



Due Diligence in Franchise System Acquisitions

By Edward (Ned) Levitt* and Andrae J. Marrocco**

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** Edward (Ned) Levitt is a Certified Franchise Executive, a partner at Dickinson Wright LLP, Toronto, Canada, and provides legal services to Canadian and international clients on all aspects of Canadian franchise law. He was General Counsel to the Canadian Franchise Association (2000-2007) and is a member of the American Bar Association Forum on Franchising, the International Bar Association and the International Committee of the International Franchise Association. As a member of the Ontario Franchise Sector Working Team, Ned was instrumental in the creation of Ontario's franchise legislation and has had significant input in the franchise legislative process throughout Canada. Among his many publications is the leading text, Canadian Franchise Legislation (2001, LexisNexis/Butterworths). Ned can be reached at 416.646.3842 or nlevitt@dickinsonwright.com.*

*** Andrae J. Marrocco is a partner at Dickinson Wright LLP, Toronto, Canada, and provides legal services to Canadian and international businesses on all aspects of Canadian franchise and distribution law including advice on structuring/expansion strategies, negotiation of franchise, distribution and licensing agreements, regulatory/disclosure requirements, trademarks, acquisitions/dispositions, disputes and enforcement. He has worked with a range of franchise businesses from start-ups to mature international franchise systems in industries such as restaurant, retail, healthcare and commercial services. He has developed specific expertise advising foreign franchisors expanding and adapting their systems to the Canadian market. Andrae can be reached at 416.777.4046 or amarrocco@dickinson-wright.com.*

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1. INTRODUCTION

The acquisition of a franchise system presents a number of unique considerations, potential issues and challenges which inform and shape, among other things, the due diligence process in way that other merger and acquisition transactions do not. This paper provides a non-exhaustive overview of certain critical considerations that the prospective purchaser of a franchise system should assess and address during the due diligence process together with potential issues and challenges that can arise in that context.

Before turning to the due diligence considerations, it is worthwhile to consider some of the predominant ways in which the unique franchise system considerations have relevance, influence and shape the transaction beyond the due diligence process. It is well known that representations and warranties comprise a large part of standard purchase agreements. These factual statements serve to record the parties' understanding of the underlying facts upon which the parties enter into the transaction. In the merger and acquisition context, a seller typically provides the purchaser with comprehensive representations and warranties regarding the condition of the business. The nature and extent of the seller's representations and warranties negotiated in a purchase agreement can go so far as to inform the value of the business.

Negotiating and drafting meaningful representations and warranties in a transaction is often based on issues, specific risks and other matters identified through the due diligence process. While it is arguable that a standard set of representations and warranties may be generally sufficient to address most concerns, a customized set that are tailored to the specific circumstances of the transaction allow the parties to more appropriately address all concerns. In the franchise merger and acquisition context, there are a number of unique considerations that need to be assessed and addressed at the due diligence, but will also ultimately shape the terms of the purchase agreement. It is not difficult to contemplate that a franchise system by its very

nature (ie as a unique business model), comprising numerous interdependent relationships within and outside the system, as well as the predisposition for national and international expansion creating numerous jurisdictional concerns, would create a comprehensive set of considerations.

2. DUE DILIGENCE

In general terms, one of primary purposes of due diligence in a merger and acquisition transaction is to ensure (as far as is practicable) that the purchaser receives the business that it has bargained for. Determining the true value of a target company through due diligence, however, is far from the end of the exercise. Due diligence is more multifaceted and forward-looking: the process should permit the prospective purchaser to gain an appreciation of whether the determined value of the business will subsist post-closing, especially in large-scale transactions involving complex structures, duplicate management teams, and multiple sources of revenue. Ultimately, the prospective purchaser's financial and legal advisors can assist the purchaser to assess and address the information and issues revealed through the due diligence process in order to determine: (1) whether the purchaser should or should not move forward with the transaction; (2) how to craft or amend the main terms of the purchase transaction (including the purchase price); and (3) whether one or more issues or concerns can be addressed by representations and warranties (or other provisions) of the purchase agreement.

A. Goals of Due Diligence

The goals of the due diligence process in a franchise merger and acquisition transaction vary depending on the size, sophistication, and number of parties involved, as well as the nature of the transaction itself. However, generally speaking the goals include: (1) gaining assurance that the target franchise system has been correctly valued; (2) identifying the nature and extent of the risks and uncertainties with respect to the target business and the transaction – and how to

address them; and (3) collecting information that can be advantageously utilized in the negotiation of the key terms of the transaction (including the representations and warranties).

B. A Due Diligence Strategy

After a prospective purchaser and its legal counsel discuss and consider the due diligence goals based on the circumstances of the particular transaction, they should formulate a strategy to achieve those goals, and prepare a tailor-made due diligence checklist. Best practice with respect to a purchaser's due diligence strategy depends on a number of factors, including experience in acquiring franchise systems, risk tolerance, and the complexity and size of the target franchise system.

Additionally, a prospective purchaser's overall strategy may be affected by factors outside of the purchaser's control. Demand, for one, can constitute a significant challenge: if there are a number of motivated potential purchasers, the seller may not tolerate a drawn out or exhaustive due diligence process. In such circumstances, the purchaser may be facing a scaled-back process to maximize its chances of being successful in acquiring the franchise system.

In recent years, it has not been uncommon for a seller to impose strict constraints on the time permitted for the due diligence process, the amount of information made available to a purchaser, and the timing of the transaction in relation to the stages of negotiation. These constraints may have the effect of limiting a purchaser's efforts to use the information uncovered during the due diligence process in negotiations.

3. DUE DILIGENCE IN FRANCHISE ACQUISITIONS

Due diligence in the context of franchise system acquisitions will no doubt cover many of the same aspects as in the case of an acquisition of a non-franchise business. Having said that, a franchise system comprises a complex set of moving parts, including multiple interdependent relationships (ie the franchisor, franchisees, suppliers etc), diversified revenue stream, and other

unique elements of the business model that carry unknowns and risks. Accordingly, franchise specific due diligence is crucial to uncover all of the relevant risks and issues within the system that may threaten the future profitability and viability of the system. The due diligence considerations that are discussed in this paper can be classified into four broad categories: the intangible assets, third parties at the table, the viability of the system itself, and the franchise agreements and other contracts.

A. The Intangible Assets

A fundamental aspect of the franchise business model involves owning and licensing trademarks, other intellectual property, business format practices and operations, and goodwill in exchange for a fee. These intangibles constitute the foundation and most important assets of the franchise system. Assessing the vulnerability of these assets, therefore, must be one of the foremost aspects of a comprehensively designed due diligence plan.

Similar to an acquisition of a non-franchise business, the prospective purchaser must satisfy itself that the target franchisor's assets are in good standing and sufficiently protected. Each intangible asset should be assessed separately based on its strength and how it contributes to the overall value of the franchise system. Depending on the future growth of the franchise system, these values may change over time. Accordingly, this analysis must be undertaken based on current and future circumstances, both domestically and internationally. Moreover, when it comes to the intangible assets, it is critical that an assessment of each category of intellectual property is considered separately as there are significant differences in how such assets should be treated and protected.

i. Trademarks

Trademarks identify, and are of critical importance to, the franchise system. For this reason, a prospective purchaser's counsel will undertake analysis of their distinctiveness and

overall strength, registrations across jurisdictions, and whether any infringement issues exist (particularly where the target franchise system is not well established). In addition, a prospective purchaser's legal counsel should confirm that there aren't any problems with respect to the franchisor's ownership of its trademarks or their legal validity.

Trademarks should be distinctive in their class. Otherwise, a successful purchaser may run into significant challenges in protecting the trademark and avoiding confusion in the marketplace post-closing. Additionally, if the franchise system operates internationally, or the purchaser intends to expand operations to other countries, legal counsel must determine the extent to which, if any, third parties possess prior rights in any all relevant geographic areas.

The vulnerability of key trademarks must also be determined by ascertaining whether the target franchisor has effectively protected its trademarks from any third party infringement, which can potentially threaten a franchisor's ownership of the trademark. This analysis is equally important for other jurisdictions if a franchise system currently operates internationally, or may soon be exported to other jurisdictions. Accordingly, a purchaser's legal counsel should ascertain whether the target franchisor has secured the registration of its key trademarks in foreign markets, and devoted resources to protecting those trademarks in other countries. If a key trademark is unavailable in another market, a successful purchaser will likely face complications, and potentially incur significant costs to do business in those jurisdictions. A prudent purchaser will ensure that it is aware of the current circumstances of these matters as they pertain to the target franchise system and its own future expansion plans.

ii. Proprietary Software

Franchise system specific technology and systems, including its proprietary software can be the distinguishing feature between one franchise system and its competitors. This type of

intellectual property provides franchisees with a competitive edge in the marketplace and can improve efficiency and performance of the franchise system.

However, as with trademarks, clear ownership and appropriate protection of the software is of paramount importance to its value. A purchaser's legal counsel should determine whether the franchisor or a third party, such as the software developer, owns the technology. Care should be taken to ensure that if the ownership rights of the software do in fact reside with the franchisor or an affiliate, that such rights are appropriately transferred to the purchaser at closing. In the alternative, where the franchisor does not own the software, a purchaser's legal counsel should determine what rights a purchaser will have vis-a-vis continued use of the software post-closing. With respect to the software license agreements, legal counsel should determine whether the agreement contemplates future updates and support, including who shoulders the burden of the cost and expenses for such continued development.

iii. Operations Manuals, Confidential Information, and Other Intellectual Property

Operations manuals can be key assets in a franchise system, but may also serve as indicators of potential problems with respect to the day-to-day functioning of a franchise. As such, this type of asset should be evaluated not only for its current value, but also for areas of improvement and streamlining. A purchaser's legal counsel should assess whether the content of the manual is drafted sufficiently to ensure that the purchaser is shielded from any potential liability after its acquisition of the franchise system.

In addition to the operations manuals, franchise systems often possess other intellectual property that has the potential to increase the value of the franchise system as a whole, including confidential information. These assets can include secret recipes, contact lists, policies, and procedures. A prospective purchaser and its legal counsel should ascertain whether a target

franchisor has taken steps to protect that intellectual property, in addition to other copyrights, patents, domain names, and the franchise system's website.

B. Third Parties at the Table

The franchisee population is another point of distinction between a franchise system and other business models. Franchisees, although in most cases unseen at the negotiation table, wield a significant amount of power in an acquisition transaction and beyond. For example, franchisees can, depending on the circumstances, exercise their influence to make the entire acquisition process more expensive, more complicated, and more time consuming. On a worst case scenario, the franchisee population may challenge the transaction entirely, before or after closing. Alternatively, franchisees with late-term franchise arrangements may choose to exit the system at the end of the term of their franchise agreement. Conversely, if best practice approaches are adopted, the franchisees can ensure that the acquisition is profitable for all parties involved. The impact of the franchisees as a key group of participants must be carefully considered in order to examine how these third parties will affect a franchise system's earnings, and ultimately, the prospective purchaser's profit.

i. The Financial Health of the Franchisee Population

The expansion or contraction of the franchise system is subject in a large part to the franchisee population. While imminent or planned franchisee unit closings are relatively easily discoverable through due diligence, the financial health of franchisees is less so. If the franchisees are currently in, or showing signs of entering into, financial problems, closures are all but inevitable. Accordingly, a prospective purchaser must uncover any significant negative trends through the due diligence process, since this can cause the value of the franchise system itself to become uncertain in the long run. If such circumstances are discovered through

due diligence, it may require revisiting the purchase price (in order to reflect the uncertainty of the company's future profitability), or other key terms to address the uncertainty of potential outcomes.

It is of critical importance that a prospective purchaser and its legal and financial advisors review the financial information provided by the franchisees to the franchisor, and determine if the franchise unit economics are sound. Compilation reports, for example, can be used to assess the overall network performance (and system-wide comparisons and benchmarking) and to evaluate trends. These reports will also highlight poor performance by the franchisor in evaluating and managing delinquent franchisees, and can provide clues to key areas where the purchaser can focus resources and improve performance. In addition, these reports can provide a window into the operations and potential franchise system problems. To this end, a prospective purchaser and its legal counsel should determine if any franchisees are in breach of their agreements as a result of non-payment of fees, since this is an important sign of financial distress, which can lead to default or termination.

ii. “Taking the Temperature”

As stated above, a franchisee population can affect the merger and acquisition transaction both before and after closing. Effective due diligence should therefore “take the temperature” of the franchisees, to evaluate the predilections and inclinations of the franchisee population with respect to the transaction and the incoming franchisor. However, there are a number of challenges in this process. Firstly, the process of evaluating the franchisor-franchisee relationship is by its very nature, qualitative, and cannot be effectively completed by reviewing balance sheets, it is far more nuanced. Secondly, the purchaser must be able to “take the temperature” of the franchisee population, which can vary greatly in logistical difficulty depending of the size of the franchise system, without the franchisees becoming aware that the exercise is taking place at

all. It is worth noting that franchisors are often reluctant to allow “official” contact with the franchisee population.

The ultimate goal of the exercise is to ensure that at the conclusion of the process, the purchaser has a fair appreciation of the franchisees’ attitude toward the franchise system and the incoming franchisor is able to anticipate and defend against any franchise-specific challenges with respect to the franchisees. A purchaser may consider it prudent to ask a number of questions of a select group of franchisees should it become known that the franchisee population as a whole opposes the acquisition.

A purchaser should determine whether long-term franchisees intend to renew their contracts as they expire, and even if the franchisees do end up renewing, should determine whether the franchisees are likely to become unhappy or hostile following closing. If so, the purchaser may need to consider developing strategy around these issues, or may decide not to proceed with the transaction.

a) Dissatisfaction with the Franchisor

To ascertain the “temperature” of the franchisee population, and particularly the franchisee population’s level of satisfaction with the franchisor, a purchaser can scrutinize internal memoranda, letters, or reports of franchisee dissatisfaction, complaints against the franchisor, and most notably, investigate whether litigation between the franchisor and one or more franchisees is threatened or imminent. As a general matter of prudence, all the franchisor’s internal documents from the past several years regarding litigation, arbitration, or any other proceeding commenced or joined by any individual or group of franchisees should be examined.

One particularly contentious area where threats of litigation can arise is from the “encroachment” practices of the target franchisor. Purchasers should request copies of all policies, procedures, programs, and communications dealing with proximity between franchise

units, both company-owned and franchisee-owned. This includes any and all details, targets, or protocols on how the target franchisor measures “encroachment.” Poorly worded and unclear encroachment policies may increase litigation risks moving forward.

b) Franchisee Associations and Franchisor Advisory Councils

Franchisee Associations and Franchisor Advisory Councils can provide a wealth of information about the franchise system, and particularly the issues and challenges that are present in the relationship between the franchisor and its franchisees. The purchaser should obtain all information and records from any franchisee association and franchisor advisory council that have been established in the system. This includes membership, leadership, and any formal or informal agreements which would confer the ability to influence the franchisor on any issue. Even if no associations exist, enquiries should be made to ascertain whether any associations are on the verge of coming into existence, or at the very least, whether any specific information can be gleaned on how the franchise network is administered (e.g. a franchisee association may exist but with an informal structure), and any methods in which the franchisees participate in the decision making process.

C. Viability of the Franchise System

i. Compliance

Effective due diligence must take into consideration and evaluate the franchisor’s compliance with franchise legislation, in Ontario, the *Arthur Wishart Act (Franchise Disclosure), 2000*. In particular, owing to the severity of the consequences of deficient disclosure, a prospective purchaser must be able to determine whether franchise sales were made in full compliance with national and international franchise laws (as the case may be).

The burden imposed by discharging this due diligence task can clearly be quite challenging, especially if the franchise system operates internationally. In such a case, the purchaser may decide to take a sample of the franchisee population from various jurisdictions from which to undertake this due diligence exercise.

It is also critical to bear in mind that other jurisdictions may have vastly different franchise regulation, including more stringent compliance requirements. For example, if a target franchise system operates in the United States, it will likely have had to comply with registration laws applicable in certain States. In those States, franchisors are required to register and publicly file their disclosure documents. The purchaser will need to engage local counsel to confirm compliance with foreign jurisdictions requirements as part of the due diligence process.

ii. Sales Protocols

Over and above a review of disclosure documents, a purchaser's legal counsel should review and evaluate the target franchise system's sales history and protocols. This involves scrutiny of all sales advertising materials (including print or brochure advertisements, and multimedia materials produced for CD, television, or the internet) used to sell franchises in all jurisdictions. This goal in this regard is to assess whether there has been any breach of franchise laws, any misrepresentations, or any inconsistencies between sales information and materials and the franchise disclosure document. Again, the assistance of local counsel in foreign jurisdictions may be required for this task.

iii. The "Flip Rate"

The "flip rate" is also an important indicator of the ongoing profitability of the franchise system. The frequency at which franchisees transfer, sell, or assign their franchises may impact the functioning of the system as a whole in addition to its profitability. Accordingly, the

purchaser should request all of the target franchise system's records detailing past transfers, sales, assignments, and any other dispositions from the previous several years.

iv. Senior Management

The senior management of the franchise system hold extremely valuable information about the system and can also be the key to post-closing operations. A prudent prospective purchaser will seek to interview the senior management to glean the current state of affairs as they pertain to the system, and more pertinently, whether they intend to remain with the system post-closing. Having several senior managers leave at one time could have a drastic effect on the franchise system post-closing. The prospective purchaser should also look out for a number of other potentially detrimental arrangements with senior managers, including golden parachutes, relief from non-competition clauses, and change of control provisions (in their employment contracts). Such arrangements may result in the purchaser taking on payment obligations or other liabilities and risks that may be triggered by one or more of these arrangements.

D. The Franchise Agreement and Other Contracts

i. The Franchise Agreement

As we all know, the franchise agreement is at the centre of the franchisor-franchisee relationship. For this reason, and from the outset of the due diligence process, the franchise agreements (and all ancillary documents/agreements) should be carefully reviewed for their material terms (and consistency across various agreements). The prospective purchaser should also ascertain whether there has been any non-compliance by either party.

Particularly, the purchaser should evaluate whether the revenue received by the franchisor is consistent with what is contemplated under the franchise agreement. For example, the franchise agreement may allow for revenue from franchise fees, ongoing royalties (with or without adjustment mechanisms), and the sale of supplies, merchandise, and services to

franchisees. The purchaser should assess compliance with these requirements, and in addition, assess whether the revenues streams are recurring or non-recurring in order to quantify future profitability of the franchise system.

ii. Different Versions

Purchaser's legal counsel should undertake analysis to determine whether different versions of the franchise agreement exist. Since different franchisees sign and renew their agreements at different times, it is very likely that there are multiple versions of the agreement currently in use. Ultimately, a purchaser should be aware of how many different versions are currently in use, which units they cover, the differences in rights and obligations they impose, and when they expire, and any issues that may arise from such analysis.

iii. Indemnification

A purchaser's legal counsel should closely examine the franchise agreement to determine whether they contain robust, broad, and enforceable indemnification provisions that protect the target franchisor from vicarious and other liabilities. In this regard, consideration of conduct is equally important. Perhaps more importantly still, the agreement should also require the franchisee to purchase sufficient insurance to render the indemnities meaningful. These indemnities and insurance requirements must survive post-acquisition and subsist to protect any successful purchaser of the target franchise system.

iv. "Side Deals"

"Side deals" with franchisees, whereby, for example, the royalty structure specified in the franchise agreement and the disclosure document is substantially reduced in future years, can similarly eat away at the franchise system's profitability. Accordingly, all executed franchise agreements, including all amendments, addenda, modifications, and side agreements should be obtained and reviewed by a purchaser's legal counsel.

v. Logistical Concerns

From a practical point of view, a purchaser's legal counsel can face significant challenges in reviewing a target franchise system's franchise agreements, depending on the size of the franchise system, and the time available to review them. When dealing with small franchise systems, a careful review of each of the franchise agreements is relatively straightforward. The challenge arises when dealing with the acquisition of large international franchise systems, especially in the face of tight time constraints imposed by a target franchisor with a number of potential suitors. In those situations, legal counsel must work strategically, reviewing a cross-section of all available agreements.

A purchaser's legal counsel can nevertheless complete meaningful due diligence in the face of tight time constraints by reviewing a representative sample of documents. This can be accomplished if a purchaser's legal counsel requests and reviews several agreements of each type currently in use, across various jurisdictions (e.g. provinces), and across each type of franchisee, including single unit franchisees, multi-unit franchisees, area developers, and master franchisees. In this way, legal counsel can maximize the opportunity of identifying the risks and uncertainties with respect to the target franchise system's agreements and contracts, notwithstanding the significant challenges faced in due diligence.

vi. Other Contracts

The good standing of key contracts, including the underlying relationships with all third party suppliers, is critical to the continuing profitability of the franchise system post-closing. For this reason, great care must be taken by a purchaser's legal counsel in reviewing contracts with suppliers in order to identify, among other things, any unilateral termination clauses which could be triggered by a change in control.

A purchaser's legal counsel should request any information from the target franchisor to identify any circumstance which would preclude the ability of the target franchise system to effect a sale of its assets, equity, or change in control under these contracts

4. CONCLUSION

A tailored and franchise-specific due diligence strategy and approach as outlined in this paper will go a long way to ensuring that a prospective purchaser is well-informed as to the unique considerations that are relevant to the specific assets, liabilities and risks associated with a target franchise system. Increasingly, given the appeal of franchise systems as acquisition targets, a purchaser is often under time pressure to carry out an expeditious due diligence process. This together with other constraints often arising from the franchise business model (such as international operations) require a prospective purchaser to have an advanced understanding of the matters that should be addressed during the due diligence phase, and the ability to adjust and modify the due diligence strategy as the specific transaction requires.