



## *Considerations in Buying a Franchise Company*

Most buyers of franchise companies are attracted to the franchisor because of the ongoing royalty stream; however, the royalty stream is dependent on the strength of the franchise agreements, the trademarks, and the system. Due diligence on a franchise company must examine these intangible assets as well as the franchisor's regulatory compliance to evaluate the stability of the royalty stream. The 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 sales laws and franchise relationship laws.
- The general 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.

### **What to Look for and Why**

**Franchise Law Compliance:** A review of the sales efforts will help determine the potential exposure for registration/disclosure violations.

- **Franchise Disclosure Documents.** Confirm compliance with the Federal Trade Commission (FTC) Franchise Rule and state specific requirements to verify that no franchisee claims have been made against the franchisor for the use of a deficient or misleading disclosure document.
- **State filings.** Were there sales during any gaps in registration that could subject the franchisor to a rescission claim? Are the filings effective so that sales can take place? Were there stop orders that would impede the company's ability to offer franchises?
- **Delivery Requirements.** Have appropriate waiting periods been satisfied?
- **Franchise Brokers/Franchise Sellers.** Have appropriate franchise seller/broker registrations been filed?
- **Franchise Advertising.** Has advertising been filed where required? Does it contain improper financial performance claims or other questionable claims?

**Standard 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.

- **Transferability/Change in Ownership.** Are there restrictions on the seller's ability to undergo a change of ownership or control? Are

the agreements assignable to the 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?
- **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:** A list of all franchise and development agreements currently in effect, including locations, territories, and execution and expiration dates, should be reviewed to determine the future growth potential of the system.

- **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 units operating beyond the term of their agreements without renewing?
- **Development Schedules.** Are franchisees in compliance? If not, what are the consequences? Are there waiver concerns based on the franchisor's conduct?

**Franchise Files:** Depending on the size of the system, the franchise files (or a representative sampling) should be reviewed to determine the general condition of the system.

- **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 corporate franchisees?

- **Existence of Loans/Notes.** How many loans/notes and the amount?
- **Payment Status.** How many franchisees have past-due accounts, and what amounts are owed?
- **Default Notices.** Number of defaults? Reasons? How have they been handled? Will past conduct impact the system's post-closing operations?
- **Royalty Variations.** How many franchisees? Does it impact the revenue flow and the value of the company?
- **General Satisfaction.** Is there evidence of complaints or threatened claims?
- **Internal Record Keeping.** How well are the files kept?

**Former Franchisees:** A list of former franchisees should be reviewed as well as their reason 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 the potential exposure under state franchise relationship laws.

- What is the extent of turnover? Does this indicate problems with the system or franchisee dissatisfaction?
- 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 from violations of franchise relationship laws?
- What documentation exists? Are there termination or other agreements that document the end of the relationship? Do they contain releases?

**Franchisee Disputes:** A review of all concluded and pending lawsuits, arbitration proceedings, and mediation proceedings with franchisees should be conducted, 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 law.

- **Operating Manuals and Training Manuals.**
- **Franchise Advisory Council Minutes/ Franchisee Association Notes.** Is there any widespread tension or developing major 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.** 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?

**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?

**Sales Activity:** A review of the sales activity may help determine the health of the system. How many pending sales? How many resales? How many reacquisitions?

**Trademarks and Intellectual Property:** Intellectual property is critical to a franchise system. The registration status and ownership should be reviewed as well as disputes or actions involving the marks.

## Financial Transactions Experience

Wiley Rein's Franchise Group provides a full range of legal services to meet the unique needs of franchisors. Working together with Wiley Rein's Corporate attorneys, we assist both franchisors and investors in the purchase and sale of franchise systems.

We represent the interests of purchasers, sellers, and private equity firms in a variety of deals, including stock sales, asset sales of franchised systems, private placements and public offerings, debt financing, and other types of financial restructurings. On the buyer's side, we 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. On the seller's side, we assist in preparing the company for sale, help structure the due diligence process, and assist in purchase agreement drafting and negotiation.

Additionally, we assist with the buyout of franchisees, the sale of company-owned units and the negotiation with financing sources on buyout, capital expenditure, and operating financing. We also help develop mechanisms to use refranchising to stimulate system growth. ■

# FRANCHISE *Services*

Wiley Rein LLP represents franchisors on matters for which they require expert legal services. We can:

- Determine whether your business concept is a franchise. If it is a franchise, but you would prefer to avoid the registration disclosure requirements, we can help you to modify the business concept to avoid coverage by the franchise laws, if possible, or take advantage of applicable exclusions.
- Work with you to develop franchise and related agreements that will permit the growth of your concept while allowing you to maintain control.
- Seek federal registrations for your trademarks and provide assistance in maintaining and protecting those marks.
- Prepare the Franchise Disclosure Document (FDD) and provide FDD compliance training to your franchise sales and franchise administration teams.
- Prepare and file all franchise registrations, exemptions, amendments, and renewals in all applicable states.
- If you are a U.S. franchisor, assist you in developing your franchise concept abroad; if you are a foreign franchisor, assist you in bringing your franchise concept to the U.S.
- Help you understand your contractual rights and obligations and the statutory restrictions that apply to the franchise relationship, including transfers and contract renewals.
- Represent you in any proceedings brought by federal or state franchise regulators.
- Guide you in terminating the relationship with a franchisee without violating statutory restrictions.
- Represent you in litigation or arbitration proceedings with a franchisee.



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