

# A Seller's Guide to Preparing to Sell the Franchise System

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## **A Seller's Guide to Preparing to Sell the Franchise System**

The capital markets are in freefall. Lending sources are as dry as an ancient river bed after a prolonged drought. The economy is in the worst recession since the Great Depression of the 1930s. Companies of all sizes and types are simply “hunkering down,” trying to maintain or at least not lose significant market share, and generally trying to survive the current situation. So is now the time to think about selling the franchise system? Yes!

A franchise company should always be preparing for the sale of the franchise system – in strong economies, down economies, and in changing times. Preparing a franchise company for a sale to new owners, new investors, or a strategic buyer should be an ongoing process, because, as we discuss below, the process not only enhances enterprise value for the potential or eventual sale, but it provides current benefits for operations and profitability before any sale, or even if a sale does not occur for years.

### **I. Introduction**

Most principals, CEOs, and/or presidents of companies do not wake up one morning and state (to themselves or their management team), “I want to sell the company.” It is a process. This paper will address a number of issues that franchise companies should consider as part of that process. If a homeowner is considering selling her house, she undertakes a number of steps prior to putting it on the market. These include determining the value and potential asking price, retaining a broker, evaluating the strengths and weaknesses in the home and whether any work needs to be done to correct deficiencies or otherwise improve the house’s appeal and/or value. A franchise company should undertake a similar exercise.

A franchise company should understand its own strengths and weaknesses – which may be in operations, management, financial resources, franchisee relations, contractual rights, and/or other areas. The franchise company should understand what a potential buyer is or may be looking for and how the buyer will evaluate its acquisition target and negotiate the best deal. By understanding what drives a buyer, the seller improves its potential for closing a deal. This paper will consider why a franchise system should or may consider selling all or a portion of the business, how a buyer evaluates and values a potential franchise system acquisition target, the seller’s internal evaluation of its business and preparing itself for a sale, and issues related to the due diligence evaluation of a franchise company.

The focus of this paper and the accompanying presentation is on the business issues that will confront franchise systems. To be sure, there are many legal issues and many mixed legal/business challenges, and we will address some of these. However, as there have been many papers and presentations on mergers and acquisitions of franchise systems, buying and/or selling franchise companies, and similar topics at previous IFA Legal Symposiums, ABA Franchise Forum Annual Meetings, and other industry programs, we will not repeat many of those discussions and issues. For

additional information and sources for these other papers and presentations, please see Appendix A.

## **II. Why Franchise Systems Should Consider Selling a Portion or All of the Business**

There are three primary reasons a franchisor might consider an outside capital investment into the company:

1. Liquidity for founders and shareholders
2. Capital to accelerate the growth of the company
3. Combination of liquidity and growth capital

### **A. Liquidity**

For established franchisors, the ultimate reason to seek outside capital is for liquidity. Whether for the original founders or subsequent investors that have helped fuel the growth of the company, outside capital can provide the “big payday” rewarding years of hard work. In addition, often times, owners and senior executives have all or a substantial portion of their net worth tied into the franchise business and may want to consider asset diversification. An outside investment can allow the owner and shareholders to “cash out” partially or completely from the company in an effort to diversify their own investment portfolio. Outside capital can also allow for an orderly transition of generational ownership within a family.

### **B. Growth Capital**

On the other hand, for emerging companies, outside capital can allow the franchisor to build and expand its infrastructure in areas such as senior management, training, marketing, operations, and technology. In addition, in many instances, bringing in outside capital means bringing in a “partner” that can provide many additional benefits such as developing stock option plans for senior management, hiring key employees and new relationships via access to their Rolodex.

### **C. Combination of Liquidity and Growth Capital**

In many cases, franchisors seeking outside capital are looking for a combination of growth capital and liquidity. In franchising, it is frequently the case that the franchise concept is born, nurtured and matured under the leadership of the founder, but there comes a time when the founder’s skills, vision or resources become taxed, and the need arises for additional capital and outside assistance to continue expansion of the brand. Quite often, the founder is looking to take “some chips off the table” while still maintaining a meaningful equity position for a “second bite at the apple” in a future liquidity event. Often this is the best scenario for the founder and the outside investor – the founder can diversify his personal holdings and bring on a partner that can accelerate the growth of his business, while the outside investor can back an experienced entrepreneur to even further expand the concept.

### III. What are the Options for Outside Capital?

In general, as a franchisor becomes more established and generates a strong operating history, there are more options available for outside capital. But it is essential to consider every investment and the sources very carefully – there is no standard approach and each option carries its own pros and cons. The following are the main sources of outside capital for franchisors:

1. Angel investors / venture capital
2. Bank debt
3. Public equity markets
4. Strategic buyer
5. Private equity

#### A. Angel Investors / Venture Capital

Accessing outside capital for emerging franchisors has historically been, and unfortunately remains, the most challenging stage for securing outside investment. A franchisor's early stage is, by definition, inefficient and unpredictable, and institutional equity (i.e. from traditional venture capital firms) is reserved for a special few. Even with the surge in private equity, small franchisors still struggle to get the critical growth capital to invest in their concept.

Venture capital garners its fame from the technology boom in the 1990s. Many venture capital firms provided "seed" money to promising internet start-ups. However, since the technology bubble burst, venture capital is not so easy to find, especially for franchise concepts. Even today, start-up monies in the franchise sector are more likely to come from the owner's personal savings, friends and family, and local angel investors in the entrepreneur's community.

Unfortunately, in many instances, founders of franchise concepts are reluctant to bring in outside capital for fear of ownership dilution. Our observations suggest that maximizing long-term shareholder value has more to do with execution than ownership percentages. The fear of dilution has caused many common capitalization mistakes which severely restrict future growth and liquidity options. Venture capital firms generally do not require a majority position in the company (whereas, private equity firms generally, do) but will hold the entrepreneur accountable for his or her actions. The combination of external accountability and access to new contacts and resources often gives an emerging company a better chance of success than otherwise would be the case if they were to continue to develop on their own.

#### B. Bank Debt

Bank debt is the cheapest form of capital to obtain, if available, since there is no equity dilution. Unfortunately today, given the current challenges in the lending community, it is very difficult for most franchise companies to access the debt markets.

But this environment will change and traditional bank financing will once again be a common piece of the overall capital structure.

Banks grant loans based on the company's assets and cash flow. As long as monthly payments are timely made, banks require limited reporting and correspondence and their due diligence process is typically not as intensive as that of an equity investor. Although a straightforward process, timing and access can be somewhat challenging, and the borrower needs to have sufficient immediate cash flow to pay interest (whereas equity investors may be more patient). One of the greatest paradoxes is it is much easier to get a loan when you need it least and more difficult when you need it most. This again suggests that, if available, taking slightly more capital than you think you may need from an outside source, even at the risk of equity dilution or additional interest payments, is usually worth considering.

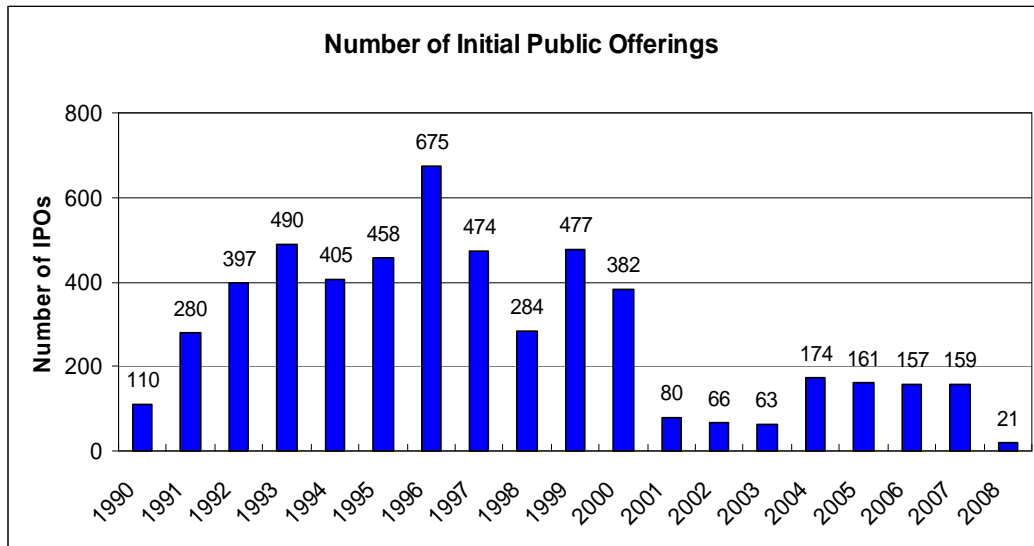
In addition, lenders usually require restrictive covenants and/or personal guarantees from an owner and they rarely bring more to the table than cash. They also may not understand the franchising (in most cases the assets of the franchisor are franchise agreements versus typical bricks and mortar and "hard assets" that they are more comfortable lending against) causing a longer due diligence process, more conservative debt levels and decreased certainty of funding. And finally, remember bank debt cuts both ways; aptly-termed "leverage," it can work well when times are good but can cause problems when trends are not so positive, as many companies have recently witnessed (Buffets, Inc, Bennigans, Mrs. Fields).<sup>1</sup>

### C. Public Equity Markets

The public equity markets are the most understood and publicized form of outside capital but also historically the hardest to access. With limited numbers of initial public offerings (IPOs) each year (see chart below), statistically speaking, it is an improbable option for most franchisors. In addition, public offerings are generally limited to larger companies – from 2001 to 2008 (i.e. post internet bubble), 69% of all IPOs involved companies whose trailing twelve month revenues exceeded \$50 million, which is generally larger than most franchisors.

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<sup>1</sup> <http://www.marketwatch.com/news/story/buffets-holdings-files-chapter-11/story.aspx?guid=%7BFA7E0C34-4E5E-4BFA-8FC5-0D3AB2014593%7D>  
<http://www.newsweek.com/id/149407>  
<http://www.reuters.com/article/businessNews/idUSN1548137920080815>



**“Some Factoids about the 2008 IPO Market”**

Jay R. Ritter, Cordell Professor of Finance, University of Florida

For those who can successfully access the public markets, and whose concept stays in favor with investors, they can have an unlimited source of growth capital to fuel future expansion. In addition, they can attract top managerial talent with lucrative stock options and equity packages. Companies such as Buffalo Wild Wings, Starbucks and Chipotle have, in general, been very successful as public companies and have grown into iconic brands in the marketplace.

Unfortunately the public markets can also be unpredictable and very unforgiving. Investors are overly focused on quarterly earnings with short-term results sometimes clouding long-term corporate reinvestment decisions. And when performance does not meet projections, fickle investors can lose confidence, immediately impacting the company’s stock price. Recovery can take multiple quarters, if at all, even if the reason for missing projections was out of your control.

In addition to the short-term focus of public shareholders, there are other issues to consider before going public (and these same considerations are driving many public companies to go private). Sarbanes-Oxley continues to impose increased compliance costs (e.g., internal compliance expenses, auditing fees, investor disclosure, and public relations costs) and is also creating an increasing mental distraction for senior management. As a result, CEOs and CFOs are spending a disproportionate time on compliance, analyst calls and conferences, and preparing quarterly and annual reports instead of doing what they do best – running their businesses. In addition, directors and officers of public companies continue to be exposed to increased personal liability.

More recently CEOs of public companies have had a new distraction to deal with – hedge funds. Hedge funds are similar to private equity funds in many respects. Both are lightly regulated, private pools of capital that invest in securities and compensate

their managers with a share of the fund's profits. Most hedge funds invest in very liquid assets (i.e., public securities), and permit investors to enter or leave the fund easily while private equity funds invest primarily in very illiquid assets (i.e. private companies) and so investors are “locked in” for the entire term of the fund.

Hedge funds have gained notoriety over the past few years for their investments in public restaurant companies such as Wendy's<sup>2</sup> and Outback Steakhouse<sup>3</sup>. Their demands usually center around a short-term liquidity solution that could potentially result in an increased stock price or one-time dividend through selling real estate for company owned locations or selling off emerging concepts. For example, Norman Peltz's group, Trian Fund Management LP, pressured Wendy's to spin off its Tim Hortons coffee-and-doughnut shop chain. Once a hedge fund extracts its payout from the company it usually sells its shares and moves on to the next target – leaving senior management with the challenges of actually running the day-to-day operations, potentially in a more challenging environment or capital structure than before the hedge fund invested.

#### D. Strategic Buyer

Another form of outside capital is an equity infusion that results from being acquired by a “strategic” buyer. Strategic buyers usually have an existing presence in the target company's industry. They could be a competitor or have a complementary product line or distribution channel or have material “back office” synergies such as purchasing, accounting, information systems and human resources.

Historically, strategic buyers have paid the highest price for franchisors because of the “synergies” they can realize from the acquisition. They also generally provide immediate liquidity for shareholders and usually require less due diligence than investments from private equity firms.

Unfortunately, synergy is usually another word for overhead reduction and in most cases the target's management team is materially decreased or eliminated. In addition, interest by strategic buyers is very cyclical. In the early 2000s, Wendy's and McDonalds were on a buying spree providing full liquidity for owners of concepts such as Baja Fresh, Pasta Pomodora, Donato's, Fazzoli's and Chipotle. Today is just the opposite – the large burger chains are selling off these investments (usually at a substantial discount to the original purchase price – Baja Fresh was purchased for \$275 million and recently sold for \$31 million) and focusing on their core brands. Of all of these purchases, arguably only Chipotle turned out to be successful.

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<sup>2</sup> Mara Der Hovanesian & Nanette Byrnes, “Attack of the Hungry Hedge Funds,” BUS. WK., Feb. 20, 2006, *available at* [http://www.businessweek.com/magazine/content/06\\_08/b3972103.htm](http://www.businessweek.com/magazine/content/06_08/b3972103.htm).

<sup>3</sup> Robert Trigaux, “A Financial Buccaneer Fires Across OSI's Bow,” ST. PETERSBURG TIMES, June 12, 2006, *available at* [http://www.sptimes.com/2006/06/12/Columns/A\\_financial\\_buccaneer.shtml](http://www.sptimes.com/2006/06/12/Columns/A_financial_buccaneer.shtml).

## E. Private Equity

And then there is private equity. Until the last several years, private equity was unknown to most outside of New York and many people associated private equity with the “corporate raiders” of the 80s. But today private equity is an accepted alternative source of capital that does not carry the burden of the short term demands of the public markets.

Private equity firms pool capital contributions from institutional investors such as pension funds and endowments, as well as high net-worth individuals with the primary purpose of making investments in private, mature companies or going-private transactions for public companies. Recent franchisor investments include such household brands such as ServiceMaster,<sup>4</sup> Schlotzsky’s Deli,<sup>5</sup> and Dunkin Brands (Dunkin Donuts, Baskin Robbins and Togos).<sup>6</sup>

Along with the increase in private equity investments, owners and senior management are learning that private equity firms can bring much more than money to the table. Private equity firms can provide:

- A sounding board and confidant for the CEO
- Assistance in recruiting and hiring key executives and board members
- Help in developing equity plans for management
- Aid in seeking complementary acquisition companies

In addition, private equity investment allows the company to maintain privacy as there are no public disclosure requirements. This allows the private equity firm to make tough or controversial decisions without having to answer to or release sensitive information to shareholders or the general public. Privacy paired with the private equity investor’s longer-term investment horizon (ranging from three to seven years), insulates the company from the whims of the public markets and allows franchisors and multi-unit franchisees to survive and thrive when the inevitable bumps in the road are felt in the business or industry.

But there are some important issues to consider before soliciting a private equity investment. Most, but not all, private equity firms prefer to purchase a controlling stake of the company. While the private equity firm has no intention of running the company day-to-day, in most cases they will want a say in significant decisions such as capital

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<sup>4</sup> *ServiceMaster Acquisition Closed*, MEMPHIS BUS. J., Jul. 24, 2007, available at [http://www.bizjournals.com/memphis/stories/2007/07/23/daily19.html?from\\_rss=1](http://www.bizjournals.com/memphis/stories/2007/07/23/daily19.html?from_rss=1).

<sup>5</sup> “Private-equity Firm Roark Capital Purchases 385-unit Schlotzsky’s Ltd. From Bobby Cox Cos.,” NATION’S RESTAURANT NEWS, Nov. 27, 2006, available at [http://findarticles.com/p/articles/mi\\_m3190/is\\_48\\_40/ai\\_n16879866](http://findarticles.com/p/articles/mi_m3190/is_48_40/ai_n16879866).

<sup>6</sup> Jenn Abelson, *A New England Brand Come Home Again in \$2.43b Deal*, THE BOSTON GLOBE, Dec. 13, 2005, available at [http://www.boston.com/business/articles/2005/12/13/a\\_new\\_england\\_brand\\_comes\\_home\\_again\\_in\\_243b\\_deal/](http://www.boston.com/business/articles/2005/12/13/a_new_england_brand_comes_home_again_in_243b_deal/).

allocation, board member selection and exit decisions. An entrepreneur must determine if he or she will be comfortable with this “shared” level of decision-making.

Additionally, the due diligence process is typically much more extensive and time consuming for a private equity investment than a strategic buyer or bank financing. Due diligence provides a thorough look “under the hood” to assure the buyer’s confidence in the franchise. It is an expensive and time consuming process but no buyer will consider a transaction without it. The challenge for the owner and management team is to balance responding to detailed information requests while continuing to manage day-to-day operations.

Also, there is a definitive time to exit. While investment time horizons may vary, ultimately the limited partners of the private equity firm will want their capital back (in addition to a nice return on their investment) and so the company must be sold. Management should make sure their time horizon is in synch with the private equity firm’s before they enter into a transaction.

#### **IV. What is a Buyer Looking for in a Franchisor; Valuation of the Company**

In general, franchisors sell based on a multiple of cash flow or EBITDA (Earnings Before Interest Taxes Depreciation and Amortization). But all concepts are not created equally and there are a multitude of factors that drive actual transaction multiples.

Understanding how a firm will value a franchisor is essential to considering an outside investment. Private equity investors have become educated on the favorable cash flow characteristics of franchisors (especially in light of the dot-com fallout) and are prospecting the sector for opportunities. When run properly, franchisors can enjoy a long-term, diversified revenue stream with little capital expenditures making them attractive, long-term cash flow investments.

In addition, historically, with all other factors being equal, larger companies will sell for higher multiples than smaller companies because banks tend to lend more aggressively to larger, more established businesses, thus allowing the buyer to pay a higher purchase price for the same effective equity returns.

For a franchisor, typically, a buyer will evaluate the following criteria:

1. Attractive unit-level economics
2. Quality of senior management
3. Competitive position
4. Franchisee satisfaction
5. Proven business model in multiple markets
6. Sound infrastructure

A. Attractive Unit Level Economics

A meaningful part of the due diligence process is spent digging into true store-level performance. No other measurement is as critical - if the franchisees are not successful, nothing else matters. The two key aspects of franchisee economics are the turn-key development costs (franchise fee, build out costs, working capital, inventory, initial marketing) and the annual cash profits an owner/operator can generate. The best franchisors continually find new ways to improve both metrics in order to provide the franchisee with the best chance of success. When the underlying store-level performance generates cash-on-cash returns that spurs continued expansion everyone wins - franchisee, franchisor and investors.

B. Quality of Senior Management

The leadership behind a franchise concept determines the overall success of the franchisor. Many exciting, emerging franchise operations never fulfill their potential because of lack of leadership and execution. The senior level executive's philosophies on franchising, their desire and capacity to drive meaningful growth and the credibility to execute their plan will have a great impact on the buyer's investment decision.

C. Competitive Position

Why does the franchisor exist and who is its target customer? Within a crowded franchise market, the buyer wants to ascertain whether the franchisor can maintain its competitive position even as copy-cats or imitators emerge. What is it that the company does well that will differentiate it and create a unique, defensible position?

D. Franchisee Satisfaction

Closely tied to unit-level economics, the relationship between the franchisees and franchisors is important to the investor, whether investing in a franchisor or a multiple-unit franchisee. The franchisee's confidence level and trust in the leadership of the brand are a strong indicator of the health of the system. In due diligence, the buyer will want to interview a number of franchisees regarding their view on new product development, marketing, store design, and systems support. A good investment partner will want to know what the franchisor does well and where are the areas of improvement to help improve overall franchisee performance.

E. Proven Business Model in Multiple Markets

This doesn't mean the franchise needs a presence across the country, but it must show broad appeal across multiple markets within the same region. More or less, the buyer wants to see promising expansion prospects – that the concept has “legs” to continue expansion.

## F. Sound Infrastructure

It takes more than just a good idea to successfully grow a franchise chain. In most cases, having built a solid operating platform in areas such as training, marketing, real estate, and technology are as crucial to development of the concept as the original idea itself. Franchisors with a strong commitment to infrastructure will be better positioned as a prospect.

No investor expects perfection in all six of these valuation categories, but they are looking at the overall health of the franchise chain and prospects for continued growth. Reviewing internally these areas of valuation in advance of calling a private equity investor will greatly enhance the franchise chain's ability to position its business favorably.

## V. **The Seller's Perspective**

When a franchise company makes the decision to begin the process of finding a buyer for the system and navigating the sales process, there are many issues that arise and preparations that need to be made so that the process is a smooth one. The process impacts multiple facets of the franchise network, including franchise operations, corporate and legal formalities, and the possible hiring of an investment banker or other advisor. The process also impacts many groups – both internal and external – with interests in the franchise company, including franchisees, employees, suppliers, and lenders.

### A. Operations

The essence of any company is its operations and how it functions on a day-to-day basis. This is very true of a franchise company where ideally the brand is a cohesive collection of franchisees – perhaps several hundred or thousand franchisees – operating units nationwide or even internationally according to the franchisor's tried and tested system. Before the franchisor takes the company to market, its management team should take stock of its operations because this is the first component a buyer will likely examine.

At the earliest stages of the sales process, a buyer interested in purchasing the franchise company will likely perform some level of preliminary operational due diligence. At the outset, this may consist of visiting numerous units in different cities and states to get a feel for whether all the units are following the system and the customers are leaving the business with a great and consistent experience.

The franchisor's management team should spend time reviewing the field audits of its units and should go and visit as many of its units as it can to see for themselves the state of the company's operations. If the operations do not look crisp and consistent, the franchisor needs to decide whether to proceed with the sales process or take some time and try to improve the operations. This is not the time to try and put "lipstick on the pig" and hope that the buyer will not notice the state of the operations. In

order to get top dollar for the franchise company, the state of the system's operations will be key.

## B. Corporate/Legal Formalities

Another issue that often arises prior to or during the sales process is the franchise company's corporate and legal formalities. The ideal time to conduct an internal review of such formalities would be prior to putting the franchise company up for sale. This is the time to make sure that the corporate minute books are in order and that all corporate formalities have been followed like having annual meetings of shareholders and regularly-scheduled meetings of the Board of Directors with the minutes of these meetings properly filed in the minute book. An examination of the shareholder ledger and the bylaws should also be made as well as checking to see if the company has current address information for each of the shareholders which will be critical when sending out notices for the special shareholders' meeting to approve the sale of the company prior to the closing. If anything is out of the ordinary, this is the time to deal with it.

In small, closely-held companies, corporate formalities are often dispensed with and many times share certificates have never even been issued or even worse are misplaced or lost. Prior to the sale is the time to deal with these issues because if issues such as these are not resolved, they are almost certain to be discovered by the buyer and may slow the whole sales process or in a worst case scenario may scuttle the deal or result in a re-negotiation of the sales price.

## C. Use of an Investment Banker or Advisor

Deciding whether to use an investment advisor or banker for the sales process is a major decision. An investment banker generally has the ability to make the process smoother and assist with issues that arise before the company is put up for sale, during the sales process and during the due diligence and contract negotiation phase of the transaction. An investment banker will ideally bring the experience of many deals and transactions with it; a seasoned investment banker will likely have seen just about everything that can possibly happen during the sale of a company.

The investment banker might be most valuable in a situation where the company has many sizable shareholders but, perhaps, no shareholder with a majority of the outstanding shares. In a situation like this, with many different constituencies, problems and infighting can arise at various times during the sales process; an investment banker that has been hired by the Board of Directors can navigate these troubled waters and bring calm to these problems.

Some companies choose not to work with an investment banker. In a case where the transaction is relatively small or the company is adverse to paying the fees that would be commanded by an investment banker, it might be best for the company to go it alone.

If the franchise company chooses to hire an investment banker, it is wise to look for someone who has handled similar transactions and ideally someone who is knowledgeable in the franchise company's industry and with franchise transactions. A transaction involving franchised units brings a different set of issues, problems and opportunities than the sale of a non-franchised company so it certainly helps to have an investment banker that is familiar with the franchise relationship and dynamics. The Board of Directors of the franchise company should actively seek out several investment bankers that meet these criteria and interview them and perhaps most importantly get a feel for whether the Board and the investment banker would work well together during a potential sales process. The sales process can be a long, grueling undertaking so it is important that the Board and the company's management team have a trust and a cohesive working relationship with the investment banker as there may be many long days and nights ahead.

After the Board of Directors has interviewed the candidates and reviewed the financial proposals, it should make a decision and begin the process. The Board of Directors will decide the course of the transaction. In some cases, the Board may ask the investment banker to undertake a valuation of the company before the Board decides whether to sell the company. This process can take weeks or months depending on the complexity of the company but will be useful for the company in not only deciding whether to go forward with the sale of the company but in negotiating the sales price with potential purchasers.

If the Board decides to go forward with the sales process, the next step for the investment banker is to put together a marketing piece for the company. This marketing piece or "the book" as it will usually be called is a very important piece to selling the company and putting it in its best light. The book will generally consist of an overview of the company, its history, biographies of the management team, photos of operating units, geography of the units, growth history, franchise sales overview and deal pipeline, and historical financial results as well as projected financials for the next three to five years. The investment banker will work very closely with the management team to complete the book and once it has been approved by the Board will be primarily responsible for its distribution to potential purchasers.

The investment banker will assist in setting appointments for the potential purchasers to attend a management presentation at the franchise company's headquarters and once the presentations have concluded will solicit bids from those potential purchasers wishing to buy the company. Once the bids have been received, the investment banker will meet with the Board and help them understand the bids including any contingencies and assist the Board in making the ultimate decision of which bid to accept. After selecting the purchaser, the investment banker will assist with contract negotiations with the buyer and with any issues or problems that arise during the due diligence phase and will be available until the deal is closed.

#### D. Managing the Process

In order for the sales process to run smoothly and efficiently, it is imperative that the process is managed effectively from the very beginning until the closing and even thereafter in the handling of post-closing issues.

Once a franchise company begins the process of deciding whether to put the company up for sale, the management team should begin to get the company ready for sale. This would include gathering all of the various documents that a buyer will want to examine during the due diligence phase. The reason to gather these at the outset is to ensure that they are available and that everything is in proper order. If there is a problem, it is best to find out at the beginning rather than have a buyer find it which could result in a closing delay or in the worst case scenario, a scuttling of the entire deal. These documents would include: audits and other financial paperwork; loan documentation; leases for company units; corporate minute books and other corporate records; franchise files including all signed FDD or UFOC Acknowledgment of Receipt pages, executed franchise agreements and other franchise documents; franchisee correspondence; field audit reports; Franchise Disclosure Documents and Offering Circulars for the last five years; state franchise registration files including correspondence with franchise examiners and advertising filings; supplier contracts; employment agreements; and all other material contracts and agreements. These materials should be placed in a "data room" or preferably sent off to a company to create a virtual data room which will make the due diligence process easier and more efficient for a buyer. The company's attorneys and accountants should also be notified at this time so that they may start preparing their files as well.

The seller should also assemble a team to deal with any issues that come to light in the due diligence and contract negotiation phase. This will usually include the company's chief financial officer, general counsel and outside attorneys as well as key members of the management team and the investment banker. This team should be in constant communication with the Board of Directors. The seller has to be responsive to the buyer (or multiple bidders) when the buyer (or a bidder) is requesting a document or has questions during the due diligence phase. It is in the best interests of the buyer and seller to make the due diligence phase quick and efficient.

Although the closing date is seen as the finish line, there are many details that must be handled after the closing. Depending on the type of transaction, they may include ensuring: that shareholders have received their share proceeds via check or wire; lenders receive their payoffs and UCC releases and other releases are properly filed; any required post-closing filings are made with the secretary of state's office; a new Board of Directors is formed and officers are appointed; proper notification of the transaction is sent to suppliers, landlords and others pursuant to their contracts or agreements; revisions are made to the Franchise Disclosure Document and filed with the appropriate states; employees are notified; and press releases are prepared and sent to the local and trade press.

## VI. Stakeholders

When a franchise system is sold – and even during the pre-sale evaluation period – there are many distinct groups and constituencies that will be affected by the sale. These groups or “stakeholders” will need to be addressed by both the buyer and seller at various times during the sales process. Dealing with the stakeholders entails deciding when to notify them that a sale of the franchise system is taking place and addressing their issues and concerns.

### A. Franchisees

A seller has to decide when and how to notify the existing system franchisees that the franchise system is for sale. Since some buyers will want to speak with existing franchisees directly during the due diligence period, it is probably best that the franchisees be notified of the sale early in the process.

In a small franchise system, the franchisor’s founder or CEO may choose to contact each franchisee individually to give them the news of the potential sale and to answer any questions that the franchisees may have. As a franchise system increases in size, it becomes a more difficult process. In a large system some franchisors may decide to notify their franchise advisory committee early in the sales process and may use the committee members to help notify other franchisees. The advisory committee may also be used earlier in the process, as a sounding board, and during the process to help reluctant or concerned franchisees understand the value of a sale to them. This notification may take place via direct calls by the franchisor’s management team and field staff, via a systemwide conference call of all franchisees, via a system wide voice mail system, or via email or the company’s intranet. However the notification takes place, there should be a process in which the franchisees can ask questions and receive answers. The lack of information in a franchise system breeds distrust and allows gossip to run rampant. The sales process is not the time for the franchisees to be spreading rumors due to a lack of relevant and timely information being disseminated to them.

Once the franchisees are notified, both the buyer and the seller will want business to continue as usual so it is important that the franchisees realize that they need to keep operating their units in the same high quality manner that they always have. They should be reassured that their franchise agreements will remain in place under the new ownership so they should not have to worry about their futures so long as they continue to run a high quality operation and remain in compliance with their agreements. This is where an open, positive relationship with a franchise advisory committee can pay dividends for a franchisor.

### B. Employees

Deciding which of the franchisor’s employees to notify about the sale of the franchise system can be challenging. Ideally only those corporate employees who will be involved in the sales process should be told of the impending sale. Depending on

the size of the franchise company, this may entail notifying a sizable number of employees beyond the management team. Those notified may include professionals as well as support staff who will be instrumental in gathering the materials needed during the sales process.

The risk of telling too many employees at the outset is that the sale becomes a distraction to the operations of the business with people worried about whether they will have a job after the close of the transaction. A franchise company runs the risk of good people leaving the company in search of “stable” employment elsewhere or staying and being a source of gossip within the company which may lead to more turmoil in the ranks.

The franchisor’s management team should stress to those employees who are told about the sale that it is important that they continue to do their jobs and to keep the information about the possible sale to themselves. The buyer can help this situation by reassuring key employees that they will have a job at the end of the process or, if not, by promising the employees a retention bonus or other incentive if they agree to stay until the transaction closes.

In most cases, employees at the unit level including unit level managers should not be told of the impending sale until the sale has actually been consummated. Telling these employees will just exacerbate the potential for disruption to the unit.

#### C. Suppliers

Few things are more critical to a business than the uninterrupted supply of goods. A franchise company’s suppliers are really partners in the success of the business. The seller has to decide whether to inform its suppliers of the impending sale or to wait until the transaction has closed.

If the buyer and seller agree that there will be no supplier changes immediately after the transaction closes, there may be no need to inform the suppliers of the sale before it is completed. If the buyer has decided to change a supplier after the sale is completed, the buyer should review the suppliers’ contracts early in the sales process to examine the notification and termination section. If a supplier is to receive 30 or 60 days’ notice prior to terminating the contract, this may have to be given during the course of the sales process. The seller and buyer will have to work closely on this matter as there is risk to the seller that they may be left without a supplier if the sale does not ultimately close.

#### D. Lenders

At the outset of the sales process, the seller should review their loan documents to see what their rights and responsibilities are when selling the company. The buyer has to decide whether it wants to assume the franchise company’s debt as part of the process or if it will be paying it off and/or replacing it with debt from a different lender. If the buyer wishes to assume the debt, it should have a discussion with the lender as

early as possible so that the closing will not be delayed. If the buyer wants the debt satisfied prior to closing, the seller should begin discussions with the lender early in the sales process. Lenders will often bundle a company's debt with debt from other companies and sell these in the public markets or to private investors. This is especially true with institutional lenders like G.E. Capital and getting these unbundled and paid off can be both costly – with additional, substantial payoff penalties – and time consuming, and can lead to a major delay in closing if not handled early in the sales process.

Another issue that is common deals with personal guarantees. In a small franchise company, the founder or other principals may have personally guaranteed the company's debt. If the buyer wishes to assume the debt, a discussion should occur with the lender about releasing the principals from the guarantees. If the lender refuses, the buyer and seller will need to discuss how this matter will be handled between them.

Finally, the seller may have borrowed money from a Small Business Investment Company ("SBIC") or similar investor in which equity rights may have been granted in addition to the promise to repay the debt. The buyer and seller should be aware of the notification rights and other rights the SBIC may have pursuant to their loan agreement.

#### E. Franchisor's Shareholders

In order to complete the sale of a franchise company, the proposed sale will have to be approved by the company's shareholders. In a small company, there may only be one or two – or at most a handful of – shareholders; in a family-owned franchise company, the shareholders may all be members of the family. In larger franchise companies there may be 50 or more shareholders including employees who have become shareholders through the exercise of stock options.

The notification of the shareholders of the proposed sale should probably not occur until a special meeting of the shareholders has been called to ratify the sale of the franchise company to the buyer. At this time, the shareholders would receive a packet containing all of the pertinent information regarding the sale and the right to vote at the upcoming meeting.

Depending on the bylaws of the franchise company, it may take anywhere from a simple majority of outstanding shares to a supermajority of outstanding shares in order to approve the sale of the company. It is critical, therefore, that the company has good records of shareholders with current addresses to which to send the notice of the shareholders' meeting.

The transaction will not be able to close until all corporate formalities approving the sale according to the company's bylaws have been met. Both the seller and the buyer will want to ensure that all of these formalities have been met and that the shareholders have been properly briefed so that the requisite number of shares vote on and approve the sale.

## F. Management

Perhaps more than anything else, a buyer tends to value the franchise company based on its management team. A franchise company with a seasoned management team with a proven track record will prove to be very valuable to a buyer. It is imperative, therefore, that the company's management team be involved in the sales process and incentivized to remain with the company.

During the sales process, the management team will be forced to wear many hats. They will be expected to participate in the creation of the offering book and the management presentations to prospective purchasers and also to be available to potential buyers in order to answer questions and assist in the due diligence process. At the same time, they will be expected to perform their regular business duties in order to keep the company performing at a high level.

The buyer should speak to the management team at the outset of the process and answer any questions they may have. The main question will be whether the management team will remain employed with the franchise company after the transaction closes. It is in the buyer's best interests to be forthright with the management team. If members of the management team are not going to be retained, they may be offered a retention bonus or similar incentive to stay until the completion of the sale and perhaps a few months afterward in order to have an orderly transition from seller to buyer. If the management team will be retained, they will have questions regarding salary and equity participation in the company. The buyer may wish to discuss these issues at the outset to keep the team motivated.

## VII. **Due Diligence**

As noted above, the decision to consider selling the franchise company, and then deciding to proceed with a sale, involves many steps, evaluations and decisions along the way. We have alluded to "due diligence" – by the buyer and seller. This is a crucial and multi-faceted process.

The due diligence review of a franchise company is generally considered the purview of the buyer. The fundamental purpose of due diligence is to evaluate the nature and value of what is being acquired, and assess the liabilities or other problems of the seller that the purchaser may assume. While an asset sale will, generally, allow the purchaser to avoid acquiring many of the liabilities of the seller,<sup>7</sup> many of the due

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<sup>7</sup> The general rule regarding "successor liability" is that where one company sells or otherwise transfers all of its assets to another company, the latter is not liable for the debts and liabilities of the transferor. There are four recognized exceptions to the general rule of successor liability: (a) an express or implied assumption of liabilities; (b) a consolidation or merger of two corporations; (c) the mere continuation of the seller in the form of the purchaser; or (d) the transaction is entered into fraudulently in order to escape responsibility for debts and liabilities. For a discussion of successor liability issues in franchise company transactions, see Schwartz, et al. v. Pillsbury Inc., et al., Bus. Fran. Guide (CCH) ¶10,059 (9th Cir. 1992); Sterling Vision DKM, Inc. v. Gordon, Bus. Fran. Guide (CCH) ¶11,271 (E.D. Wis. 1997); Wine Imports of America, Ltd. v. Gerome's Liquors, Ltd.; 563 F. Supp. 1623 (E.D. Wis. 1983), Buskin v. IHSS, Inc., et al., Bus. Fran. Guide (CCH) ¶10,160 (Wis. Ct. App. 1993); and Ata-Boy, Inc. v. National 60 Minute Tune, Inc., Bus. Fran. Guide (CCH) ¶10,011 (D. Or. 1992).

diligence considerations will be the same if the transaction is an asset sale or stock sale. It is up to the buyer to investigate and evaluate the franchise company – its assets, its management, its franchisees and franchise relationships, its compliance with franchise laws (and other laws and regulations), its operations, potential liabilities, and many other aspects of the franchise system.

A due diligence investigation of the franchise company need not be limited to the buyer. A seller should also undertake due diligence. Due diligence enables the seller to identify any “skeletons in its closet,” and possibly remedy problems before discovered by the purchaser. Also, if the defects are not curable, due diligence will enable the seller to better assess the value of the assets it is selling, and negotiate and draft appropriate representations and warranties, and/or caps or limits on its post-closing obligations or indemnifications. Further, due diligence enables the seller to prepare development schedules and exhibits for the purchase agreement. There is an old saying: “time kills all deals.” If thorough due diligence by the seller enables the seller to address issues before they become problems and grease the wheels of the transaction by providing the buyer (or bidders) with relevant information and schedules, the likelihood of closing a sale increases.

#### A. Recordkeeping

Before the seller can assess its own company, and before a buyer can conduct due diligence, the seller must have the records available to permit due diligence. Records – paper or electronic – are one of the keys that can unlock the secrets of a system, and can impact the valuation of a franchise company, either positively or negatively. The records will touch all aspects of a franchise company’s history and operations. These include:

- franchise disclosure and registration documents
- franchise agreements
- franchisee files
- trademarks and other intellectual property
  - trademark
  - copyright
  - URLs
  - website agreements
  - Internet agreements

- advertising and marketing
  - financial (funds received and expended)
  - marketing plans and programs
- financial data and back-up
- vendor and supply agreements
- personnel, including agreements with lay employees and shareholders
- corporate documents
- loan and financing agreements
- real estate and equipment leases

The franchisor's management should determine if it has the records it needs, and then assess those records. If records are missing or incomplete, management needs to locate or reconstruct those records. Recall our home buyer – before she puts her house up for sale, she should have records of insurance coverage, maintenance contracts for HVAC, regular termite inspections, etc. The simple fact that a seller (of a home or franchise company) has records available and the records are in good order sends a positive message to a potential buyer. If the franchise company learns that something is missing, it can correct the situation before it retains an investment banker or advisor, and before it invites the scrutiny of one or more potential sellers.

While an exhaustive list of due diligence documents and due diligence issues is beyond the purview of this paper, we will address several critical issues that are of particular interest to franchise companies.<sup>8</sup>

## B. Franchise Documents

A significant portion of a due diligence inquiry will focus on issues related to the selling company's compliance (or lack of compliance) with laws. In many situations, the first stage of due diligence should be a preliminary evaluation into the principal assets of the franchise company; that is, the franchisees and the franchised businesses that form the heart and soul of the franchise company. And the first stage of that analysis is the franchise agreements. More often than one might imagine, the current management team of a franchise system does not have a detailed understanding of the franchise

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<sup>8</sup> For sample due diligence lists, and additional discussion of due diligence, see *Mergers and Acquisitions of Franchise Companies*, L. Vines, editor, Appendices A-C; "Due Diligence in Buying and Selling Franchise Companies," Scott Pressly, Neil Aaronson, Doug Berry, 39<sup>th</sup> Annual IFA Legal Symposium, May 7-9, 2006; and "Mergers and Acquisitions Involving Franchise Networks," Kenneth Kaplan, Mark Kirsch & James Rubinger, 32<sup>nd</sup> Annual IFA Legal Symposium, May 23-25, 1999.

agreements that their franchisees have executed, particularly if the system has grown or undergone changes over several years. While it is sometimes impractical to evaluate all franchise agreements in a system as part of the overall due diligence, it is important to have a good “snapshot” of the system as early as possible.

## 1. The Franchise Agreements

For franchise companies that have many franchised outlets and/or a long operating history, it is not unusual to find many forms of franchise agreements that have been executed over the years, and are still in effect. To understand its own system, the seller should have (a) a list of all franchised outlets, organized chronologically by date of execution, and by future date of expiration of the relevant agreement; (b) copies of all forms of agreements executed with the franchisees (which will eventually need to be supplemented with any franchisee-specific negotiated changes to, or modification of, the franchise agreements); and (c) a list of which, and how many, current franchisees are operating under each form of contract. A buyer and its advisors will want this same information when it starts its own due diligence, so the seller should compile this data in a useful format. The company should then evaluate each form of contract to determine if there exist any initial obstacles to accomplishing the goal of a potential sale.

### a. Critical Issues

#### (1) Transferability of the Franchise Agreements

One initial hurdle to clear is the determination of whether the franchise agreements of the franchise company, or ownership of the company, may be transferred to a purchaser. Most franchise agreements explicitly state that the franchisor may assign the franchise agreement, or the franchisor’s ownership of, or rights in, the franchise agreement, to any third party, in the franchisor’s sole discretion, and without affording the franchisee any rights in or to such transfer. It is important to note that the perceived unfettered right to transfer a franchise agreement may be limited by state statute or state regulatory action. For example, the Iowa Franchise Law<sup>9</sup> places certain limitations on a franchisor’s ability to transfer its interest in a franchise. Under the Iowa law:

“[a] franchisor shall not transfer its interest in a franchise unless the franchisor makes reasonable provision for the performance of the franchisor’s obligations under the franchise agreement by the transferee. For purposes of this subsection, ‘reasonable provision’ means that upon the transfer, the entity assuming the franchisor’s obligations has the financial means to perform the franchisor’s obligations in the ordinary course of business, but does not mean that the franchisor transferring the franchise is required to guarantee obligations of the underlying franchise agreement.”

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<sup>9</sup> Iowa Code, tit. XX, ch. 523H, § 5(6).

Also, in New York, the Department of Law (the agency charged with regulating the offer and sale of franchises in New York) has in the past required as a condition of granting registration of a franchise offering the inclusion of language in the franchise offering circular or franchise disclosure document that addresses the franchisor's right to transfer the franchise agreement. Specifically, if Item 17 of the FDD or UFOC contains a statement that the franchisor has the right to transfer its interests in the franchise agreement, the franchise examiners in New York may require a substantive, additional disclosure such as "No assignment will be made except to an assignee who in the good faith judgment of the franchisor is willing and able to assume the franchisor's obligations." Therefore, in Iowa or New York, a seller's right to transfer its franchise agreements to the purchaser, or sell its ownership interest in the franchise agreements to the purchaser, may be limited by the purchaser's capability (presumably in terms of business and management skill, financial strength, and other attributes) to carry on the business of the franchisor.

It is not unusual for franchisees to express concern regarding a sale or pending sale of their system, and franchisees or a group of franchisees have challenged the proposed sale of franchises system, relying on various legal theories. In Marc's Big Boy Corp. v. Marriott Corp., et al., Bus. Fran. Guide (CCH) ¶9100 (E.D.Wis. 1988), a case in which the franchisee was not successful in seeking to enjoin the sale of the Big Boy system from Marriott to one of Marriott's largest Big Boy franchisees, the court did note that a franchisee may have a legitimate interest in who controls the franchisor. The court, however, did not find that the transferee lacked the qualifications to be the franchisor. In sum, the case law, along with a few statutes and regulatory action, indicate that the ability of a franchisor to assign a franchise agreement may be subject to a challenge based upon the qualifications, management and financial capability, and viability, of the surviving entity.

## (2) Changes to the Franchise System Following the Transaction

A second inquiry relates to whether a purchaser of the franchise system may implement changes for the system. While the current owners of a franchise system may be perfectly content with the operations, results and direction of their company, they need to be prepared that potential new owners may have different plans for the franchise system. If a goal of an acquiring company, investor group, or private equity firm is to convert the target network to the new system, the trademark provisions in the franchise agreements must explicitly permit the change of trademarks, trade dress, and other intellectual property at the discretion of the franchisor. While many agreements may make one or several references to changes to the marks, these provisions should make clear that the franchisor (which will mean the purchaser, following the transaction) may not only modify the marks (e.g., changes in style, lettering or color), but may substitute completely new and different trademarks, logos, and names. Further, the franchise agreements should also permit the franchisor to change and amend the "system" in any manner, including adding to or removing from the system various operational elements, systems, and requirements. Even with language that grants the

franchisor a broad right to modify the system and marks, there is likely to be an outside boundary of such action, which crossed, may give rise to a claim of breach of the covenant of good faith and fair dealing, and/or other claims that franchisees may raise to prevent such action.<sup>10</sup>

### (3) Territorial and Exclusivity Issues

A third inquiry at the initial evaluation stage is whether any exclusive rights in a territory granted to a franchisee (or, put another way, any limitations on the franchisor's ability to establish or license others to establish outlets within a territory granted to a franchisee) may prohibit a potential purchaser's planned activity. This is especially critical if a potential purchaser owns or controls a competing system. Whether a purchaser's goal is to operate dual systems, or convert one chain to the name and system of the other, a selling franchisor must realize that the greater flexibility it has with respect to territory, the more desirable it will be for potential buyers. The franchise company will eventually need to turn over to a purchaser a list of the locations of all franchised and company-owned outlets, including all territories granted to the franchisees, or territories otherwise associated with each outlet. The purchaser will then create a similar map for its system, and overlay its own system map over the map of the target company.

A purchaser's right to operate and franchise the target system, or operate competing systems will depend, in large measure, on the franchise agreement terms. If the franchise agreements of the selling franchise network include promises that the franchisor will not operate the same business under the same marks within the franchisee's territory, the territorial overlaps will identify outlets, or markets, where conversion of one system into another may be problematic. If the franchise agreements state that the franchisor will not operate or franchise a competing business under the same, similar, or different marks, within the territory granted to a franchisee, the operation of parallel or dual systems in the same or similar business may be problematic in the areas with a territorial overlap. This will limit the number of potential suitors for a franchise system, and may possibly negatively impact the value of the franchise company.

### (4) Other Potential Problems

An early review of the franchise company's agreements may reveal other potential post-acquisition problems. For example, a system may have a form of agreement, utilized early in its history, or with special circumstances, in which the franchise agreements grant the franchisees an opportunity to "walk away" from the franchise system by providing advanced notice of termination. If franchisees are not happy with the merger/acquisition, or with the purchaser following the transfer, the

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<sup>10</sup> For example, changing a hamburger restaurant to quick copy and print shop, or changing a takeout and delivery pizza business to a takeout and delivery Chinese food business, may be beyond the reasonable expectations of a franchisee and outside the scope of contemplated actions, even if done under the guise of "system changes."

franchisees, individually or collectively (system-wide, or market by market), could leave the system on relatively short notice. Even if breaking away from the system is not a goal of the target system franchisees, such a provision leaves the franchisees with considerable leverage in negotiating with the new franchisor.

The preliminary evaluation of the forms of franchise agreement may detect other potential future problems. For example, a restaurant franchisor that had entered into a significant number of agreements for co-branded, and/or satellite, operations at convenience stores and gasoline stations, utilized a form with limited three-year terms, and with no post-termination or post-expiration non-competition clause. Much of the recent growth of the system was built on these co-branded franchises. Therefore, within a span of two to three years, a significant number of franchise agreements could expire, and the franchisees could re-brand their outlets. This fact caused a reassessment of the value of the assets of the franchised company. While these types of provisions are not illegal and do not raise any issues as to liability, they will have an impact on the pre-acquisition contract negotiations, and the post-acquisition actions of the purchaser. In short, the initial internal evaluation may uncover problematic aspects of a franchise system and may suggest to the franchisor reasons to make changes before the system is put up for sale.

The inventory of franchise agreements should also include a list of amendments, side letters, and negotiated terms and conditions. The selling franchisor and any potential buyer will want to know the nature, scope and type of variations from the standard form franchise agreement that have been offered and now permeate the franchise system. In addition, many purchasers will request a representation from the seller in the purchase agreement that except as otherwise disclosed in a schedule to the purchase agreement, all of the franchisees have executed and are operating under the standard form of agreement. The seller will need this list of non-standard or negotiated agreements to provide to the buyer.

## 2. Franchise Disclosure and Registration Documents

One of the fundamental questions a purchaser will ask is whether the target company “complied with the law.” This is a critical inquiry for the seller as well. In light of the multilevel regulatory scheme under which franchisors operate, the “compliance with law” can be a complex inquiry.

A franchise may not be legally offered or sold in this country without the franchisor providing a franchise disclosure document to a prospective franchisee.<sup>11</sup> Whether that document is a Uniform Franchise Offering Circular (or “UFOC”) prepared under the North American Securities Administrators Association (or “NASAA”) Guidelines, which were required or permitted prior to July 2008, or is a Franchise Disclosure Document (“FDD”), prepared under the amended FTC Rule or NASAA Guidelines after July 2007 (and required as of July 1, 2008), all franchisors must have

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<sup>11</sup> The Federal Trade Commission’s Trade Regulation Rule on Franchising (the “FTC Rule”), 16 C.F.R. § 436.1 et seq.

(or have had) a UFOC or FDD for all offers and sales, unless an exemption under federal or state law is applicable. Also, a franchise may not be offered or sold in the registration states without first obtaining the approval of, and registration by, the state agencies.

The franchise company, in reviewing its own UFOCs and FDDs, should determine whether it has complied with applicable laws. This requires an evaluation of the following questions:

- Does the franchisor's current FDD comply with the applicable disclosure rules (principally the FDD Guidelines issued by the FTC and NASAA), and did previous versions of the FDD/UFOC comply with these laws?
- Does the current FDD, and previous versions of the UFOC, comply with each franchise registration state's disclosure laws, including:
  - were appropriate changes made to the documents to comply with the laws?
  - if amendments to the FDD or UFOC were required due to material changes, were such changes made in a timely fashion?
- Did the franchise company register its franchise offering in all of the franchise registration states, or secure exemptions from the registration requirements?
- Did the franchisor register its advertising and promotional materials in all applicable states?
- Did the franchisor register its salesmen and/or franchise brokers in the appropriate registration states?
- Did the franchisor's franchise registrations lapse in any state, and if so, how long was the lapse period? As noted below, the key issue is not whether there was a lapse, but rather whether the franchisor made offers to prospective franchisees, or executed any franchise agreements, in those states during the lapse periods.

In reviewing the selling franchise company's compliance with franchise laws, the evaluation should not overlook the state business opportunity laws.<sup>12</sup> While many franchisors, particularly companies that offer business format franchises, will be exempt or excluded from the definition of a business opportunity (due to one or more reasons,

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<sup>12</sup> There are 24 states with business opportunity laws, which require the registration and/or pre-sale disclosure of business opportunities, along with, in some cases, bonding requirements, limitations on earnings or revenue projections or statements, and statutorily mandated changes to the agreement.

including, compliance with the same state's franchise registration law, compliance with the FTC Rule, or the offer of a marketing plan in conjunction with the license of a registered (or some cases, a federally registered) trademark), the company should determine whether its franchises are/were exempt or excluded from the business opportunity laws in the states in which the franchisor operates. Further, several business opportunity states require annual, or one time, filings of notices of exemption from the state's business opportunity law (e.g., Kentucky, Nebraska, Utah, and Texas).

It is not enough for the company to determine whether it has and had an FDD that complies (complied) with the NASAA Guidelines and the FTC Rule, or whether it maintained effective franchise registrations. It is vitally important to determine if the franchise system complied with the applicable franchise laws with respect to the offers and the sales of franchises, including compliance with the FTC Rule's pre-sale disclosure timing rules.<sup>13</sup> Several areas of inquiry include:

- When did the franchisor have its first contact with a prospect and "the first personal meeting" with a prospect?
- What date was the FDD/UFOC delivered to the prospect?
- Which form or version of the FDD/UFOC was delivered to the prospect?
  - was the FDD/UFOC that was provided to the prospect registered in the state in which the prospect lives, or in the state in which the franchise will be operated, or in the state in which the sale was made or accepted?<sup>14</sup>
  - was the FDD/UFOC currently effective, that is, was the registration effective, at the time the offer or sale was made?
- On what date did the franchisee execute the franchise agreement or any preliminary agreement, or pay any money or other consideration to the franchisor?

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<sup>13</sup> Under the FTC Rule prior to July 2008, a franchisor must deliver the UFOC to a prospective franchisee at the earlier of: (1) the "first personal meeting," or (2) at least ten business days before (a) the signing of any franchise (or other) agreement, or (b) the receipt of any money or other consideration from a prospective franchisee.

Under the Amended FTC Rule, the FTC abolished the "first personal meeting" rule, and changed the ten business day rule to 14 calendar days.

Also under the pre-amended FTC Rule, the prospective franchisee was required to have the completed purchase agreement with all variable terms and blank lines completed, for a period of at least five business days prior to execution of the agreement.

<sup>14</sup> A state franchise registration law may apply if the offer is made in the state; if the offer is received in the state; if the offer is accepted in the state; if the prospect lives, is a resident of, or is domiciled, in the state; and/or if the franchised business is or will be operated in whole or in part in the state. The jurisdictional rules vary from state to state.

The documents that are critical to any franchise due diligence are the FDD/UFOC acknowledgments of receipt. The receipts are evidence of the fact that an FDD/UFOC has been delivered to a prospective franchisee, along with the date of delivery.

Further, if the FDD/UFOC and/or state registrations have been amended during the course of a year, the franchisor is required to provide the new, amended disclosure to prospective franchisees, and to re-disclose prospective franchisees “in the pipeline” who may have received the previous form of disclosure document. A similar requirement is imposed following an annual update of the FDD/UFOC, or the annual renewal of a state franchise registration. A review of the franchisee files, the acknowledgment of receipts, and the state franchise registration history should reveal whether the franchisor has complied with these laws.<sup>15</sup>

### 3. Franchisee Files

The franchise agreements executed by existing franchisees will reveal a great deal of information to both the seller and to potential purchasers about the franchise system – on a “macro” level. On a micro level, a significant source of material for the due diligence investigation will be in the files of the operating franchisees. These files will reveal crucial dates for determining compliance with the franchise investment laws (e.g., agreement execution dates, the acknowledgment of receipt, execution of state-required addenda). In addition, these files reveal negotiated franchise agreement terms, the franchisee’s compliance with various contractual obligations, including filing of periodic reports and copies of relevant documents (e.g., tax returns, periodic sales reports, financial statements, certificates of insurance); the payment of royalty, advertising, and other fees, and whether, and to what extent, each franchisee is delinquent in those payments; reports on substandard operations or conditions, and/or notices of default or pending defaults; and correspondence that may indicate potential or actual problems or lawsuits.

The franchisee files will be a rich vein to mine by the purchaser or its counsel during due diligence. Therefore, the seller should be aware of what is in – and what is not in – the franchisee files. The pre-sale evaluation may uncover franchise law violations. Or more likely, it may reveal lax franchise administrative practices and/or lax franchise operational review practices. A lack of field reports, certificates of insurance, or follow-up reports from deficiency notices, may be a wake-up call to create better administrative and management practices. They may also be early warnings that one or more aspects of franchise operations are not up to brand standards. This can be a harbinger for future franchisee operational miscues, poor or negative trending of franchisee financial performance and/or franchisee unrest or complaints. The time to shore up franchise system operations – which may mean more franchisor support and

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<sup>15</sup> For a discussion of a situation where a franchisor was liable for rescission of the franchise agreement for failing to redisclose to a prospective franchise “in the pipeline” with its recently amended UFOC, see Video Update, Inc. v. Guenther, et al., 741 F. Supp. 172 (D. Minn. 1990).

attention – is before the franchise system is put under the harsh glare of the purchaser’s due diligence lights.

Another area of inquiry pertains to former franchisees. Even though a former franchisee is no longer part of the system (whether by transfer, termination, non-renewal, or expiration of a franchise agreement), it is important to determine whether the sale of the franchise to that franchisee was made in compliance with the applicable franchise investment laws, and whether the transfer or termination was made in compliance with law.<sup>16</sup> A review of the transfer files will also shed light on the franchisor’s practices with respect to transfers, and whether such practices would be considered offers or sales of franchises (which would require the furnishing of a FDD or UFOC to the prospective franchisee/transferee).<sup>17</sup>

The pre-sale evaluation should inquire as to whether each termination was undertaken in compliance with the applicable franchise relationship law (which requires, in many cases, advance notice of termination, and an opportunity to cure, and, in some cases, good cause for termination). A review of the files of franchisees who were terminated, or who transferred their interests, should remind the seller whether any former franchisees threatened or initiated action against the franchisor or raised allegations of improper or illegal actions. Many franchisors execute termination agreements (with terminating franchisees), or assignment, assumption and consent agreements as part of a transfer. The franchise files for former franchisees should include such agreements. Again, even if there are no pending actions by former franchisees, or threatened action, the presence or lack of releases and termination agreements may suggest a need to modify a system’s practices before the franchise company is put up for sale.

#### 4. Vendor Contracts

The franchise company should have, and should carefully review, the supply and distribution agreements between the franchisor and its franchisees, and/or between the franchisor and its outside suppliers and vendors, and all cooperative or joint purchasing arrangements. This exercise is critical to an understanding of the franchise system, and should be undertaken at least annually by a franchise company. These arrangements,

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<sup>16</sup> The following states have franchise relationship laws that govern relationships between franchisors and franchisees: Arkansas, California, Connecticut, Delaware, Florida, Hawaii, Illinois, Indiana, Iowa, Louisiana, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, New York, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. The laws in certain of these states sometimes include, among other things, limitations on a franchisor’s ability to terminate or not renew a franchise, imposition of substantive requirements prior to termination, and prohibiting transfers without good cause.

<sup>17</sup> The FTC Rule requires that franchisors provide a disclosure document to prospective franchisees prior to the sale of a franchise. The FTC’s Interpretive Guides provide that a purchaser of a franchise who acquires his/her franchise from an existing franchise is not a “prospective franchisee” if there is no significant contact with the franchisor. Conversely, if the franchisor’s role in the transfer is significant, and is more than the mere exercise of a right to approve or disprove the purchaser, the purchaser/transferee will be deemed a prospective franchisee and disclosure under the FTC Rule will be required. Many of the state franchise investment laws reflect a similar view – if the franchisor is not directly involved in the transfer, disclosure is not required. Note, however, that many franchisors provide a UFOC even if not mandated by the law.

if any, will shed light on the potential revenue stream following closing, a potential reduction in costs (if the goal is to merge the two systems or to merge certain functions of the two systems), and the potential liability for antitrust violations or violations of the franchise disclosure rules with respect to required purchases and/or payments or kickbacks made in connection with these purchases. Often, supply arrangements are not carefully documented. Therefore, the franchise company may wish to shore up its recordkeeping and possibly reevaluate or renegotiate its arrangements with some suppliers before it puts the company up for sale. As noted earlier, a potential buyer may wish to modify supply contracts and/or eliminate some existing suppliers. Understanding the vendor landscape is critical for the seller.

## 5. Trademarks and Intellectual Property

A central component of the franchise company's assets will be its intellectual property. The company's trademarks and other intellectual property may be quite considerable. In short, the analysis should include a review of schedules of trademarks, service marks, trade names, copyrights and patents that are owned, licensed or used by the franchisor or its affiliates, including the evidence of all registrations and the agreements. Does the company have records of all filings, renewals and agreements? Are there any limitations to using, or licensing others to use, the marks? The evaluation should also include a review of all disputes, infringements or other actions regarding any of the intellectual property and all agreements regarding the intellectual property. The due diligence will look at questions as to the status of the marks, including the ownership of the marks, unregistered marks, possible infringements, trade dress infringement, liens, the effect of any state trademark anti-dilution statutes, and any pending controversies involved in the marks. The selling franchise company should carefully review and analyze of all licenses, including, exclusive and non-exclusive licenses, control over the licensees, assignability of the licenses, indemnification and insurance issues relating to the licenses. This process may reveal potential imitations on the purchaser's use of the marks following the closing.<sup>18</sup>

The trademark and intellectual property inquiry should also include all foreign marks and agreements executed for operations, or even potential operations, in foreign companies. The IP inquiry will also include domain name registrations, website hosting agreements, intranet agreements, software development and licensing agreements. The selling franchise company must assure itself that it has access to, and ownership of, all critical software and source codes that are necessary to operate and support the franchise system.

In short, if the trademarks and other intellectual property are central to the value and operations of the franchise system – and they are – the seller needs to know that they are sound and secure.

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<sup>18</sup> For additional discussion, see Raman, W. and Jones, D. "Trademark Considerations in Franchise Transfer," in *Mergers and Acquisitions*, L. Vines, editor.

## 6. Financial Information

The financial health of a franchise system and its prospects for ongoing positive financial performance is directly attributable to the financial success of its franchisees. Therefore, the internal franchisee reporting to the franchisor, and the collective franchise system financial records (in addition to financial statements), are crucial to understanding the financial health of the system. The franchisor should make sure that it has regular reports from franchisees, and that there exists clear back-up for all data. As noted earlier, a buyer will dive head first into an evaluation of franchise unit economics. The franchisor's data at the unit, market and regional level must support the system wide data that will be supplied to a buyer.

### **VIII. Flagging System Problems**

As noted above, preparing for the sale of a franchise company will undoubtedly reveal some defects in the system. These may be uncovered through the seller's own due diligence, a review of operations, meetings with potential investment bankers, or in other aspects of the self-assessment. It is critical for the franchise system to understand the nature of these problems and determine how to proceed. One course of action is to retreat from potential sale discussions or inquiries. Another is to develop long range and short range remedial actions. This may be as simple as implementing document management systems, or may entail hiring consultants, investing in franchisee training and re-training and/or implementing new operating and marketing plans. It may include a re-assessment of the potential value of the company and a willingness to accept a lower price and let the new owners address the issues. But, the franchise system must know that whatever problems, issues, or smoking guns exists, these will not be swept under the rug, only to later develop as a surprise problem to the purchaser.

Buyers of and investors in franchise companies generally know where to look for the problems. And, they will generally find them. Moreover, the purchase agreement will contain representations and warranties of the seller (and, in some cases, the seller's principals) regarding the franchise company and the franchise system. These "reps and warranties" provide insurance to the buyer that any and all warts have been revealed before the deal closes.<sup>19</sup>

### **IX. Franchise Disclosure Issues**

As discussed earlier in this paper, what to say to franchisees and employees, and when to say something about a potential sale, are critical considerations. The issue of disclosures to prospective franchisees of a pending, or even an imminent, sale of the company has been addressed in other materials (see Appendix A) and need not be

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<sup>19</sup> A sample purchase agreement provision with franchise-related representations and warranties appears at Appendix B of this paper. These are fairly extensive reps and warranties, but they illustrate the types of issues that a franchisor seller will face when putting the company up for sale, and the representations that a buyer may require to obtain the comfort and peace of mind that it is acquiring quality assets without many or significant deficiencies or liabilities.

repeated in detail here. The nature of the proposed sale, the likelihood that it will be consummated, the timing, the agreement(s) in place (whether there is an executed sale agreement, a letter of intent, a pre-sale “bid” process, or informal discussions with potential suitors), and the franchise company’s tolerance for risk, will shape the decision as to when prospective franchisees should be advised of a pending sale. A prospective franchisee that is considering a purchase of a franchise, based on the information in the FDD is entitled, under the law, to be made aware of “material changes” in the offer. If a deal to sell the franchise company to a competitor, or to a strategic buyer, or to a private equity firm is highly likely, and imminent, and there is a strong likelihood of changes to the system, these changes are likely to be considered “material.” In this situation, a franchise company should cease franchise sales until the deal is closed and the FDD is amended, or amend the FDD prior to closing with new material information, and continue franchise sales with the amended FDD. For a company that is simply exploring possibilities, and undergoing its internal due diligence and evaluation, there is no need to amend the FDD or cease sales. Such an action is premature, and there are few, if any, details that can be provided. And, such a vague disclosure only raises more questions than it resolves. What is important for a selling franchise company to remember is that at some point in the process a selling franchise system will have a fundamental decision to make: (a) amend its FDD to advise all prospective franchisees of the potential sale of the franchise company, or (b) cease all franchise offers and sales until the deal is closed or a new or amended FDD is issued. Knowing that an FDD amendment (or a decision to cease sales) will be in a company’s future, the company may be able to time its discussions and negotiation to minimize the amount of down time, or the “going dark” period when it ceases franchise sales.

## **X. Conclusion**

The sale, or potential sale, of a franchise system is just one event in the evolving life cycle of a franchise company. In fact, such an event may inject more money, energy, talent and growth into a system. And, the sale of all or part of the ownership of the franchise company may occur several times in the life of the company. To get the most out of a sale, or potential sale, the franchise company must be prepared for the transaction. The preparation takes months, and more likely years, to get the system in the best and right place for a sale or other financial infusion transaction. The franchisor should evaluate its goals and understand its potential options – growth capital, liquidity, venture capital investors, private equity investors, strategic buyers, IPOs, and other alternatives. The franchise company – as potential seller – should understand how the various options may impact current shareholders, management, employees, franchisees and the overall health of and prospects for growth of the brand. Engaging an investment banker or other financial advisor is often desirable to help obtain the best deal and to navigate the process.

One of the critical aspects of the process is evaluating the strengths and weaknesses of the system. This can be an enlightening, but sometimes sobering, process of legal, corporate, operational and managerial due diligence. The franchisor should not shy away from the warts or deficiencies, and should try to find them and fix

them before a potential seller discovers them. This may involve improvements in operational systems, better field/franchise advice, new reporting systems, better attention to contract and legal administration, new or revised marketing plans, shoring up supply chain issues, improving franchisee relations and/or franchise unit performance, and/or other major or minor changes in the system. This process improves the health of the franchise system – even if the company is never sold. And it creates value for the franchise company for that eventual sale.

In sum, preparing the franchise system for sale is an ongoing process, which, if undertaken diligently over time, will yield positive future results by minimizing potential stumbling blocks for buyers, facilitating a smooth transaction, enabling franchisees, employees and managers to focus on their principal duties during and after the sales transaction, and in the end increasing enterprise value.

## APPENDIX A

The following are a number of papers and presentations that address a myriad of issues related to the sale of franchise networks and mergers and acquisitions involving franchise companies.

### ABA Forum on Franchising: Monograph Series

1. *Mergers and Acquisitions of Franchise Companies*, Leonard D. Vines ed., American Bar Association, 1996

### IFA Legal Symposium Papers and Presentations

1. "Advanced Issues in M&A," Jeffrey Brimer, Joel Buckberg, Jack Santaniello, 41<sup>st</sup> Annual IFA Legal Symposium, May 11-13, 2008
2. "After the Acquisition: Legal Issues Affecting the Integration/Conversion of Acquired Units," James Rubinger, Brian Schmidt, Charles Bengochea, 39<sup>th</sup> Annual IFA Legal Symposium, May 7-9, 2006
3. "Due Diligence in Buying and Selling Franchise Companies," Scott Pressly, Neil Aaronson, Doug Berry, 39<sup>th</sup> Annual IFA Legal Symposium, May 7-9, 2006
4. "Acquisitions and Sales of Franchise Companies," Charles Modell, Donna Christopherson, Mark Siebert, 38<sup>th</sup> Annual IFA Legal Symposium, May 8-10, 2005
5. "Mergers & Acquisitions," Patrick Meyers, Andrew Perrin, & Les Wharton, IFA 34<sup>th</sup> Annual IFA Legal Symposium, May 6-8, 2001
6. "Acquisitions and Mergers Involving Franchise Networks," David Kaufmann, Steve Peden & Les Wharton, 33<sup>rd</sup> Annual IFA Legal Symposium, May 14-16, 2000
7. "Mergers and Acquisitions Involving Franchise Networks," Kenneth Kaplan, Mark Kirsch & James Rubinger, 32<sup>nd</sup> Annual IFA Legal Symposium, May 23-25, 1999

### ABA Forum on Franchising Papers and Presentations

1. "Financing, Liquidity and Growth Capital Tools from Traditional Lending to Private Equity and Venture Capital," Kenneth R. Costello and Scott Pressly, Phoenix, 2007
2. "Litigation After Acquisition of a Competing Franchise System," Kirk W. Reilly, L. Seth Stadfeld and Philip L. Wharton, Boston, 2006

3. "Basics of Buying and Selling a Franchise Company," Joel R Buckberg and Richard G. Greenstein, Orlando, 2005
4. "Touchstones in Successful Acquisitions Involving Franchise Systems," Jan S. Gilbert and Lou Hendrick Jones, San Francisco, 2001
5. "Legal Issues Arising from the Ownership of Competing Franchise Systems," Joel R. Buckberg, W. Michael Garner and Jonathan Solish, Palm Springs, 1999
6. "Buying and Selling Franchise Businesses – Why is this Deal Different from All Other Deals?," Jeffrey A. Brimer, Cathryn S. Gawne and Leonard D. Vines, Colorado Springs, 1997
7. "Combining Affiliations: When Competitors Merge Their Franchise Systems," Ann Hurwitz and John R. F. Baer, San Diego, 1994

## APPENDIX B

### Sample Representations and Warranties

#### 5.20 Franchise Agreements; Franchise Law Compliance; Franchise Matters.

(a) Franchise Agreements and Ancillary Documents. Section 5.20(a) of the Disclosure Schedule is a true, correct, and complete list of the following:

(i) All of the:

(A) oral and written franchise agreements, license agreements, subfranchise agreements, sublicense agreements, master franchise agreements, area development agreements, development agreements, and option agreements (each a "**Franchise Agreement**" and, collectively, the "**Franchise Agreements**") which grants or purports to grant to a third party the right to operate or license others to operate or to develop within a geographic area, at any location or within any area in the world, "Brand X" restaurants, or other concepts operated or franchised under the Business System by the Company or any of its Affiliates (each a "**Franchise**"), and such list includes the name of the Franchisee, the location of the franchised outlet, the date upon which the franchise or development rights were granted, the expiration date of the agreement, the franchised territory and/or the franchise development area, the royalty rate payable by the Franchisee, the advertising fund contributions payable by the Franchisee, and the contract amendment and/or transfer history; and

(B) the guaranty agreements and/or guaranty and subordination agreements, and/or similar agreements under which one or more individuals or entities guaranty to Seller the payment of all monies and the performance of all duties under a Franchise Agreement (each a "**Guaranty Agreement**"); and

(C) trademark agreements, service mark agreements, business opportunity agreements or trade name agreements (each an "**Ancillary Document**" and collectively, the "**Ancillary Documents**"),

that are currently in effect between (i) the Company, any of its Affiliates, and any Franchisee or other licensees, subfranchisees, sublicensees, master franchisees and developers (collectively, the "**Franchisees**"); or (ii) any Franchisee and any third party (each a "**Subfranchisee**"). Seller has delivered or made available to Buyer true and correct copies of all Franchise Agreements Guaranty Agreements and Ancillary Documents identified in Section 5.20(a)(i) of the Disclosure Schedule.

(ii) All of the Franchise Agreements that have expired or been terminated for any reason whatsoever during the five-year period immediately prior to the date of this Agreement. The list in Section 5.20(a)(ii) of the Disclosure Schedule sets forth the name of the Franchisee, the (former) location of the franchised outlet, the development area (if any) that was the subject of the Franchise Agreement, the date

upon which the franchise was granted, the date upon which the Franchise Agreement expired or was terminated, and the reasons for any termination prior to the applicable expiration date.

(iii) All loans to Franchisees by Seller or the Company or any of their Affiliates, or loans to Franchisees guaranteed by Seller, the Company or any of their Affiliates and, if guaranteed by Seller, the Company or any of their Affiliates, the name of the lender.

(iv) All of the persons to whom the Seller or its Affiliates have forwarded UFOCs or FDDs (defined below) who are currently under consideration by the Seller for the sale of a franchise, including the name of such person, the proposed location of the franchised business and/or development area, and the status of the negotiations or discussions with such person.

(v) Each current Franchisee for whom the Seller has given written notice of material default under a Franchise Agreement or Ancillary Document for any reason and which notice remains outstanding, and each current Franchisee for whom the Seller knows is in material default under a Franchise Agreement, whether or not such Franchisee has been issued a notice of default.

(b) Franchises and Franchisees.

(i) Except as set forth in Section 5.20(b)(i) of the Disclosure Schedule, each currently-effective Franchise Agreement is not materially different from the form of Franchise Agreement incorporated into the applicable FDD (the “**Standard Form Franchise Agreement**”) that was delivered to the Franchisee prior to the sale of that particular franchise by the Seller (or its predecessors) to the Franchisee; provided, however, that Section 5.20(b)(i) of the Disclosure Schedule shall describe only those differences between the Franchise Agreement described in Section 5.20(a) of the Disclosure Schedule and the Standard Form Franchise Agreement that provide for terms and/or renewal periods that are longer or shorter than standard, reduced or altered fee and/or payment requirements, or other changes that may reasonably be expected to have a material effect on the Business.

(ii) Except as set forth on Section 5.20(b)(ii) of the Disclosure Schedule, and except as may be granted by operation of Law, no Franchisee has a protected territory, exclusive territory, right of first refusal, option or other arrangement, that (A) in the case of Franchise Agreements that are unit franchise agreements, is materially different from the territorial grant set forth in the Standard Form Franchise Agreement, (B) in the case of the area development agreements and other multiple-unit development or franchise agreements, is materially different from the territorial grant set forth in the Standard Form Franchise Agreement, or (C) except as set forth in the respective Standard Form Franchise Agreement, grants a right to acquire additional franchises or expansion of the Franchisee’s territory or area.

(iii) Except as set forth in Section 5.20(b)(iii) of the Disclosure Schedule, there are no existing defaults by the Seller or any of its Affiliates, and no event has occurred which, with notice or lapse of time, or both, would constitute a default by the Seller or any of its Affiliates, under any such Franchise Agreement, which default would have a Material Adverse Effect, nor would such default permit a Franchisee to terminate such Franchise Agreement and such termination would reasonably be expected to have a Material Adverse Effect.

(iv) Except as set forth in Section 5.20(b)(iv) of the Disclosure Schedule, each of the Franchise Agreements, Guaranty Agreements, and Ancillary Documents is valid, binding and enforceable in accordance with its terms against each Franchisee (or other party in the case of Guaranty Agreements and Ancillary Documents) thereunder, and complies in all material respects with all applicable laws and any applicable judgments, consents or decrees from any Governmental Entity having jurisdiction with respect to the offer and sale of franchises by the Seller or its Affiliates, except to the extent that any unenforceable Franchise Agreement, Guaranty Agreement or Ancillary Document provision, or any Franchise Agreement, Guaranty Agreement or Ancillary Document that does not comply with applicable law would not result in a Material Adverse Effect.

(c) Franchise Legal Compliance. Section 5.20(c) of the Disclosure Schedule is a true and correct list of the jurisdictions in which the Seller or any of its Affiliates is currently registered or authorized to offer and sell franchises (under a Registration Law, defined below, and/or any foreign law) and the jurisdictions, including individual states and territories in the United States, and foreign countries, territories and jurisdictions, in which the Seller or any of its Affiliates offered or sold a franchise since January 1, 2000. The Seller has provided Buyer with a copy of the Seller's past and currently effective Franchise Disclosure Document ("**FDD**") ("FDD" also includes Uniform Franchise Offering Circulars, or "UFOCs") for each state, and for each foreign country, territory or jurisdiction, in which the Seller is (or was at any time since January 1, 2004) offering and selling franchises. In connection with the Seller's Brand X FDDs and franchise registration and disclosure obligations, and its franchise offers and sales in the United States and throughout the world:

(i) Since January 1, 2004, the Seller has prepared and maintained each FDD in material compliance with: (A) the Uniform Franchise Offering Circular Guidelines adopted by the North American Securities Administrators Association on April 25, 1993 and any and all successor rules and guidelines, including those promulgated in 2008 regarding FDDs ("**UFOC Guidelines**"); (B) the Trade Regulation Rule on Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures promulgated by the Federal Trade Commission, 16 C.F.R. Part 436 (the "**FTC Rule**"); and (C) any and all applicable laws of the various states of the United States that require such registration before a company may offer and/or sell franchises or business opportunities ("**Registration Laws**").

(ii) Since January 1, 2004, the Seller has obtained written confirmation of its approval and/or exemption under such Registration Laws before engaging in making any offer or sale of franchises in such states (except as otherwise specified in Section 5.20(c)(ii) of the Disclosure Schedule); and the Seller has made on a timely and accurate basis all required additional filings under the Registration Laws, including but not limited to filings with respect to material changes, advertising, salesperson registrations, amendments, and renewals, except to the extent such failure would have a Material Adverse Effect.

(iii) There are no stop orders or other proceedings in effect or, to the Knowledge of Seller, threatened that would prohibit or impede Seller's ability to offer or sell franchises or enter into Franchise Agreements, except supplemental filings that may be required to reflect the transactions contemplated by this Agreement.

(iv) Section 5.20(c)(iv) of the Disclosure Schedule lists all of the foreign countries, territories and jurisdictions in which the Seller has offered or sold franchises or any form of agreement for operations outside the United States. For all such offers and sales of Brand X franchises, or other franchises under the Business System, outside of the United States, Seller has, except as disclosed in Section 5.20(c)(iv) of the Disclosure Schedule (A) complied with all foreign laws, rules, regulations, and procedures governing or affecting the offer and/or sale of franchises in such countries or to residents of such countries, (B) obtained and maintained all permits, licenses, registrations, and authorizations to offer and sell franchises and to provide support and assistance to and/or provide products or services to franchisees in such countries, and (C) provided to each franchisee the appropriate, complete, accurate, and truthful franchise disclosure documents, if required, for all such offers and sales of franchises. Except as set forth in Section 5.20(c)(iv) of the Disclosure Schedule, no executed Franchise Agreement has been registered or recorded with any governmental agency in any jurisdiction outside of the United States.

(v) The Seller has previously delivered or made available to Buyer true and correct copies of all applications and filings containing FDDs and other franchise disclosure documents (for use in the United States and all foreign jurisdictions) required to be filed with the appropriate Governmental Entities or jurisdictions where such filings have been required since January 1, 2004. The Seller has not, in any of the aforementioned documents or filings with states under the Registration Laws, made any untrue statement of a material fact, or omitted to state any fact necessary to make the statements made by the Seller, taken as a whole, not misleading, in connection with the offer or sale of any franchise or business opportunity, except to the extent such statement or omission would not reasonably be expected to have a Material Adverse Effect.

(vi) There are no actions, suits, proceedings or investigations pending, or to the Knowledge of Seller, threatened, which may result in the revocation, cancellation or suspension, or any adverse modification of any license, permit,

registration, consent, approval, certificate, authorization, declaration or filing made by the Seller with respect to any franchise, franchise offering or Franchise Agreement.

(vii) Except for the earnings claims or Financial Performance Representations that are included in the Seller's FDD, the Seller has not authorized its officers, directors, salespersons, and/or other representatives to furnish to prospective franchisees any materials or information that could be construed as "earnings claim" or financial performance representation information in violation of the requirements specified in Item 19 of the UFOC Guidelines and/or 16 CFR § 436.1(b) (together, "**Financial Performance Representation(s)**"); and to the Knowledge of the Seller, no Financial Performance Representation, except for Financial Performance Representations that are included in the Seller's FDD, has been made since January 1, 2004, to any prospective franchisee by the Seller or an officer, director, salesperson, or representative of, the Seller.

(viii) Except as otherwise disclosed in Section 5.20(c)(viii) of the Disclosure Schedule, since January 1, 2004, neither the Company, the seller nor any of the Seller's Affiliates has offered or executed a Franchise Agreement or offered or sold the rights granted therein in any jurisdiction in which such offer and sale was not duly registered (if registration was required by a Registration Law) or exempt from registration at the time the offer was made and the sale occurred, except where such failure to register or obtain an exemption would not have a Material Adverse Effect, and the Seller and its Affiliates have otherwise complied with all applicable franchise offering circular and Franchise Agreement delivery requirements under applicable state and federal Laws (including, without limitation, the Registration Laws), obtained all required receipts with respect to delivery thereof and maintained books and records regarding franchise sales activities in compliance with applicable Law, except for such failures that would not, individually or in the aggregate, have a Material Adverse Effect. Since January 1, 2004, neither the Seller nor any of the Seller's Affiliates has otherwise engaged in the offer, sale, or execution of Franchise Agreements in violation of applicable Registration Laws, business opportunity Law, or unfair or deceptive trade practices Law or regulation or similar Law or regulation in the United States and in a foreign country, territory or jurisdiction, except for such violations that would not, individually or in the aggregate, have a Material Adverse Effect. Without limiting the generality of the preceding sentence, the Seller is, as of the date of this Agreement, current with respect to the filing of all required disclosure statements, amendments, reports, consents and other documents required under franchise related Laws, except with respect to disclosure of this Agreement and the Transactions contemplated by this Agreement.

(ix) There are no proceedings pending, or to the Knowledge of Seller, threatened, alleging failure to comply with the Registration Laws of any jurisdiction except as specifically disclosed in Section 5.20(c)(ix) of the Disclosure Schedule.

(d) Franchise Operations. Seller and the Company further represent and warrant that, except to the extent it would not have a Material Adverse Effect:

(i) Except as set forth in Section 5.20(d)(i) of the Disclosure Schedule, the purchase by Buyer of the [Assets] will not require a notice to any Franchisee or approval by any Franchisee under any Franchise Agreement;

(ii) No Franchise Agreement is subject to any right of rescission, set-off, counterclaim or defense, and neither the terms of the Franchise Agreement, nor the exercise of any rights thereunder, will render the Franchise Agreement unenforceable, in whole or in part, or give to the Franchisee any right of rescission, set-off, counterclaim or defense, and no such right of rescission, set-off, counterclaim or defense has been asserted by a franchisee with respect thereto;

(iii) The Company and its Affiliates have not assigned or pledged any Franchise Agreement or its or their rights thereunder, and have good and marketable title to such Franchise Agreements, and the Seller is the sole holder of each Franchise Agreement and the rights of the franchisor thereunder, free and clear of any Lien or Encumbrance of any kind or nature.

(iv) Except as set forth in Section 5.20(d)(iv) of the Disclosure Schedule, the Seller's franchise operation manuals do not impose any obligations or set forth any requirements that are inconsistent with any of the Franchise Agreements and/or UFOCs or FDDs that the Seller has previously used, and currently uses, to offer and sell franchises.

(v) With respect to all terminations, non-renewals, and transfers since January 1, 2004, the Seller has complied with all applicable franchise termination, unfair practices, and/or relationship laws, including but not limited to those laws' requirements with respect to the proper notice of default, time to cure, and the actual termination of any Franchisee or business opportunity operator ("Relationship Laws").

(vi) Except as set forth in Section 5.20(d)(vi) of the Disclosure Schedule or as disclosed in an applicable FDD in accordance with the UFOC Guidelines, the Seller and its Affiliates have not, since January 1, 2004, entered into any Contract, orally or in writing, whereby the Seller or an Affiliate receives rebates, commissions, discounts or other payments or remuneration of any kind (collectively, "Rebates") from suppliers selling products or services to Franchisees. Section 5.20(d)(vi) of the Disclosure Schedule identifies all Contracts under which the Seller or any Affiliate receives, or may receive, Rebates, whether or not such Contract or arrangement is disclosed in an FDD, and whether or not such Rebates are utilized by Seller or expended in connection with the operation of the Business System, such as for advertising and marketing purposes. There are no material agreements or special arrangements with any Franchisee that are prohibited by the particular Franchise Agreement or not disclosed in accordance with the UFOC Guidelines in the relevant FDD.

(vii) Any funds administered by the Seller on behalf of one or more Franchisees have been administered in accordance with all applicable Laws and the Franchise Agreements.

(viii) The Seller and its Affiliates have no currently effective oral or written contracts, or verbal understandings, with any formal or informal franchisee association or group of franchisees regarding any Franchise Agreement, Standard Form Franchise Agreement, franchise operational matter or franchise system matter.

(e) Litigation Against Franchisees. If any Franchisee asserts any claim, demand or matter which arose or was incurred prior to the Closing Date (exclusive of any litigation which arises out of or in connection with an indemnified liability), the expenses (including legal fees) incurred by the Buyer in connection therewith shall be the responsibility of the Seller, and if the Franchisee is entitled to damages, reimbursement of expenses or other sums pursuant to an order of a court or a negotiated settlement (collectively, "**Franchisee Damages**"), then the Seller shall be solely responsible for, and shall reimburse Buyer for, all such Franchisee Damages in the manner provided in Article XI, subject to the limitations of liability set forth in Article XI and subject to the provisions set forth in Article XI.