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Considerations in Buying a Franchise Company – What to Look for and Why

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In recent years, franchised companies have become an attractive target for private equity companies and other firms focused on investing capital in private businesses for a number of reasons. These include the ongoing royalty stream, the potential for additional growth and expansion without significant capital investment and the existence of a preexisting network of experienced operating partners. However, potential buyers must proceed carefully with any acquisition because long term success is directly related to, among other things, the strength of the franchise agreements, the trademarks, and the system.

As such, due diligence on the franchised business prior to closing is of critical importance. It is essential that potential buyers examine a franchisor's intangible assets, regulatory compliance and contractual compliance to evaluate the financial value of the acquisition and stability of the future royalty stream. Due diligence on a franchised company includes considerations that may not be present in the acquisitions of other businesses. An explanation of the key information that should be derived from the due diligence process—and why that information is important—is discussed below.

Generally, the following areas should be investigated:

- The company's general level of compliance with franchise disclosure, registration and relationship laws;
- The level of consistency between the company's standard documents and practices and the franchise "norms;"
- The general state of relations between the company and its franchise community;

- The degree of internal variation between the company's standard form agreements and the agreements as signed.

Key Areas for Due Diligence Review

Franchise Law Compliance: A review of the sales efforts will help determine the potential exposure for registration/disclosure violations. Review for franchise law compliance should include a review of:

- *Franchise Disclosure Documents (FDDs)*. Do the documents comply with the Federal Trade Commission (FTC) Franchise Rule and state-specific requirements? Have any franchisee claims been made against the franchisor for the use of a deficient or misleading FDD?
- *State filings*. Were there sales during any gaps in registration that could subject the franchisor to rescission or damage claims? Are state filings effective so that sales can take place? Are there regulatory orders that would impede the company's ability to offer franchises?
- *Delivery Requirements*. Have appropriate waiting periods been satisfied? Does the franchisor have policies in place to ensure compliance with waiting period requirements?
- *Franchise Brokers/Franchise Sellers*. Have appropriate franchise seller/broker registrations been filed?
- *Franchise Advertising*. Has advertising for franchisees been filed where required? Do any marketing materials contain improper financial performance claims or other questionable claims?

Standard Form Agreements: All standard form franchise-related agreements for at least the past several years should be reviewed for provisions that could impede the sale or implementation of the post-closing business model. In reviewing the agreements, the following issues should be considered:

- *Transferability/Change in Ownership*. Are there restrictions on the franchisor's ability to undergo a change of ownership or control? Are the agreements assignable to a new owner? Are the agreements terminable by a franchisee upon a change in ownership?
- *Renewals*. Are there unlimited renewal periods that could impact the post-closing business model? When are franchise agreements up for renewal? If a significant number come up at or close to the same time, what impact might there be if a number of franchisees choose not to renew?
- *Special Fee Arrangements*. Are there any fee-reduction riders or incentive programs that allow franchisees to reduce their royalty or advertising fees?
- *Reservation of Rights*. Do the agreements limit distribution through alternative channels?
- *Modification of the System and Marks*. Do the agreements permit system modifications needed to implement the purchaser's plans for the system?

Currently Effective Agreements: Due diligence must include a review not only of the form franchise-related agreements, but also of the details of currently effective agreements. Specifically, a list of all franchise and development agreements currently in effect, including information on locations, territories, and execution and expiration dates, should be reviewed to determine the future growth potential of the system. The following considerations should be noted:

- *Territories*. What areas are locked up (and for how long) by franchisees? Do franchisees have option rights?
- *Renewals*. Will there be a significant change in the franchise population in the near future based on the number of upcoming renewals? Are franchisees operating beyond the term of their agreements without renewing?

Franchise Files: The files maintained by the franchisor for each franchisee should be reviewed to determine the general condition of the system. For larger systems, where it may be logistically possible to review only a sampling, care should be taken to review a universe of files that is representative of the system as a whole—*e.g.*, varying times in the system, franchisee sizes, geographic locations, performance levels, etc. In reviewing franchise files, the following issues should be considered:

- *Negotiated Changes to the Standard Form Agreements*. Are there changes to fees, assignability, exclusivity, and/or non-compete provisions?
- *Existence of Personal Guaranties*. Are individuals personally liable for franchisees that are business entities?
- *Existence of Loans/Notes*. How many loans/notes are outstanding, and what amounts are owed?
- *Payment Status*. How many franchisees have past-due accounts, and what amounts are owed?
- *Default Notices*. How many franchisees are currently in default? What is the nature of the defaults? How have they been handled? Will past conduct impact the system's post-closing operations? Has the franchisor waived its ability to enforce certain agreement provisions?
- *Development Schedules*. Are franchisees in compliance? If not, what are the consequences? Are there waiver concerns based on the franchisor's conduct?
- *Royalty Variations*. How many franchisees pay non-standard royalty rates? Will royalty variations impact the revenue flow and the value of the company?
- *General Satisfaction*. Is there evidence of complaints or threatened claims?
- *Internal Record Keeping*. Are the files complete? How well are the files kept?

Former Franchisees: A list of former franchisees should be reviewed as well as their reasons for leaving the system (*i.e.*, terminated, expired, refused renewal, bankruptcy, transfer). For those franchisees terminated by the franchisor, the franchise files also should be reviewed to determine potential exposure for failure to comply with state franchise relationship laws. A review of former franchisees should consider the following:

- *Numbers.* What is the extent of turnover? Does the rate of turnover indicate problems with the system or franchisee dissatisfaction?
- *Procedures.* Were proper and timely notices of default and notices of termination sent as required by the agreements and applicable state law? Is there potential exposure for violations of franchise relationship laws?

- *Documentation.* What documentation exists? Are there termination or other agreements that document the end of the relationship? Do they contain releases?

Franchisee Disputes: It also is essential to conduct a review of all concluded and pending lawsuits, arbitration proceedings, and mediation proceedings with franchisees, as well as all threatened claims by current or former franchisees and pending government inquiries. These claims affect the financial condition of the company, and in some situations, such claims could significantly affect future sales of new franchises. Examples of such claims include:

- Claims involving rebates or marketing and advertising allowances received from suppliers;
- Claims concerning approval or disapproval of suppliers nominated by franchisees;
- Claims relating to the company's disapproval of proposed sites;
- Claims relating to territorial disputes;
- Claims concerning markups or distribution fees on required products sold to franchisees;
- Claims relating to sales practices;
- Claims involving renewals/terminations;
- Claims involving enforcement of post-termination covenants.

System Operations and Marketing: A review of the system operations should be conducted to determine if the operations are in line with the standard documents, if they are in line with the post-closing business model, and to gauge the satisfaction of the franchisees. Marketing materials should be reviewed to determine compliance with relevant laws, and other materials for review should include:

- *Operating Manuals and Training Manuals*. How robust are these materials? Are there any unusual inclusions or omissions?
- *Franchise Advisory Council Minutes/Franchisee Association Notes*. Is there any widespread tension or any major developing issues between the company and its franchisee community? Do the organizational documents suggest a structure that will impact the buyer's future plans for the franchise system (*e.g.*, approval rights on advertising expenditures)?
- *Marketing Information*. What information is included in internal reports and reports given to franchisees regarding the collection and expenditure of marketing and advertising contributions?
- *Franchisor Sponsored Intranet for Franchisees*. What documents are available to franchisees? What are franchisees saying?
- *Procedures to Monitor Operations Compliance*. Are there effective procedures in place to regularly monitor operations compliance of franchisees?

Other areas: Due diligence review also will include an evaluation of other company files and practices, including:

- *International*. If the company is expanding internationally, a review of the international files should be conducted. In particular, has the company complied with local franchise, registration, or disclosure laws? Does the company have policies in place to detect and deter violations of domestic anti-corruption laws, such as the Foreign Corrupt Practices Act (FCPA)? What due diligence does the franchisor conduct with respect to foreign franchise prospects?
- *Sales Activity*. A review of the sales activity may help determine the health of the system. What is the volume of pending sales? Resales? Reacquisitions?
- *Trademarks and Intellectual Property*. Intellectual property is critical to a franchise system. The registration status and ownership of all intellectual property should be reviewed, as well as disputes or actions involving trademarks and other intellectual property.

Summary

The acquisition of a company is no small undertaking, and in the franchise context, it is important for potential buyers to be mindful of the myriad considerations unique to a franchised business that will affect the ultimate value—and potential for future success—of the acquisition. Experienced counsel can help assess the target's level of regulatory compliance, determine the status of existing agreements, flag issues to help value the transaction, identify the potential risks and liabilities that need to be addressed, and assist in purchase agreement drafting and negotiation and post-transaction issues.