

MERGERS AND ACQUISITIONS INVOLVING FRANCHISE NETWORKS

PRE-ACQUISITION ANALYSIS AND DUE DILIGENCE OF A FRANCHISE COMPANY

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I. INTRODUCTION

A casual observer of the business landscape will recognize that corporate merger and acquisition activity has included a significant number of franchise companies during the past ten years. While the factors that drive mergers and acquisitions generally may be shared by franchise companies, it is important to recognize and understand the unique aspects of franchise company mergers -- from the motivations of the sellers and purchasers, to the nature of the assets to be acquired, to the operation of the acquired business after the transaction. This paper will focus on several issues that franchisors encounter when contemplating the acquisition of merger with, or sell to, another franchise company, including pre-acquisition evaluation and due diligence

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investigations of the target company. Other sections will discuss business considerations related to integrating new franchise networks into existing networks, and operating competing franchise networks.^{1/}

The structure of a franchise company merger or acquisition transaction is often shaped by the nature and size of the companies involved, the motivations of the purchasers and sellers to enter into the transaction, and the plans of the surviving entity (or acquiring entity) for the franchise systems or networks following the transaction. A franchisor may seek an acquisition target to increase market share in a core business and may do so by acquiring a competitor, or a franchisor may wish to increase utilization of core competencies, promote market efficiencies or improve economies of scale. An acquisition may be designed to add a new product or service line to the existing business, or to diversify the business as whole. A franchise company may decide to sell its franchise network as an exit strategy for the owners, to align itself with a larger company to derive the benefits of greater resources and support, or to shed an unprofitable business unit (or one that no longer meets expectations). The purchaser's plans for the acquired franchise system following the merger or acquisition may envision the franchise system as an independent franchise network with a brand identity separate from the franchise network(s) of the purchaser. Or, the purchaser may desire that the target

network be swallowed up and converted to the acquirer's brand, or may wish to have the target network exist as a product line extension for, or a co-branding or multi-branding opportunity with, the acquirer's brand. All of these factors and considerations will affect the pre-transaction evaluation of the business, the negotiations over the purchase contract, and the legal and business issues of post-acquisition operations and development.

II. EVALUATION AND INVESTIGATION OF A FRANCHISE COMPANY

In any merger or acquisition transaction, whether the target is a franchise company or not, the purchaser must focus on several threshold questions: (1) What assets will be acquired in the transaction? (2) What liabilities will be acquired? and (3) What will the surviving entity do with these assets after they are acquired? Whether the acquiring company is purchasing assets, or purchasing stock of another company, the purchaser must obtain detailed information regarding the assets acquired, and the liabilities associated with these assets and/or the liabilities of the company from whom the stock is being acquired.

A. PURPOSE OF DUE DILIGENCE

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,^{2/} many of the due

^{1/} There are a host of issues that arise in franchise company mergers and acquisitions, including tax issues, real estate considerations, and trademarks and other intellectual property matters, just to name a few. For additional discussion of these and related topics, see Mergers and Acquisitions of Franchise Companies, ABA Forum on Franchising, Leonard Vines, Editor, 1996 ("Mergers and Acquisitions"); "Problems of Mature Franchise Systems," David J. Kaufmann and Rochelle Buchsbaum Spandorf, 1998 ABA Annual Forum on Franchising; and "Purchasing a Competing a Franchise System," Kenneth S. Kaplan, Stephen Russo, and Gerald J. O'Neill, 1998 ABA Mid-Year Forum.

^{2/} 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;

diligence considerations will be the same if the transaction is an asset sale or stock sale. The due diligence efforts in either scenario will be designed to uncover not only liabilities, but also “defects” in the assets. In addition, the acquiring entity must also determine the financial and operational viability and health of the target franchise network. Due diligence should be designed to enable the prospective purchaser to review and analyze the seller’s operational, financial, marketing, and legal structures, the nature and value of the assets, the seller’s compliance with applicable laws, and the ability of the purchaser to operate the seller’s franchise network following closing, and/or the ability to merge the seller’s franchise network into the purchaser’s franchise network.^{3/} Companies and their counsel need to recognize the special attributes of franchise companies, and must tailor their due diligence to obtain the information most vital to the acquisition/purchase decision. For example, because many of the valuable assets held by a franchise company are contract rights (i.e., the franchise agreements) and intellectual property (i.e., the trademarks, confidential operating systems), the due diligence investigation of these assets differs from the evaluation of other types

of assets. Another reason that the acquisition of a franchise company poses unique challenges not always present in other acquisitions is that the franchise systems, and the assets that comprise the franchise system, are subject to a considerable amount of federal and state regulation. Failure by the target franchisor to comply with the laws may provide state and federal agencies, as well as private parties (i.e., franchisees), with rights to pursue significant remedies ^{4/} that could derail an acquisition or negatively impact the value of the assets to be acquired. Therefore, the determination of whether the target franchisor has complied with the law can become a valuable, but time-consuming, labor-intensive, and document-intensive, process. Further, if the target system is large, with many franchisees, the time necessary to complete the due diligence may be significant.

The purchaser should also utilize the due diligence investigation as a means to identify weaknesses in the assets that may require purchase price adjustments in the purchase agreement, or other agreement changes to protect the purchaser after closing, such as post-closing indemnifications. In some situations, due diligence may uncover defects or impediments that form a basis to abandon the proposed transaction prior to closing.

A due diligence investigation of the seller need not be limited to the purchaser. A seller should also undertake due diligence. Due diligence enables the seller to identify any “skeletons in the closet,” and possibly remedy problems

(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. Gerolmo’s Liquors, Ltd.; 563 F. Supp. 1623 (E.D. Wis. 1983), Buske 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).

^{3/} Due diligence will also involve investigations of the target company’s operations that are not franchise-specific, such as real estate holdings and liabilities, financing plans, human resources, tax issues, employee benefit plans, and similar issues.

^{4/} Violation of state franchise laws may give rise to claims for actual damages and/or injunctive relief, or in some cases, rescission. The state authorities may issue cease-and-desist orders, bring an action to enjoin unlawful conduct or enforce compliance with the laws, or impose civil penalties, penal fines, or jail sentences. Violations of the FTC Rule may result in civil penalties, injunctive relief, consumer redress, or cease-and-desist orders.

before discovered by the purchaser. Also, if the skeletons or other 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.

B. TIMING OF DUE DILIGENCE

Because due diligence creates a risk that the deal may never proceed to closing, or that the final structure (and price) may be radically different at the end of the process than at the beginning, there is a natural tendency to delay due diligence until the “business terms” are settled. From the purchaser’s perspective, however, the ideal time for due diligence is prior to the negotiations of any definitive purchase agreement. Due to the scope of a purchaser’s likely due diligence, the documents to be reviewed, and the individuals to be interviewed, many sellers prefer to delay the intrusive nature of the due diligence until there has been some preliminary understanding concerning significant deal points, and until a significant portion of the purchase agreement has been drafted. (In fact, sometimes due diligence does not occur until late in the negotiation process because the parties have not focused on either party’s due diligence needs until the representations and warranties have been drafted.) The timing of the due diligence may be subject to negotiation between the parties much like other aspects of the transaction.

C. THE DUE DILIGENCE CHECKLIST

When conducting due diligence, the purchaser and its counsel should start with a comprehensive due diligence checklist. One should be wary of simply utilizing a due

diligence checklist from another corporate transaction – this will, most likely, fail to include a review of many franchise assets and potential franchise-specific liabilities. Further, the use of a due diligence checklist from a previous franchise-related acquisition may not be sufficient to uncover and assess the assets and liabilities of the current target franchise network. Each due diligence effort, and the underlying due diligence checklist, should be tailored to the particular target system or network. For example, does the target franchise network utilize single unit franchise agreements, area development agreements, master franchise/subfranchisee agreements, or all three? Does the franchisor use selling agents, brokers, or other third parties to promote franchise sales? What is the nature of the advertising program, and does it include the use of a system-wide fund, and/or regional cooperatives? Does the franchisor provide goods and/or services to the franchise system, and are there product supply/distribution arrangements that are critical to the franchise system? The answer to these and other questions will shape the nature and scope of the due diligence investigation. Attached as Appendix A is a sample due diligence checklist that focuses primarily on the franchise-specific assets and issues of a target company.^{5/}

Due diligence can be productive if counsel requests, and receives access to, all relevant documents and information. It is, therefore, imperative that counsel knows what to ask for and what to review. We suggest that counsel for the purchaser develop an understanding of the franchise network before a due diligence checklist is prepared and forwarded to the seller. This knowledge can be obtained, at a preliminary level, by obtaining and reading the

^{5/} A comprehensive due diligence review of a target company as a whole will involve a review of corporate records, real estate, accounting, tax and financial matters, labor and employee matters, environmental issues, and other issues.

target franchise system's current UFOC and agreements, the financial statements, publicly available documents (such as SEC filings, if the target is a public company) and the other information concerning the franchisor's network. While much of this information may be provided by seller, the purchaser and/or its counsel may obtain this information from public sources, including the Internet. (The target franchisor's website and the websites of franchisees may be rich sources of information concerning the health and viability of the target system, and may serve as a basis for more detailed inquiries about the target system as part of due diligence process.) From this early analysis, an appropriate due diligence list may be developed.

D. PRELIMINARY ANALYSIS AND EVALUATION OF THE TARGET FRANCHISOR

While no two merger/acquisition transactions are alike, the purchaser, may engage in multiple-stage evaluations and investigations of the target company (which usually occur after the target has been identified from a larger group of potential merger/acquisition candidates or opportunities). These investigations will delve into franchise-specific aspects of the business, as well as other corporate, finance, and business/operations issues.

As discussed in detail below, the due diligence investigation will evaluate many aspects of a franchise company's present, and prior, operations. A significant portion of the due diligence inquiry will focus on issues related to the target company's compliance (or lack of compliance) with laws. In many situations, however, the first stage of due diligence -- even before a detailed due diligence checklist is prepared -- should be a preliminary evaluation into the principal assets of the franchise company; that is, the franchise agreements. Whether the transaction is the purchase of stock,

or an acquisition of assets, a crucial post-closing result of the transaction will be that the franchise agreements will be owned or controlled by a new entity. While it is sometimes impractical to evaluate all franchise agreements in a system as part of the overall due diligence, it is important for the prospective purchaser and its counsel to have a good "snapshot" of the system as early as possible.

1. THE FRANCHISE AGREEMENTS

When dealing with target 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 get a handle on the system, one of the early requests for documents should include: (a) a list of all franchised outlets (which should be available from the most current UFOC), 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 (this request can ignore, temporarily, any franchisee-specific negotiated changes to, or modification of, the franchise agreements); and (c) an indication of which, and how many, current franchisees (identified in (a)) are operating under each form of contract (identified in (b)). Counsel should then evaluate each form of contract to determine if there exist any initial obstacles to accomplishing the acquisition goals. If many forms exist, counsel's initial focus will be the version or versions of the franchise agreements which have been signed by the largest number of franchisees, to quickly assess whether the proposed acquisition will have major stumbling blocks.

2. THRESHOLD ISSUES

a. Transferability of the Franchise Agreements

One initial hurdle to clear is the determination of whether the franchise agreements of the target company, or ownership of the target franchisor, may be transferred to the purchaser. Many franchise agreements drafted in the last five to ten years 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. If the franchise agreements of the target company contain such a provision, the purchaser should feel fairly comfortable, at least during the early stage of the investigation, that a merger or acquisition is not prohibited by the agreements. It is important to note, however, 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^{6/} 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.”

Also, in New York, the Department of Law (the agency charged with regulating the offer and sale of franchises in New York) often requires as a condition of granting registration of a franchise offering the inclusion of language in the franchise offering circular that addresses the franchisor's right to transfer the franchise agreement. Specifically, if Item 17 of the 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, the target company'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 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

^{6/} Iowa Code, tit. XX, ch. 523H, § 5(6).

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.

b. Changes to the Target System Following the Transaction

A second threshold inquiry relates to the purchaser's plans for the target company's franchise network. In short, the purchaser must determine whether the franchise agreements allow the franchisor to carry out its post-acquisition plans. For example, if a goal of the acquiring company 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.^{7/}

^{7/} 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

c. Territorial and Exclusivity Issues

A third inquiry at the initial investigation 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 the purchaser's planned activity. Whether the purchaser's goal is to operate dual systems, or convert one chain to the name and system of the other, the purchaser must undertake a careful territorial evaluation. The purchaser should obtain from the target company a list of the locations of all franchised and company-owned outlets,^{8/} including all territories granted to the franchisees, or territories otherwise associated with each outlet. The purchaser should then create a similar map for its system, and overlay its own system map over the map of the target company. The result will be an initial identification of potential territorial conflicts. The nature of the conflicts, or the potential conflicts, will be shaped by the territorial protection granted to franchisees in each system, and under each form of contract.

The purchaser's right to operate and franchise the target system, or operate competing systems will depend, in large measure, on the franchise agreement terms.^{9/} If the franchise agreements of the target 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

franchisee and outside the scope contemplated actions, even if done under the guise of "system changes."

^{8/} The list should include any affiliate-owned outlets, and any outlets that operate under any of the marks of the target franchisor.

^{9/} See discussion of this issue in the paper by James Rubinger that is included with these presentation materials.

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. By reviewing the various forms of franchise agreements in existence (without reviewing all franchisee agreements), the purchaser and its counsel may obtain an overview of the two systems, and an understanding of how the agreements may permit, or frustrate, the purchaser's post-acquisition plans. Further, this knowledge, early in process, is valuable in structuring, negotiating and drafting the purchase agreement, particularly those provisions that address issues such as valuation of assets and indemnification.

d. Other Potential Problems or Limitations

An early review of the forms of agreements utilized by the target franchise network may reveal other potential post-acquisition problems. For example, the author is aware of several franchise systems (including one that was the target in an acquisition several years ago) in which the franchise agreements grant the franchisees an opportunity to "walk away" from the franchise system by providing advanced notice of termination.^{10/} If franchisees are not happy with the merger/acquisition, or with the purchaser following the transfer, the target franchisees, individually or collectively (system-wide, or market by market), could leave the system on relatively short notice. In this circumstance, the purchaser would be acquiring a system which, six months to one year later,

could be devoid of a significant number of franchisees (if many franchisees elect to terminate the agreement, and sell the outlets or re-brand the outlets under a different name, mark or system). 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 utilized by a franchisor may detect other potential future problems. For example, during the due diligence review of 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, the prospective purchaser discovered unique attributes of the franchise system that could have negative implications in the future. Unlike the franchisor's standard form of franchise agreement that had a twenty-year term, each of these non-traditional location agreements contained a three-year term, with no post-termination or post-expiration non-competition clause. Also, 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 discovery caused a reassessment of the value of the assets of the target 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 due diligence investigation may uncover the fragile nature of a franchise system.

e. Due Diligence -- Areas of Evaluation and Investigation

1) General Areas of Inquiry

^{10/} While such a provision (along with a liquidated damages clause) is quite common in the hotel/lodging industry, it is more atypical in other industries that engage in franchising, such as restaurants and other food service.

Assuming that the initial evaluation of the target company does not reveal insurmountable hurdles, the purchaser and its counsel (as well as the seller) should proceed with a thorough due diligence evaluation of the entire company and its assets.

Even though no two franchise systems are the same, and the acquisition transactions will vary from deal to deal, there are certain areas of investigation that are likely to be common to many due diligence investigations. These areas of investigation are (and will be described in greater detail below):

- Franchise law compliance
 - ❖ Pre-sale registration and disclosure compliance, franchise offers and sales, and contract execution
 - ❖ Compliance with franchise relationship laws
- Franchise agreements (and area development agreements, master franchise agreements, etc.) -- analysis of the principal contracts under which the system operates
- Current franchisees -- analysis of the health and character of the system by identifying positive and negative aspects of the current franchisees, developers, subfranchisors, etc.
- Financial health of the system, including analysis of royalty and advertising fee payment histories, financial defaults under agreements, and records regarding persistence payment delinquencies.
- Former (transferred, terminated) franchises
- Trademarks and intellectual property
- Advertising and marketing systems and programs
- System operations; manuals; and training

- Supply and distribution arrangements
- International franchise operations
 - ❖ Agreements
 - ❖ Disclosure
 - ❖ Trademarks and intellectual property
- Franchise-related litigation
 - 2) Specific Due Diligence Areas of Investigation
 - a) *Compliance with Franchise Laws*

One of the fundamental questions to answer when conducting a franchise company due diligence is whether one target company “complied with the law.” In light of the multilevel regulatory scheme under which franchisors operate, the “compliance with law” issue can be complex inquiry.

As lawyers and business people with only a passing familiarity with franchising and franchise law know, a franchise may not be legally offered or sold in this country without the franchisor providing a franchise disclosure document to a prospective franchisee^{11/}. (The franchise disclosure document is sometimes referred to as a franchise prospectus, or more often, a Uniform Franchise Offering Circular, or “UFOC”, if the document was written in accordance with the Uniform Franchise Offering Circular Guidelines. The UFOC Guidelines were promulgated by the North American Securities Administrators Association (“NASAA”) and adopted, by statute or rule, by the fourteen states that have pre-sale franchise

^{11/} The Federal Trade Commission’s Trade Regulation Rule on Franchising (the “FTC Rule”), 16 C.F.R. § 436 et seq.

investment laws^{12/} (the so-called “registration states”). 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. Compliance with the FTC Rule and state law requires an analysis of the following:

- Does the franchisor’s current UFOC comply with the applicable disclosure rules (principally the UFOC Guidelines), and did previous versions of the UFOC comply with these laws?
- Does the current UFOC, and previous versions of the UFOC, comply with each franchise registration state’s disclosure laws, including:
 - ❖ were appropriate changes were made to the documents to comply with the laws?
 - ❖ if amendments to the UFOC were required due to material changes, were such changes made in a timely fashion?
- Did the target franchisor register its franchise offering in all of the franchise registration states, or a 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 target franchisor’s franchise registrations lapse in any state, and if so, how long was the lapse period? As noted

^{12/} California; Hawaii; Illinois; Indiana; Maryland; Michigan; Minnesota; New York; North Dakota; Rhode Island; South Dakota; Virginia; Washington; and Wisconsin.

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?

To determine whether the target company has complied with the FTC Rule and the state franchise investment laws, the purchaser or counsel must review each offering circular used, and franchise sales made, during the five-year period prior to the proposed transaction,^{13/} and must assess whether complete and accurate disclosures were made. This evaluation should be made after reviewing documents that the franchisor relied upon when drafting or updating the UFOC, and/or discussing material changes with the target company’s personnel. To determine whether the franchisor maintained active franchise registrations, counsel should review all correspondence between the state agencies and the franchisor, and internal documents related to the registrations. The purchaser or counsel should create a chart (if not prepared or provided by the target company) which lists all registration states, the effective dates of registrations and any lapse periods, as well as charts for franchise salesmen and franchise advertising registrations.

In reviewing the target company’s compliance with franchise laws, counsel conducting the due diligence should not overlook the state business

^{13/} We suggest a five-year period for review of documents because many franchise laws have a statute of limitation period for violations of the law that is five years or less. For example, California, Michigan, Rhode Island and Virginia all have statute of limitations periods of four years to bring a civil action. In Illinois, Maryland, Minnesota, New York and Oregon, the statute of limitations for civil actions is three years. During the course of the diligence, the purchaser may request additional documentation, particularly if there are franchise sales activity in a state with a longer limitations period, or if there appears to be irregular, or possible illegal, action in such state.

opportunity laws.^{14/} 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, 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), counsel should determine whether the target company's franchises are 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).

b) Offers and Sales of Franchises

It is not enough for the purchaser to determine whether the target franchise system has a UFOC that complies with the UFOC Guidelines, or whether the target franchisor maintained effective franchise registrations. It is vitally important for the acquiring company (and the seller) to determine if the target franchise system complied with the applicable franchise laws with respect to the offers and the sales, of franchises,

^{14/} 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. For further discussion of business opportunities laws see "Franchising Distribution," Philip Zeidman, Bret Lowell & Barry Heller, 1998 Program sponsored by The George Washington University Law School; "Multilevel Marketing and Direct Selling," David A. Beyer and Joseph A. Mariano, 1997 ABA Annual Forum on Franchising; "Franchising: Regulations of Buying and Selling a Franchise," Section XVII on Business Opportunity Laws, Philip F. Zeidman, Perry C. Ausbrook, and H. Bret Lowell, Bureau of National Affairs, 1997;

"Business Opportunity Law Traps," Richard M. Asbill and Judith M. Bailey, 1992 International Franchise Association Legal Symposium Program.

including compliance with the FTC Rule's ten business day rule and five business day rule.^{15/} 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 UFOC delivered to the prospect?
- Which form or version of the UFOC was delivered to the prospect?
 - ❖ was the 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 sell was made or accepted?^{16/}
 - ❖ was the 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?

The documents that are critical to any franchise due diligence are the UFOC acknowledgments

^{15/} Under the FTC Rule, 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.

Also under the FTC Rule, the prospective franchisee is 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.

^{16/} 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.

of receipt. Franchisors instruct franchisees to execute and date the receipts and return them to the franchisor when the UFOCs are provided to the prospect. The receipt will be evidence of the fact that a UFOC has been delivered to a prospective franchisee, along with the date of delivery. By having executed and dated UFOC receipts, along with the answers to several of the questions above, the purchaser and its counsel should be able to determine whether the target franchisor has complied with the various federal and state franchise disclosure rules.

Further, if the 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 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.^{17/}

The need to obtain acknowledgments of receipt from prospective franchisees is well ingrained in the conscience of many franchisors and their executives and franchise salesman. Most franchisors are able to produce copies of most of the receipts. It is the rare case, however, when a franchisor can produce the correct receipt for each and every franchise sale. If the due diligence investigation reveals a significant number of franchise offers or sales without receipts, that lack of critical documentation may point to either isolated franchise law compliance

lapses, or systemic franchise law compliance problems.

As the size of the target system increases, the analysis required and the due diligence becomes more complex. In an effort to capture data on many franchise law compliance issues, it is often useful to prepare a chart or matrix to record the results of the investigation. The matrix may include state registrations by year, lapse periods, and the franchisee list, organized by state, along with cross-references and checklists for dates of acknowledgments of receipt, and dates that the franchise agreements were executed. As noted above, it is also important to determine that the appropriate offering circular was provided to prospective franchisees. For example, if the franchisor has different forms of offering circulars in different states, the offering circular provided to a franchisee in a particular state should match that which is registered in the state. Further, to the extent that a franchise system requires more than one person as a signatory on the franchise agreement (for example, a husband and wife; two or more partners; or two or more individuals who later form a corporation), it is important to determine that each individual received a franchise offering circular in compliance with the FTC Rule and applicable state law. Collection of this data is designed to answer the general question of whether the franchisor complied with applicable laws with respect to the offer and sale of franchises.

Unfortunately for both purchasers and sellers, a determination of the seller’s compliance with the franchise laws with respect to the sale of franchises cannot be determined solely from documentary evidence. If a franchisor’s franchise salesman or executive provided written material or made oral representations that were not consistent with the UFOC disclosures, or engaged in the offer of a franchise without providing the UFOC, those actions may be violations of law. In addition, these pre-sale

^{17/} For a discussion of a situation where a franchisor was liable for rescission of the franchise agreement for failing to re-disclose to a prospective franchisee “in the pipeline” with its recently amended UFOC, see Video Update, Inc. v. Guenther, et al., 741 F. Supp. 172 (D. Minn. 1990).

activities, particularly statements made outside of the UFOC could be grounds for future fraud claims. It is, therefore, necessary to review the franchisor's franchise sales practices and procedures, and discuss those procedures with various personnel of the target system franchisor.

c) *Franchisee Files*

As noted in Part II.D, above, the franchise agreements executed by existing franchisees will reveal a great deal of information about the target 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 should 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 should 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, 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 are a rich vein to mine during due diligence. However, counsel should recognize that all of the relevant documentation may not be filed in one location. Franchise companies may maintain separate franchisee files in the legal department, the operations department, the accounting department or comptroller's office, and the marketing department. Therefore, it is imperative that counsel direct the seller to circulate the due diligence checklist to all departments, and that

the purchaser has access to the heads of each department for interviews and discussions concerning the documentary evidence available.

d) *Former Franchisees*

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.^{18/} The 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 franchisees (which would require the furnishing of a UFOC to the prospective franchisee/transferee).^{19/}

^{18/} 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.

^{19/} 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.

The due diligence investigation 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 also uncover former franchisees who have threatened or initiated action against the franchisor or raised allegations of improper or illegal actions. Finally, many franchisors execute termination agreements (with terminating franchises), or assignment, assumption and consent agreements as part of a transfer. The franchise files for former franchisees should include such agreements. A review of these agreements will reveal whether the franchisor obtained releases of claims from the former franchisees in connection with the separation.

e) *System Operations and Marketing*

Another area of the due diligence inquiry is an evaluation of the target company's on-going operations. The franchisor should closely scrutinize systems/operations documents such as operating manuals and training manuals. Also, the entire advertising and marketing structure needs to be reviewed to determine compliance with law (e.g., substantive advertising regulations, unfair and deceptive trade practice laws and franchise advertising registration) and compliance with tax issues relating to the structure of marketing and advertising funds. Further, potential concerns raised by existing franchisees regarding the use of the funds (which has been and will continue to be a source of much friction between franchisors and franchisees) should be explored carefully.

f) *Supply and Distribution*

A review of the supply and distribution agreements between the target franchisor and its franchisees, and/or between the franchisor and its outside suppliers and vendors, and a review of all cooperative or joint purchasing arrangements, is critical to an understanding of the franchise system. These arrangements, 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, so the due diligence inquiry may require comprehensive interviews with the franchisor's personnel, along with the review of documents.

g) *International Considerations*

If the franchise system has significant international operations, the due diligence should have a significant international component. The information to be gathered with respect to international operations will be similar to the information on the domestic operations, including an analysis of all franchise

agreements and other agreements related to system expansion, such as master franchise agreements, national development agreements, and/or subfranchise agreements, as well as any unit franchise agreements. Also, to the extent franchises were offered in countries with specific pre-sale franchise disclosure obligations, the due diligence inquiry should investigate whether an appropriate disclosure document was prepared and provided to the prospective franchisee. While there is some debate within the franchise community and franchise bar regarding the applicability of the FTC Rule to sales of franchises for locations outside of the United States, a determination should be made as to whether a U.S. disclosure document was provided with respect to foreign transactions, and if not, the extent of the potential liability for such failure to provide disclosure. Finally, the due diligence investigation should evaluate the trademark and intellectual property registrations and applications in foreign countries, including technology transfer filings and similar documents.

h) Trademarks and Intellectual Property

As noted above, a central component of the target company's assets will be the intellectual property, and the necessary analysis of the target 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. It 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. Also, counsel 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.^{20/}

i) Other Areas

As noted above, a significant portion of the due diligence investigation is geared to respond to the question of whether the franchisor or seller has been "in compliance with law." The purchaser is interested in this question because it does not wish to obtain "tainted" assets, or assume unknown or hidden liabilities. The seller is interested because it will be required to provide a representation or warranty that it has been in compliance with law (or, more likely, a more tailored representation concerning its franchise law compliance). Other representations and warranties of the seller will require an assessment of other documents and assets of the Seller. Therefore, the areas of inquiry, including those noted in the due diligence checklist in Appendix A, can be quite expansive. For example, the due diligence may probe into compliance with the Americans with Disabilities Act, insurance coverages, and labor issues (to the extent it impacts on franchise operations). Each party must undertake a due diligence investigation this is appropriate for its own circumstances and goals.^{21/}

^{20/} For additional discussion, see Raman, W. and Jones, D. "Trademark Considerations in Franchise Transfer," in Mergers and Acquisitions.

^{21/} For additional issues, both with respect to general corporate due diligence checklists, and franchise-specific checklists,

III. UTILIZING DUE DILIGENCE RESULTS

During the course of due diligence, the purchaser (and seller) and their counsel should uncover a wealth of information concerning the target franchise network, and the assets and the liabilities of the Seller. This information will be useful for several purposes.

A. PURCHASE AGREEMENT

The results of the due diligence investigation will have an immediate impact on the negotiations regarding, and the terms of, the purchase agreement. The purchaser may wish to revise price terms, and the seller may wish to revise representations and warranties, and/or indemnification provisions. An interesting example of how due diligence was used to revise a purchase agreement can be found in Appendix B. The first part of Appendix B is an excerpt from the first draft of a purchase agreement, prepared by purchaser's counsel. The provision is a relatively simple representation concerning compliance with franchise laws. After both the purchaser and the seller, and their counsel, undertook due diligence of the company, the parties realized that the seller could not make the representations and warranties requested by the purchaser. The contract was eventually modified. The second part of Appendix B contains the negotiated franchise representations and warranties, which reflect a more comprehensive understanding of franchise law issues and the franchise-specific assets of the transactions, as well as the problems uncovered during due diligence.^{22/}

see Baer, J., "Due Diligence in the Acquisition of a Franchise Company," in *Mergers and Acquisitions*.

^{22/} Note that in addition to the provisions in Appendix B, several other representations and warranties were revised due to the results of the due diligence.

It is also important to recognize that there will be provisions scattered throughout a purchase agreement that will have implications on the franchise-specific aspects of the business. Each provision, therefore, should be reviewed, drafted, and negotiated through a franchise "lens." The parties and their counsel should recognize that the due diligence results could affect the entire mosaic of the purchase agreement. For example, if the due diligence investigation uncovers significant potential liabilities of the seller, or potential problems with the assets, adjustments can be made in the price, the representations and warranties, the "knowledge standard" applied to the representations and warranties, the "materiality" standard applied to breaches of the representations and warranties, the indemnifications provided by the seller, the amount of any funds that may be held-back from the purchase price to pay for any post-closing liabilities that may arise, and the duration of the hold-back period. In short, the due diligence should be viewed as a process where both sides work to develop a fair and comprehensive understanding of the assets and liabilities involved in the transaction.

B. OPINION LETTER

In many transactions, counsel for the seller may be required to opine that the seller has complied with applicable law, and/or opine as the nature of the assets being sold. Since it is the rare case that a franchisor has not violated any franchise law with respect to any sale, counsel will not be able to provide a clean opinion. The due diligence will allow counsel to be informed as to potential defects in the assets and the proposed transaction. After due diligence, counsel can (and should) tailor its opinion to reflect the results of the investigation.

C. DUE DILIGENCE REPORT

Prior to commencing due diligence, and possibly following due diligence, the party conducting the investigation may inquire whether it is necessary or desirable to prepare a written due diligence memorandum. Preparing a written record, and summarizing the results of a due diligence investigation, serves many functions. First, a due diligence memorandum provides the basis for negotiating the purchase agreement, and is written support for the opinion of counsel (if one is requested). Second, the memorandum will record for posterity (and for future disputes) the exact nature of the results of the investigation. In many cases, the sheer volume of information, and degree of minutiae, may be overwhelming for a purchaser and its executives. The due diligence memorandum can make order out of chaos. Third, the due diligence memorandum will provide a blueprint of issues (legal, financial, operational, franchisee-related) that may need to be addressed by the purchaser following closing of the transaction. In some cases, the due diligence memorandum is utilized by the purchaser to implement changes in policies, practices and/or systems promptly after assuming control of the target network.

D. NEGOTIATIONS WITH FRANCHISEES OF THE TARGET NETWORK

As noted above, the due diligence process may reveal potential obstacles to achieving the purchaser's post-closing goals. In particular, if due diligence reveals potential violations of the franchise laws that may give rise to claims by the target system franchisees for damages or rescission, the purchaser must exercise damage control prior to closing. If the purchaser wishes to ameliorate the risks of post-closing claims or lawsuits by the acquired system franchisees, the purchaser may, in conjunction with the target company, seek to obtain releases from the target company franchisees for pre-closing liabilities.

In most cases, the purchaser must provide the franchisees with some benefit in exchange for a release, such as a royalty reduction, financing for renovations, rights for new development, and/or other considerations. If the purchaser is not assured of acquiring compliant – if not happy – franchisees, the purchaser may be leery about proceeding with the transaction.

Territorial conflicts may force the purchaser to offer incentives to the franchisees of the acquired system to modify agreements in order to achieve the post-closing plan (particularly if that plan involves the conversion of outlets from one system to another, or operation of competing a system with outlets of one system in close proximity to outlets of another.) Several potential options include:

- A waiver of royalties for a limited period of time, or reducing the royalty fee payable by the franchisees over a longer period of time, possibly for the balance of the term.
- Like the adjustment in royalty fees, a franchisor/purchaser could offer a waiver of advertising fees, and similar marketing contributions, for a limited period of time, or a reduction in the amount of fees or contributions for a longer period of time.
- A promise by the acquiring company to provide additional or supplemental marketing programs, monies, or assistance to franchisees in territories in close proximity to or, impacted by, other franchisees of the competing system.
- An offer to the franchisees (or to those franchisees most affected by the encroachment) of an opportunity to acquire new units in new territories, at reduced fees and with attractive financing.
- If all else fails, or if territorial conflicts are irreconcilable, the acquiring franchisor should be prepared to purchase the existing

franchisees' businesses at a fair market value or a commercially reasonable price. Another alternative, is to simply let the affected franchisees "walk away" – that is, the franchisees could terminate their existing franchise agreements, execute mutual releases, and de-identify the units. A franchisee would continue to operate the business, at the same location, but under a different name or mark. This would, in many cases, require a waiver of the post-termination non-competition covenants.

If the due diligence indicates that accomplishing the purchaser's post-acquisition plans may not be achieved, absent the grant of significant concessions to the target system franchisees or the acquiror's franchisees, one or both parties may wish to reconsider the wisdom of proceeding with the transaction.

IV. CONCLUSION

The due diligence investigation of a franchise company that is the subject of a merger or acquisition transaction can be a complicated and time-consuming project. It is, however, a process that is absolutely vital to both the purchaser and seller, as they negotiate the business and legal terms in the purchase agreement, and as they plan for the post-closing operation of the merged or acquired franchise network. Thorough preparation for, and careful execution of, the due diligence process, particularly by counsel, will prove beneficial to all parties involved in the transaction.

XYZ, INC.

Due Diligence Review of Franchise Operations and Franchise Law Issues

EXECUTIVE SUMMARY

The following documents and files will be reviewed in connection with the proposed acquisition [of shares of] [of assets of] XYZ, Inc., and in preparation of an opinion regarding XYZ, Inc.'s compliance with the franchise laws:

1. Franchise agreements executed with existing and former franchisees (from 1994 to present).
2. Current franchisees, including a list of franchisees, the franchisee files, and relevant agreements and documents.
3. Other agreements (if any) with franchisees, such as development agreements, option agreements, area franchise agreements, master franchise agreements, etc.
4. Former (terminated or transferred) franchisees (from 1994 to present), and documentation concerning the termination or transfer of franchises.
5. UFOCs and state franchise registration materials.
6. Earnings claims and other sales/revenue projections or statements.
7. Advertising materials, manuals, and other system operations documents.
8. Supply and distribution agreements.
9. International franchise documents, if any.
10. Franchise financing documentation.
11. Trademarks and intellectual property.
12. Litigation-related information.

* * *

Attached is a more comprehensive list. Please contact _____ if you have any questions.

XYZ, INC.

Due Diligence Review of Franchise Documents

Please provide the documents and lists described below. Certain documents may be responsive to more than one request below. In order to avoid duplication of effort, please cross-reference previous or subsequent responses.

[Note to reader: the following list can be further segmented into individual document checklists, or can be condensed into broader categories. The former can be daunting to, and imposing on, the company that is the subject of the due diligence, but detailed checklists will make easier the task of indexing and reporting the results.]

I. **FRANCHISE DOCUMENTS AND FILES**

A. **Franchise Agreements -- List of Agreements Executed with Franchisees**

1. Chronological list (and copies, if not provided in response to I.B.2.a. below) of all executed franchise agreements (including standard franchise and non-traditional franchise agreements), identifying the outlet and whether:
 - a. in operation (with original owners);
 - b. executed, but not yet in operation;
 - c. transferred but still in operation with date of transfer;
 - d. terminated; or
 - e. reacquired
2. All forms of franchise agreements currently in effect (including any amendment made to standard forms of the documents), accompanied by a list for each such form, showing:
 - a. dates of use; and
 - b. the exact location (or identifying number) of each franchise outlet covered by each different form.

B. **Current Franchisees**

1. A list of all XYZ franchisees, in the U.S. and elsewhere, including all current franchisees under franchise agreements.
2. Franchisee files for each franchisee listed in #1 above, including:
 - a. franchise agreement, with all negotiated changes and amendments

- b. any state-specific addenda to the franchise agreement
 - c. signed acknowledgment of receipt from UFOC
 - d. lease or sublease of the premises (if applicable)
 - e. financial and tax records, and other data and reports (indicating financial status of the outlet and the franchisee entity)
 - f. loans or other collateral agreements (with XYZ, an affiliate, or a third party)
 - g. notes of discussions with prospective franchisees who later signed a franchise agreement
 - h. periodic reports submitted by franchisees, or created by XYZ, concerning the franchisee's operations
 - i. correspondence or other documents indicating potential or actual problems or lawsuits
- 3. A schedule of, and copies of, all correspondence and materials related to franchisees in default under franchise agreements, leases, loans or other contracts with XYZ or its affiliates, and a description of such default.
 - 4. A descriptive list of all persons who are in process as prospective franchisees (including applicable geographic area).

C. Development Agreements, Option Agreements, and Other Agreements

- 1. A chronological list of development agreements, option agreements, area franchise agreements, subfranchise agreements, master franchise agreements, joint venture agreements, license agreements, and other agreements (collectively, "Other Agreements") offered, used, or currently in effect, and including any amendment made to a standard form, showing:
 - a. whether still in effect or terminated; and
 - b. if in effect;
 - (1) the territory(ies) covered by the agreement
 - (2) the number of outlets subject to the agreement
 - (3) the number of outlets developed versus the number to be developed
 - (4) whether the developer is meeting its development schedule
 - (5) the date of expiration

2. Area franchisee/Developer/Optionee files for each area franchisee, developer, or optionee, etc. (if not provided above).
3. List of, and copy of, any other area agreements, or any other contracts (not previously disclosed) which may bear on any rights to be granted.

[Note to reader: if the preliminary review of the system reveals special contracts or situations, it is appropriate to investigate these other areas. For example:]

- a. [agreements with ABC, Inc. for reciprocal franchise rights for co-branding operations]
- b. [reacquisition of area franchisees]
- c. [other brand license or franchise agreements]

D. Former (Terminated, Transferred) Franchisees*

1. Information for franchisees of XYZ whose franchise agreements were transferred and/or terminated:
 - a. List of, and copies of, all correspondence and materials related to terminated franchisees, including allegations of contract breaches or violations of law.
 - b. List of, and copies of, all correspondence and materials related to transferred franchisees.
 - c. Franchise files (unless provided above) from:
 - (1) terminated franchisees, and
 - (2) franchisees who transferred their franchise; including
 - (a) copies of the acknowledgment by franchisees of receipt of offering circulars,
 - (b) executed agreements (e.g., assignment and assumption agreements; termination and transfer agreements); releases (if executed); and related documentation.
2. Former franchisees of XYZ who have threatened or initiated action against XYZ, or raised allegations of improper or illegal actions.

II. UFOCs AND FRANCHISE REGISTRATIONS (INCLUDING ADVERTISING AND SALESMAN REGISTRATIONS)

* From January 1, 1994 until the present. *[Note to reader: the due diligence checklist should consider statute of limitations issues when determining which files to review.]*

A. Unit Franchises

1. Schedule by state, of all state franchise and business opportunity registrations and exemptions for single-outlet, or unit franchises, including effective dates, expiration dates and lapse periods.*
2. Copies of all correspondence with state and federal (if any) franchise and/or business opportunity law administrators.*
3. All offering circulars, including exhibits and state addenda, if any, used, marked to indicate:
 - a. dates of use; and
 - b. jurisdictions in which used.
4. Copies of franchise sales advertisements, brochures, etc. used by XYZ and applications filed with state franchise law administrators for approval of such materials, if any.
5. List of franchise salesmen and franchise brokers employed or hired by XYZ, and copies of state salesmen registration forms, if any.
6. List of all franchise salesmen and franchise brokers who had been hired or retained by XYZ and who are not currently employed by XYZ.

B. Master Franchise/Subfranchisees/Other Agreements (“Other Agreements”) (If XYZ has offered other forms of agreements in UFOCs that are separate from the UFOC that includes the unit franchise agreement)

1. Schedule by state, of all state franchise and business opportunity registrations and exemptions for other agreements, including effective dates, expiration dates and lapse periods.
2. Copies of all correspondence with state and federal (if any) franchise and/or business opportunity law administrators.
3. All offering circulars, including exhibits and state addenda, if any, used, marked to indicate:
 - a. dates of use; and
 - b. jurisdictions in which used.

* From January 1, 1994 until the present.

4. Copies of franchise sales advertisements, brochures, etc. used by XYZ and applications filed with state franchise law administrators for approval of such materials, if any.
5. List of franchise salesmen and franchise brokers employed or hired by XYZ, and copies of state salesmen registration forms, if any.
6. List of all franchise salesmen and franchise brokers who had been hired or retained by XYZ and who are not currently employed by XYZ.

III. FRANCHISE EARNINGS CLAIMS OR SALES/FINANCIAL PROJECTIONS

- A. Instructions to franchise sales staff or franchise broker(s) regarding the making of representations regarding financial performance.
- B. Copies or descriptions of all earnings claims, or other earnings, revenue, profit, or financial statements or projections made or provided to prospective franchisees (in the UFOC or not in the UFOC).

IV. SYSTEM OPERATIONS (MANUALS, ADVERTISING, ETC.)

- A. Operating manuals currently in use for the XYZ system.
- B. Previous versions of operating manuals.
- C. A description of all training programs provided to franchisees in the last three years, including copies of all written materials provided to franchisees, and instructions from XYZ to the training staff.
- D. Governing documents of, and the correspondence files related to, meetings or correspondence with, the XYZ Franchisee Association.
- E. Copies of all franchise advertisements and brochures.
- F. Any agreements with the marketing committee related to the advertising fund.
- G. Organizational documents of, meeting minutes of, and correspondence with, the advertising fund [and/or the entity that administers the fund].
- H. Both internal reports, and any reports given to franchisees, with respect to the collection and expenditure of marketing and advertising contributions.
- I. An account of advertising deposits currently held, and any correspondence with franchisees relating to advertising deposits.
- J. Copies of all organizational and governing documents of any advertising cooperatives.

V. SUPPLY AND DISTRIBUTION

- A. Agreement(s), if any, between XYZ and its affiliates related to supply and/or distribution of products or services.
- B. All supply and distribution agreements between XYZ and any suppliers, distributors or agents, by which XYZ receives monies or rebates from the supplier.
- C. All supply and distribution agreements between XYZ and its franchisees.
- D. All vendor lists.
- E. Copies of plans or studies regarding the possibility of XYZ becoming a supplier of products, equipment or goods to the franchise system.
- F. Documents concerning approval or disapproval of suppliers, including all correspondence on the subject.

VI. INTERNATIONAL

- A. Agreements: Copies of all agreements and other documents relating to system expansion in foreign countries, including:
 - 1. any Master or National Development Agreements.
 - 2. any Franchise Agreements.
- B. Disclosure Documents: Franchise disclosure documents used with respect to the offer and sale of franchises in foreign countries.
- C. Intellectual Property: Any trademark, service mark, or copyright registrations or applications in foreign countries.

VII. REAL ESTATE, OTHER ASSETS, FINANCING

- A. List of outlets (franchised), indicating whether XYZ is the lessor, prime lessee or lease guarantor, and copies of leases, subleases, or guarantees to which XYZ is a party.
- B. All loans, notes, guarantees, lease guarantees, installment contracts, equipment leases, equipment purchase agreements, or other financing arrangements in which XYZ or one of its affiliates is a party to the agreement or receives monetary or non-monetary compensation for such financing (whether or not such arrangement is disclosed in the UFOC).

VIII. INTELLECTUAL PROPERTY

- A. A schedule of all trademarks, service marks, trademark registrations, trade names, brands, copyrights, patents, trade dress, Internet domain names and web pages, recipes and all other intellectual property rights whatsoever owned, franchised or used by XYZ, and/or any affiliate, or any related entity, in the U.S. and elsewhere, including registration numbers and expiration dates. The response to this request should include:

1. Trademark, service mark, copyright, and patent applications and registration certificates.
 2. Trademark, service mark, copyright, and patent application and registration prosecution files.
 3. Search reports and opinions for all copyrights, patents, marks, brands, trade dress, and names used in the System.
 4. Documents concerning or relating to infringements, conflicts or objections to use of the various copyrights, patents, marks, brands, trade dress, and names associated with the system, whether the objections were made by, or received by XYZ and/or any affiliate.
 5. All agreements concerning or relating to the various copyrights, patents, marks, brands, trade dress, and names associated with the system, including, without limitation, license agreements, work for hire agreements, settlement agreements, assignments, security agreements, coexistence agreements, and concurrent use agreements.
 6. Evidence of registration of all trademarks, service marks, trade names, brands, trade dress, copyrights and patents owned, licensed or used by XYZ at the state and federal level in the U.S., and internationally.
 7. Documents relating to unauthorized third party uses of the trademarks, service marks, trade names, trade dress, brands, copyrights and patents owned, licensed or used by XYZ and/or any affiliate.
 8. Questions about ownership and the right to use computer software, advertising or [recipes] *[if applicable]*.
 9. Any agreements with third parties concerning the marks; particularly co-branding agreements.
- B. A schedule of all disputes, infringements or other actions regarding any trademarks, service marks, trademark registrations, trade names, brands, copyrights, patents, trade dress, Internet domain names and web pages, recipes and all other intellectual property rights owned, licensed or used by XYZ and/or any affiliate in the U.S. and elsewhere.
- C. [A schedule of, and copies of, all recipes and formulae related to preparing proprietary products and other food and bakery items that are offered, or were offered, at any restaurant or other food service operation in the system. Include, as well, a schedule of any secret and proprietary plans developed by XYZ and/or any affiliate for the preparation of food items in, or operation of, an XYZ restaurant.] *[Note to reader: modify this request, as necessary, for the franchise system being investigated.]*
- D. A schedule of, and copies of, all architectural plans and/or designs, specifications and models, for any and [all restaurants, kiosks, food service businesses.] *[Note to reader: modify this*

request according to the system] or other operations under the XYZ marks, including renderings and drawings of all buildings, and interior and exterior layouts and designs.

- E. A copy of all intercompany, or affiliate agreements related to for use of any of the XYZ marks.

IX. LITIGATION

- A. Information related to any pending, threatened, or alleged action or other claims against XYZ involving operation of its franchise program, or its operation under the franchise laws.
- B. All information used to support and prepare the Item 3 disclosure in all UFOCs referred to in II. above.
- C. Responses to auditors' inquiries regarding actual or pending litigation or disputes.

X. OTHER

- A. Copies of all laws and regulations specific to the industry in which XYZ operates.
- B. Copies of all press releases issued in the last three years.

Revisions to Representations and Warranties
(an example of changes as a result of due diligence)

A. Representation and Warranty of Seller – Drafts Prior to Due Diligence

3.28 Compliance with Franchise Laws. The Company has complied with all applicable franchise laws in the jurisdictions in which it operates. Except as set forth on Schedule 3.28 hereto, since January 1, 1995, there has been no dispute between any franchisee and the Company, the Company has not received notice from any franchisee setting forth any grounds for dispute, and, to the knowledge of the Company, there is no reasonable basis for any such dispute.

* * *

B. Revised Representation or Warranty of Seller – Drafted After Due Diligence

3.28 Franchise Matters.

(a) The Company has previously delivered, or made available, to Purchaser true and correct copies of the current or most recent Uniform Franchise Offering Circulars (the “Circulars”) of the Company used in the offer and sale by the Company of franchise area development rights and franchises, which are required to be delivered by the Company to first-time franchise area developers and franchisees pursuant to the Rules and Regulations of the Federal Trade Commission (the “Rules”) or state law. Each Circular complies in all material respects with the requirements of the Rules and does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made therein, in light of the circumstances in which they were made, not misleading. The Company has previously delivered to Purchaser true and correct copies of all the current or most recent applications containing Circulars required to be filed with the appropriate state authorities for those states where such filings are required and in which franchise area development rights or franchise rights have been offered for sale by the Company within the last year. Except as set forth on Schedule 3.28, each application has been declared effective in all jurisdictions where the Company is required to file such applications, and there are not any stop orders or other proceedings in effect or, to the knowledge of the Shareholders of the Company, threatened which would prohibit or impede the ability of the Company to sell franchise area development rights or franchises in such jurisdictions. Except as set forth on Schedule 3.28, the Company has sold or solicited the sale of franchises and franchise area development rights only in compliance with all applicable laws governing such activity, except where the failure to comply would not have a material adverse effect on the business as currently conducted, the assets, condition (financial or otherwise), or the results of operations of the Company taken as a whole. Except as set forth on Schedule 3.28, there are no actions or proceedings pending or, to the knowledge of the Company, threatened which allege failure to comply with the laws of any jurisdiction relating to the solicitation and sale of franchise area development rights or franchises by the Company.

(b) The Company has delivered or made available to the Purchaser all franchise area development agreements and franchise agreements now in effect, and the Company is not in violation in any material respect of any franchise area development agreement or franchise agreement to which it is a party or by which it is bound, except as would not reasonably be expected to have a material adverse effect on the Company taken as a whole.

(c) Except as set forth in Schedule 3.28, to the knowledge of the Shareholders of the Company, no area developer or franchisee is in violation of any term of any franchise area development agreement or franchise agreement between the franchise area developer or franchisee and the Company, except for any violation that would not reasonably be expected to have a material adverse effect on the Company taken as a whole.

(d) Except as set forth on Schedule 3.28, the Company is in compliance with and has complied at all times with all applicable laws regulating the relationship of the Company with its franchise area developers and franchisees, except as would not reasonably be expected to have a material adverse effect on the Company taken as a whole.

[Note to reader: Schedule 3.28 contained descriptions of the various defects or problems]

3.29 Compliance With Franchise Laws. Except as set forth on Schedule 3.29, the Company has complied with all applicable franchise laws in the jurisdictions in which it operates, except for any non-compliance that would not reasonably be expected to have a material adverse effect on the Company taken as a whole. Except as set forth on Schedule 3.29 hereto, since January 1, 1995, there has been no dispute between any franchisee and the Company, the Company has received no written or, to the knowledge of the Company, oral notice from any franchisee setting forth any grounds for dispute, and, to the knowledge of the Company, there is no reasonable basis for any such dispute.

[Note to reader: Schedule 3.29 contained descriptions of actual and potential violations of law, and disputes with franchisees]