have extremely broad criminal and civil powers to investigate and prosecute what they deem to be unfair or inequitable practices. Note in this regard that most franchise administrators are empowered to themselves institute civil proceedings seeking injunctions and/or restitution of behalf of franchisees allegedly victimized by franchisor practices deemed to be fraudulent or illegal. In addition, note that most franchise administrators also possess "stop order" powers -- that is, the ability to summarily revoke a franchisor's ability to offer and sell franchises pending ultimate adjudication of the state's claim .

The cost of defending state franchise administrative investigations and subsequent civil prosecutions has been known to be in the hundreds of thousands of dollars – which can go up if multiple states' investigatory or enforcement authorities are involved.

Moreover, franchisees can also complain to other government officials having criminal and/or civil prosecutorial authority, including the U.S. Department of Justice and the Federal Trade Commission (the former prosecutes criminal violations of the Sherman Act, the latter civil prosecutions).

What is impossible to quantify, and what no franchised brand (or its acquiror) ever wants to experience, is the negative publicity which undoubtedly will attend any franchisee-sponsored litigation and/or state or federal investigators or enforcement actions commenced against franchisors seeking to merge, acquire or be acquired.

Franchisors whose merger or acquisition activity will result in the "conversion" of the merged/acquired chain to the name and format of the acquiror will sometimes feel it fair and benevolent to permit the franchisees of either or both chains to determine how encroachment issues will be handled (i.e., which of the acquired units will be permitted to convert and which will not). It is imperative to remind those franchisors that it has been held to constitute a violation of Section 1 of the Sherman Act (as a "horizontal market allocation") for a franchisor to permit existing franchisees to determine whether a new franchisee will be allowed to enter territories served by said existing franchisees. To the contrary, such franchisor liability has been well established. See, for example, American Motor Inns, Inc. v. Holiday Inns, Inc., 521 F. 2d 1230 (U.S. Ct. App., 3rd Circ., 1975).

All of the above result in the need to prepare for certain "hard costs" of recompensing franchisees of the target network who may feel that their territory has been encroached upon. Such hard costs may include, for example, negotiated reductions of royalties; assisting such franchisees with boosting their marketing, and even more extreme costs such as offering to buy-out / refranchise units of franchisees who refuse to cooperate with the changes in their system. Some franchisors have policies in place to address such concerns, and those policies should be followed carefully. Due diligence on the target franchisor must examine how it has determined how close either corporate-owned or franchised outlets within its network may be placed proximate to each other and/or how it measures "encroachment" (including any market impact studies relevant to this subject) and whether it has bound itself, by policy or by its standard practice, to following any particular protocol in this regard. While it is by no means the norm, franchisees complaining of encroachment despite language in their franchise agreements that would seem to foreclose such a claim, have occasionally encountered success in nonetheless prevailing on encroachment claims based on the implied covenant of good faith and fair dealing.[22]

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[22] In re Vylene Enterprises, Inc., 90 F.3d 1472 (9th Cir. 1996)(finding the establishment of a new company-owned restaurant 1.4 miles away from franchisee's location to be a breach of the implied covenant of good faith and fair dealing, even though an exclusive territory right was not granted in the franchise agreement); Scheck v. Burger King Corp., 798 F. Supp 692 (S.D. Fla. 1992)(holding that an express denial of an exclusive territorial interest to the franchisee in the franchise agreement did not give Burger King the right

Finally, in the U.S. at least (and likely in various other jurisdictions as well), if the planned franchise-related merger or acquisition will result in a situation where the authorized sources of supply for one or both affected chains will significantly shrink, then antitrust exposure is heightened and this risk must be considered as well.

g. **Contractual alignment and system changes**

Key to a buyer's planning process must be how much flexibility it will have to modify the franchise system of the target brand it is acquiring, post-closing. With the pace of change ever increasing, there are both legal and pragmatic questions to consider in this regard. Is the target company able to adapt to new technologies, service lines, or ways of doing things, sufficiently rapidly? Are its franchisees in a position (both economically and attitudinally) to do the same? If not, then an acquiror's desire to make changes and quickly increase the value of the acquired brand is likely to run into trouble.

h. **Co-branding and Re-branding**

An acquiror that already has another brand in a complementary or otherwise related segment of the given market, may desire to co-brand some units from the acquired system and/or its existing owned franchise systems. The existing franchise agreements of both systems must be examined to determine to what extent that will be permissible. In other situations, a "refresh" of a somewhat dated brand may be desirable. Of course, who pays the costs of the new signage, advertising collateral and related costs of refreshing a brand, will play into such a decision – and what, if anything, the existing franchise agreements state about it must be ascertained well ahead of time.

i. **Relationship management**

Whether the acquiror communicates with the target company's franchisees before or after the transaction is consummated, effective and swift communication is the order of the day.

A nationwide (and, if necessary, worldwide) series of franchisee conferences should be scheduled; hotel meeting rooms booked; franchisee travel arrangements made; and, all other particulars taken care of so that meetings with all of the targeted system's franchisees can be quickly held. Ideally such meetings occur in person, but in the interest of time and to reach everyone, private online video conferences have also become common, especially in the age of COVID. At such meetings, the acquiror should spend a little time introducing itself, its management team, its philosophy and its goals --

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to open other units nearby due to the implied covenant of good faith). *But see* Burger King Corp. v. Weaver, 169 F.3d 1310 (11th Cir. 1999)(rejecting Scheck); Barnes v. Burger King Corp., 932 F. Supp. 1420 (S.D. Fla. 1996)(repudiating *Scheck* and rejecting a claim for breach of implied covenant of good faith and fair dealing where a franchisor directly competed with its franchisee and the franchise agreement did not grant any territorial protection for the franchisee); Chang v. McDonald's Corp., 105 F.3d 664 (9th Cir. 1996)(repudiating *Vylene*).

but far more time addressing how the transaction will affect the "nuts and bolts" of the acquired franchised network and the franchisees' bottom lines, hopefully in a salutary fashion. It is critical at such meetings for the acquiring company to listen carefully to the fears, objections and concerns of franchisees -- and to respond to same in a forthright manner (which response can range from dismissing the fear/complaint as unjustified to promising to swiftly rectify what is perceived by the acquiror to be a flaw in the franchise network or relationship).

Naturally, if the acquired chain will retain its identity following the acquisition, fewer problems arise (there will still be franchisee fears of "divided loyalty" and favoritism toward the acquiror's chain, however, which must be addressed).

It is when the acquired chain will be "converted" to the acquiror's business format that greater problems arise. First, there will be the "hard costs" of conversion. Second, and most critically to franchisees of the acquired chain, there is the realization that they will wake up one morning and find themselves operating under the same name, format and system as that of their nearby competitor (who has operated under that name, format and system for many months or years prior to the transaction). As mentioned above, these territorial conflicts must be dealt with. Ideally, any decision to involuntarily subject an acquired chain's franchisees to territorial conflicts following a merger or acquisition should be made only following the procurement of a market research study which supports the proposition of enhanced franchisee income due to the acquiror's superior name recognition, advertising programs, products/services, management and systems. The results of such market research studies should be widely broadcast to the targeted chain's franchisees at the acquiror's first meetings with them.

Moreover, those franchisees ideally will be advised of the acquiror's plans for future advertising programs, marketing efforts and other measures designed to maintain and/or enhance the revenues of the targeted chain's "converted" franchisees.

With regard to territorial conflicts which will be engendered following the "conversion" of the acquired company's franchisees, certain additional ameliorative steps will almost always have to be taken. First, if conflicts are especially harsh in certain geographic regions, the targeted company's franchisees situated therein may wish to continue operating under their old name and format. This may prove acceptable to the acquiror as an easy way out of lawsuits, damage awards and/or having to purchase these now conflicted businesses at or above market prices. Where instances of harsh territorial conflict are not restricted to certain market areas, but are rather geographically diffused, then the franchisor has several options to consider for the units most deleteriously affected:

- A reduced continuing royalty for the balance of the term of the franchise, or a waiver of royalties entirely for an extremely limited period of time.

- Any diminished or waived royalty payments should only be granted in accordance with a schedule which objectively reflects demonstrable, caused and proximate diminution of existing franchisee revenues solely attributable to the merger or acquisition on a "sliding scale" basis.

- Reduction or temporary suspension of advertising fee contribution requirements, with the franchisor making up the difference.

- A commitment by the acquiror or the newly combined franchisor to engage in a supplemental advertising program in encroached territories at its expense.

- Where no other option would truly ameliorate the negative impact of territorial encroachment following the merger or acquisition activity, the acquiror or merged franchisor may extend one of two offers: (i) buy out the affected franchisee's business at a commercially reasonable price, or (ii) when the acquired chain will be "converted" to the acquiror's format, offer to release terribly encroached franchisees from their franchise agreements (and the covenants not to compete contained therein), grant them a perpetual license to use the acquired chain's name, mark and system and work with these soon to be former franchisees to establish purchasing and advertising cooperatives, all to permit them to "carry on" the otherwise defunct acquired chain and all, naturally, in exchange for general releases.

Finally, companies considering the acquisition of, or merger with, franchise chains should be aware of an anomaly. Frequently, the franchisees of those chains will be the most vociferous supporters of the planned merger or acquisition. This response has many roots but the same salutary result for an acquiror/merger partner. Indeed, even after the merger or acquisition takes place, the acquiror may find the targeted chain's franchisees to be its greatest ally in reforming the system to meet current competitive needs and terminating franchisees who chronically fail to adhere to the system's standards, norms and procedures.

j. **Resource allocation**

When a franchised brand is acquired, the franchisees of that brand may have serious concerns that the management team remaining (or installed) in place over their franchise system is (or may) changing the methods, frequency, and overall resources allocated to franchisee supervision and support, and that it could hurt their brand and their bottom line. The field representatives that the franchisees once interacted with might change and the franchisees might feel that the new management they must deal with are less knowledgeable about the particulars of their brand standards, unwritten practices, real needs, or even “culture” of the franchise network. The previous sources that unit franchisees turned to for franchisor know-how, such as operations manuals, might be eliminated, replaced or revised in a manner some franchisees may find objectionable. Whether franchisees will bring any actual legal claims in this area depends on many factors, including the extent to which new ownership of the brand gives them comfort regarding these concerns and listens to their needs attentively. If legal claims are brought in this regard, the extent to which the complainants will encounter difficulty surviving a motion to dismiss will also depend on many factors, perhaps most importantly how their franchise agreements are drafted and what support obligations are placed on the franchisor. While most franchise contracts give franchisors a great deal of flexibility to "modify the System," including changing their operations manuals or manner of operations in general in the franchisor's business judgment, it is nonetheless important, as we have stressed above, to communicate often with franchisees about such concerns. Generally, in the absence of bad faith or improper motive, claims attacking the franchisor's business judgment based on an implied covenant of good faith and fair dealing are likely to fail.

k. **Sharing proprietary information across brands**

In franchise brand acquisitions, if the buyer is a directly competing franchise system (or an owner of same), there are likely to be concerns regarding the protection of the confidential and proprietary information of each system from the other system's franchisees.[23] The acquiror – especially one doing so strategically as it is in a competing business area -- must be very careful not to usurp for itself and use the acquired franchised system's (or that system's franchisees') proprietary processes or confidential information (such as customer lists, marketing plans, pricing paradigms, forthcoming sourcing of new products or other systems, protocols or plans that are specific to the target) and use them to compete against that acquired system's franchisees. Careful attention should be paid to this concern to maintain the integrity of each franchised brand, and where necessary, the flow of information should be subject to information "walls" (whether real or virtual) erected toward this end.

Generally speaking, there should ideally be minimal (if any) direct communication from the acquiring franchise system's management with any franchisees of the acquired franchise brand. Rather, all communications with the target's franchisees should come from the management of that acquired brand itself (and any reference to the acquiror in such communications to franchisees should always refer to the acquiror as "our corporate parent" or the like). These formalities are important to avoid blurring lines that should not be crossed and maintain the integrity of each brand. There are exceptions to this general rule, such as when the acquiring brand (or a sister brand owned by the acquiror) serves as a supplier to the target brand's franchisees (in such circumstance of course the acquiror or its other owned brand's executives may communicate directly with such franchisee-customers). But even then, the acquiror should take care not to communicate with the acquired brand's franchisees as the entity which owns and controls the acquired brand but, rather, only as a supplier. The point here is simple: if the acquiror engages in direct communications with the acquired brand's franchisees regarding their businesses, requirements/restrictions/prohibitions related thereto, or other elements of their operations, then the acquiror may run the risk of being deemed the co-franchisor of the acquired brand and thus exposed to liability in franchisee lawsuits and/or government actions. There will be antitrust implications as well. In short, if the acquired brand is to continue operating as its own brand, it should be treated that way.

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[23] For further discussion of these concerns, see Kirk Reilly et al., Litigation After Acquisition of a Competing Franchise System, ABA 29TH ANNUAL FORUM ON FRANCHISING W-6 at 8–12 (2006).

To be clear, this is not prohibiting the sharing of <u>any</u> useful information. For example, ideally any products, vendor relationships/discounts, proprietary information/knowhow or initiatives which the strategic acquiror elects to share with the acquired brand's corporate management team (it is not compelled to do so under any circumstance) should also be shared with the acquired brand's franchisees - - not directly, of course, but by authorizing the acquired brand's management team to do so.

4. **Conclusions**

Franchise brand acquisitions present a panoply of issues – some recurring and common to all M&A activity, while others are new and present novel challenges to today's legal practitioner. While these issues can present complex problems to solve, none of them are insurmountable. First, the right questions need to be asked throughout the process. And, if those questions are adequately addressed, such transactions present enormous potential upside to strategic, financial and other acquirors alike, as well as the franchisees and all constituencies concerned.