



Franchise-Related Considerations in Preparing Your Franchise Company for a Strategic Buyer

Private equity funds continue to target franchised businesses, in part, because of their predictable, recurring royalty streams. This document addresses some basic considerations in preparing for a private equity transaction as well as franchise-specific considerations once the deal is underway.

Establish and Be Able to Articulate the Owners' Objectives

The interests and objectives of business owners may be inherently different from those of a private equity fund. Owners therefore must address the following concerns and objectives, preferably before meeting with private equity sources:

- **Control:** Are the current owners interested in giving up some or all of the day-to-day control of the business? Some private equity players are passive—preferring to allow the existing management to stay intact. Others play a more active role and may have specific plans for revising or redirecting the business plan.
- **Horizon, Exit, and Transition:** How long do the current owners intend to remain involved in the business? Do they have a second generation of management ready (or expecting) to step in? Do the current owners have a plan for disposing of their interest in the business (selling it whole, in pieces, or

through an IPO)? The private equity source may have a different plan or exit strategy.

- **Understand the Business's Value:** Valuation is one of the most important elements in any equity transaction. The amount of capital sought from equity sources is determined by the business plan. The valuation will determine how much of the company will be handed over to get that capital and pursue the business plan. Before approaching private capital sources, a business owner should understand the business's value, and, more importantly, take whatever steps possible to enhance that valuation.
- **Understand the Business:** Make sure the current owners understand and can articulate all aspects of the business in order to present the business to a private equity source.

Analyze the Private Equity Source

The current owners must make sure they are comfortable with the style of the private equity firm. They must thoroughly screen the private equity source before selling.

- **How:** The best way to do this is to call other CEOs and CFOs who have used the private equity source (current and prior companies).

In addition, get a reputation check from bankers, lawyers, and consultants who know the private equity source.

- **What to Ask:** Will the current owners have the autonomy to run the business their way on a day-to-day basis? Is the private equity source available to discuss business ideas and issues? How does the private equity source react to periods when the company is not performing well? Does the private equity source think it is important to maintain the current culture? Will it keep the same employees? Does the source understand franchising and encourage the company to focus attention on making the franchisees successful? These questions will help determine the level of involvement of the private equity firm and the length of commitment to the company.

The Negotiating Team

Set up a negotiating team that understands the concept. The business owners must appreciate how all-encompassing the process is, its impact on operations, and that the finance and legal departments as well as the CEO will be lost to the deal. Since the business of negotiating the terms of new capital is not ordinarily within the core competency of most executives, retaining qualified support—financial and legal—helps to even the playing field with the capital players who do this for a living. Add skills where needed, and maintain independence from the private equity source.

Due Diligence Process

Once the preliminary negotiations are completed, the private equity source needs to gain a deeper understanding of the company—for example, is the company worth the price, are there significant problems or issues with the company, and are there challenges facing the company in the future?—through the due diligence process. In addition to the normal areas of inquiry, the following additional areas will be investigated for a franchise company:

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

In order to complete the due diligence process, records, files, and documents need to be located and often compiled—putting a strain on the company's franchise administration and legal departments.

The private equity source will want to see the franchise disclosure documents and state filings for the past several years; the standard franchise-related agreements for the past several years; a listing of currently effective agreements (including locations, territories, and execution and expiration dates); a sampling of franchise files; a listing of former franchisees as well as their reasons for leaving the system; the franchise files for those franchisees terminated by the franchisor; all concluded and pending lawsuits, arbitration proceedings and mediation proceedings as well as all threatened claims by current and former franchisees and pending government inquiries; operations manuals; marketing information; franchise advisory council minutes; franchisee association notes; international files; a review of the sales activity; trademarks; and the registration and status of intellectual property.

Notifying Franchisees

- **Existing:** It is hard to keep secret the fact that control of the company may be changing. As a result, consideration must be given to what should be told to existing franchisees and when it should be told. Under existing franchise registration and relationship laws, there is no requirement

to disclose the pending sale to existing franchisees. After closing, the decision to disclose to existing franchisees is a matter of contract law. While the legal obligation to inform existing franchisees is governed by the existing franchise agreements, in practice, a plan for notifying existing franchisees should be drafted (with the input of the private equity source) and implemented.

- **Prospective:** The franchise regulations do not expressly mention anticipated changes in franchisor control or a pending sale of the franchise system; however, many states require disclosure of an actual change in ownership or control. Indeed, all franchise

disclosure laws and regulations require that the disclosure document be amended in the event of a material change. As a result, for privately held companies, the safest course is to disclose the proposed transaction no later than when a letter of intent or agreement in principle is signed. If the company is franchising internationally, attention also should be paid to the various countries' laws as disclosure documents may need to be updated as well as registrations.

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 the 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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