A Road Map to Due Diligence in the Acquisition of Franchise Companies

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The last several years have witnessed a tremendous upswing in the buying and selling of franchise companies. Much of this activity has been spearheaded by private equity investment in the franchise industry.

Because of the unique regulatory environment in which franchise companies operate and the peculiar nature of the franchise relationship, even sophisticated businesspeople considering the acquisition of franchise companies are often ill-equipped to gauge risk or measure the value of their targets. This article provides a road map to the due diligence that is appropriate in connection with the anticipated acquisition of franchise companies. It will also provide guidance on negotiating a purchase agreement that will offer the buyer the protection necessary to minimize the inherent risks involved in acquiring a franchise company. In particular, this article will consider matters to be negotiated in the letter of intent, the purposes of due diligence, construction of a due diligence checklist, considerations in evaluating franchise agreements and disclosure documents, methods of assessing litigation risks, and strategies for negotiating definitive documents. Relevant questions addressed by this article include the following:

- What due diligence should be undertaken with respect to a franchisor targeted for acquisition?
- How is the risk associated with pending litigation evaluated?
- How are unasserted claims identified and then evaluated?
- What representations and warranties are fair and reasonable, and what seemingly unfair and unreasonable representations and warranties should a buyer nevertheless demand?
- What are the essential elements of an effective and meaningful indemnification provision, how might it be negotiated and secured, and what other provisions might be considered to protect the buyer's investment?
- How are the answers to these questions affected if existing management remains in place?

UNIQUE NATURE OF FRANCHISE ACQUISITIONS

Two characteristics of franchise companies present unique challenges. The first is the nature of the assets being acquired. Unlike many businesses, franchise companies typically own virtually no tangible assets. Their primary assets consist of contract rights, intellectual property such as trademark registrations, copyrights, and trade secrets, and consumer goodwill, all of which can be difficult to value. Conversely, identifying franchisor liabilities can be a challenge. Because of laws that regulate franchise sales and relationships, a review of the target company's balance sheet may not disclose contingent liabilities, such as those arising from failure to comply with franchise laws. Although the existence of contingent liabilities may not be unique to the franchise industry, it is often more difficult to assess a franchise company's liabilities because of the number of federal and state laws that apply to the offer and sale of franchises as well as to the franchise relationship.

Second, a significant part of the value acquired (and the risk assumed) with a franchise company lies in the relationship between the franchisor and its franchisees. Unlike the acquisition of a manufacturing company, which entails the purchase of equipment, inventory, and facilities, the acquisition of a franchise company principally entails the purchase of long-term contractual relationships. The value of those contract rights is largely defined by the quality of the relationship between the franchisor and its franchisees. Simply put, there is a material difference between the net present value of the anticipated royalty stream generated by a profitable, committed franchisee and the net liability of the remaining term of a disgruntled and litigious franchisee. The proper valuation of the target company will depend in large measure on the accuracy of the assessment of the quality of these relationships and unit-level economics in a due diligence environment where sellers infrequently permit access to franchisees for the purpose of gauging the temperature of the franchisees. Further, sellers often do not have accurate unit-level profitability or other economic data, which could have a significant impact on the satisfaction of franchisees in the system.

NEGOTIATING THE LETTER OF INTENT

There are three important considerations that buyers of franchise companies should consider in negotiating letters of intent. The first consideration is whether the letter of intent will be binding. Applicable disclosure laws and regulations may require the immediate amendment of franchise disclosure documents in the event that a franchisor enters into a binding letter of intent to sell the franchise system. Whether an amendment is required will depend on the structure of the transaction, the current disclosures, and other factors.[1] If confidentiality of the transaction is a concern, the parties may prefer a nonbinding letter of intent.

Second, it is important to commit the seller to the scope of anticipated due diligence in the letter of intent. The buyer will want the franchisor to afford access to, among other things, key employees with direct operational and financial interaction with franchisees; unit-level economic information, to the extent available; franchise agreements and other related documents; and franchisee correspondence files. The franchisor's clear

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commitment to provide required categories of materials and to afford access to specific sources of information will prevent later due diligence disputes that might jeopardize the deal.

Third, the buyer should obtain from the seller a commitment to a period of exclusive dealing. Due diligence associated with an acquisition can be protracted and costly, and it typically involves engaging and coordinating the efforts of experts, consultants, and legal counsel. The time and effort investment in due diligence may be squandered if the seller is free to shop the deal for competitive bids.

WHY DUE DILIGENCE?

No buyer should consummate an acquisition without proper due diligence. It is only through proper due diligence that a buyer can balance the benefits and risks of the proposed transaction and evaluate the price it should pay in light of them. Although the parties will negotiate price (or a formula for determining price) and include it in the letter of intent, any material variance between the assumptions underlying price and the realities revealed through due diligence will typically warrant renegotiation or price concessions.

Due diligence also enables the buyer to determine the representations and warranties it will require to close. In addition to the typical representations and warranties given by the seller (e.g., payment of taxes, accuracy of financial statements, condition of assets), the buyer will want the seller to make certain franchise-specific representations and warranties. For example, if the franchisor administers a marketing fund, it is imperative for the seller to warrant that it has properly managed the fund. If the franchisor's disclosure document states that the franchisor does not receive rebates from suppliers, the seller should warrant that it has, in fact, received no rebate.

Finally, an especially important part of franchise due diligence is the assessment of litigation risk and proper disclosure of litigation in the franchise disclosure document. With respect to known and pending litigation (much of which is required to be disclosed in a franchisor's disclosure documents), due diligence will enable the buyer to make a qualitative assessment of the risk associated with that litigation. More importantly, proper due diligence may uncover the likelihood of future litigation and allow the buyer to evaluate the risk or potential liabilities associated with it by enabling the buyer to understand the culture, or "take the temperature" of, the franchise system. Only when all of the risks associated with the proposed transaction are identified and evaluated can the buyer determine what measures or adjustments are needed, whether in the purchase price or in the representations and warranties and associated indemnification provisions of the acquisition agreement.

DUE DILIGENCE CHECKLIST

✓ Time Frame

The due diligence plan consists of a checklist of areas of inquiry over a predetermined period of time. The age of the system being acquired and the applicable statutes or periods of limitation will drive the time frame of due diligence. The statute of limitations applicable to enforcement actions brought for violations of the Federal Trade Commission Disclosure Requirements and Prohibitions Concerning Franchise and Business Opportunities (FTC Rule) is five years.[2] Periods of limitations applicable to enforcement or private actions under state franchise laws range up to ten years.[3] Statutes of limitations under other state and federal laws should be considered in determining the time period for due diligence.

✓ Registrations

Fourteen states require franchisors to either register or file notice before franchise opportunities may be offered or sold in those states.[4] A buyer should review all applicable orders and filings made by the seller to ensure that the seller has met all state registration or notice requirements and that there has been no lapse in registration. Any offer or sale made during a registration lapse period could constitute a violation of the state franchise law.

In addition to these state registration and disclosure laws, many states' business opportunity laws also require either registration or notice of exemption filings.[5] Although the scope of these state laws vary considerably, they generally exempt franchisors whose franchise opportunity includes a federally registered trademark and complies with the FTC Rule. Certain state business opportunity laws require that franchisors file for such exemption. Therefore, proper due diligence will verify that the seller has complied with state business opportunity laws.

✓ Disclosure and Evidence of Compliance

The FTC Rule requires that franchisors provide a prospective franchisee with a franchise disclosure document at least fourteen calendar days prior to the earlier of the franchisee's execution of a franchise agreement or payment of any monetary consideration.[6] State franchise laws impose similar disclosure requirements. In due diligence, a buyer must determine not only that the seller has complied with federal and state disclosure requirements, having both provided the requisite disclosure document and done so timely, but also that the seller can prove compliance. The potential availability of rescission in the event of noncompliance mandates that, where feasible, the buyer examine each and every franchise file to confirm that the seller has complied with applicable laws and can verify its compliance.

With larger franchise systems, it may become cost-prohibitive to examine every franchise file to determine compliance. In those cases, it is important to identify the procedure the franchisor followed to ensure disclosure compliance and to sample the files to determine the extent of adherence to that procedure. It is also helpful to identify a representative of the franchisor familiar with applicable registration and disclosure requirements who can confirm the franchisor's practices.

✓ Operations Manuals

Virtually all franchisors provide their franchisees with operations manuals. Most franchise agreements incorporate those manuals by reference and require franchisee adherence to the standards and specifications set forth in the manuals in the operation of their franchised businesses.

It is incumbent on a buyer as part of due diligence to examine the seller's manuals to understand the contractual obligations of the system's franchisees. Poorly drafted or out-of-date operations manuals can give rise to serious risks with respect to important operational and financial aspects of the system (such as methods of operations, payment terms, sourcing issues, and the like) and create a material risk of litigation. When the seller operates company-owned units and uses the same operations manual for franchised units, there may be a significant increase in exposure created by certain mandatory terms intended only for company-owned units. For example, although franchisors should provide operational directives in manuals used by managers of company-owned units, those same mandatory terms, prescribing not merely the objective to be attained but also the methods required for getting there, may support the imposition of a franchisor's duty of care arising out of a franchisee's use of or failure to adhere to those methods.

✓ Advertising Funds

Advertising funds administered or managed by franchisors are frequent sources of disputes, mistrust, and even litigation. A buyer should determine the true nature of any franchisor-administered fund and not rely solely on the fund's name, title, or characterization to ensure that the fund is not a trust that would impose heightened or even fiduciary responsibilities on the administrator. The buyer should conduct an accounting to confirm that the franchisor or administrator has properly managed the fund and should identify and understand any rules, policies, or contractual commitments relating to the fund. The buyer should review historical expenditures to identify past practices at variance with, or in addition to, such provisions that might give rise to franchisee expectations respecting future expenditures or otherwise limit the use of fund proceeds going forward. The buyer should also review disclosures provided in the franchise disclosure document relating to historical marketing fund expenditures to ensure that such expenditures have been properly disclosed.

✓ Vendor Rebates

The FTC Rule and state laws require that a franchisor disclose the existence of any right of the franchisor to receive rebates or other consideration from vendors and suppliers from whom franchisees buy products or services. To ensure compliance with these requirements, the buyer should examine the disclosures made by the franchisor and review supplier contracts and financial statements to determine that the franchisor has properly disclosed any rebates or other consideration received. It is important that this analysis not be overly simplistic. The buyer should not overlook consideration received from a supplier simply because the franchisor has not denominated it as a rebate. Instead, a buyer should identify all consideration and other "benefits" that the franchisor and its management or employees have received from suppliers. The buyer can then confirm that the seller has complied with all disclosure requirements.

A related topic is the reservation of rights relating to use of supplier rebates in the franchisor's forms of franchise agreements. In recent years, franchisors have been careful to incorporate expansive rights with respect to the receipt and use of rebate funds into their franchise agreements. The buyer should examine all forms of franchise agreements still in effect in the system to identify and understand any limitations on the use of this increasingly important source of revenue.

✓ Accounts Receivable

The examination of a franchisor's accounts receivable list and amounts due from franchisees will not only show the franchisor's practice of collecting amounts due and owing by franchisees in a timely fashion, it will also provide a heads-up of potential disputes or litigation. Lax collection practices, often under the guise of "helping out" a struggling franchisee, can increase the likelihood of a dispute or litigation; and the larger the debt, the more incentive the franchisee will have to resist its collection. If the franchisee's debt reaches a level that the franchisee perceives to be insurmountable, the franchisee may see bankruptcy as a more attractive alternative. When a franchisor eventually attempts to recover the debt, the franchisee may counter with claims of franchisor malfeasance, waiver, breach, misrepresentation, or fraud. In short, a widespread practice of forbearance in collections should be a warning sign to buyers.[7]

✓ Expiration and Renewal

Because the principal value of a franchise system is the future revenue stream that will be generated by the contractual relationship between the franchisor and franchisees over the life of each franchise agreement, the buyer must identify the remaining term of each agreement (and any extension, renewal, or other agreement affecting that term). Beyond identifying the expiration date of each agreement, the buyer should determine whether a significant number of agreements will be up for renewal at or around the same time. In such cases, those franchisees who are negotiating renewal terms will wield far more power than a single franchisee acting alone.[8]

✓ Default and Termination

State relationship laws—those state laws that impose standards of conduct on franchisors in dealing with their franchisees—often impose substantive and procedural limitations on the franchisor's right to terminate a franchise agreement.[9] These laws will supersede less restrictive or more permissive contract terms. In reviewing franchise files during due diligence, the buyer should confirm that the franchisor has complied both with its own contracts and with any applicable state relationship laws in carrying out the termination. There are three components the buyer should examine. First, were the grounds for default or termination proper under both the franchise agreement and any applicable state law? Second, did the franchisor allow any period to cure required by the franchise agreement or state law to correct or remedy the asserted breach or default? Third, did the franchisor comply with the method for providing notice of default or termination specified in the franchise agreement? A franchisor's failure to comply in any respect with its own franchise agreement or with applicable state law will give rise to a claim for wrongful termination and a potential liability.[10]

✓ Trademark Registrations

Imagine buying a developed franchise system only to learn that the seller did not own the federal registration to the mark licensed to franchisees or that the registration had expired. Because the mark or brand is what attracts customers to a system's franchised outlets, and in turn what attracts and keeps franchisees, the buyer must determine the status of the system's marks. The buyer should conduct a trademark search to confirm that each mark is registered with the United States Patent and Trademark Office and to determine the status of each registration. The buyer should also conduct a trademark search to identify any infringing uses of the mark or, more importantly, any prior users that may have rights superior to the franchisor in a particular geographic area. Finally, the buyer should make sure that the franchisor in fact owns the registrations. Many franchisors establish affiliates to hold trademark registrations and other intellectual property and then license the use of those marks to themselves or directly to franchisees. Where this is the case, the buyer should structure the transaction to ensure that ownership of the registrations is conveyed at closing.

✓ Leases

Many franchisors seek to control the locations at which their franchisees operate, either by entering into prime or head leases and subletting to their franchisees or by requiring that certain lease terms be included in the franchisee's lease. The former approach enables the franchisor to maintain control over the location in the event of the franchisee's abandonment or termination and helps provide a smoother transition to a new franchisee or operator. But that control comes at a cost. When the franchisee abandons the franchise or is terminated, the franchisor must assume responsibility for payment of rent and other obligations under the prime lease, regardless of whether it continues operations at the site. In performing due diligence, a buyer must identify all leases to which the franchisor is a party; evaluate the terms of those leases to understand the nature and extent of its potential liability under each lease; determine the remaining term of the leases (and subleases), including the availability of any renewal rights and the probability of renewal; and evaluate the strength of the franchisor's relationship with its sublessees/subfranchisees and the corresponding likelihood that the sublease will be breached.

Although a franchisor that is not a party to the lease will not achieve the same degree of control over locations, it can still retain significant leverage by requiring the franchisee to include in the lease certain terms designed to protect the franchisor. These typically include a right to notice of any underlying default and an opportunity to cure that default; restrictions on transfer or assignment by the franchisee; use restrictions limiting the franchisee to the operation of the franchised business at the location; and a right to assume the lease under certain circumstances, including abandonment or termination of the underlying franchise agreement. Often, the franchisor will attach a required lease rider as an exhibit to the franchise disclosure document, which the franchisee must execute with the landlord. Franchisors often fail to require franchisees to execute these lease riders or to include comparable terms in the lease, so a buyer should carefully review those agreements to determine whether it will have the intended control over the leased sites.

✓ Litigation History

There are several critical reasons a buyer should understand a franchisor's litigation history. First, the buyer must determine the completeness of the seller's compliance with its obligation to disclose certain litigation in its uniform franchise offering circular or, going forward, its franchise disclosure document. A franchisor's failure to disclose in compliance with the FTC Rule and applicable state law might entitle franchisees given deficient documents a right to damages or rescission, at least in those states with registration and disclosure laws.

Second, the type and number of actions to which a franchisor has been a party is often a good indicator of the health and culture of the system as a whole and of the quality of the franchisor-franchisee relationships in that system. For example, a franchisor's repeated resort to litigation to collect unpaid royalties suggests historical laxity in collection or enforcement practices. In the worst case, those practices might give rise to a claim or defense of waiver. A multiplicity of lawsuits focusing on or complaining of a common practice or of the actions of a particular salesperson should raise a red flag and trigger further inquiry into the challenged practice or the activities of that salesperson. Of course, it is always important in these situations to look beyond the mere filing of a complaint or arbitration demand to make sure that the multiple filings are not attributable to a single lawyer with too much time on his hands.

Third, the buyer should review the franchisor's litigation history and portfolio of current litigation to understand anticipated litigation expenses going forward and to test whether the seller's revenues allow for adequate legal budgeting. The buyer should determine how much of the franchisor's litigation was commenced by the franchisor and might therefore reflect a controllable cost that could be eliminated through better management of relationships or accounts receivable. Who is litigation counsel, what is counsel's experience or expertise in representing franchisors, what rates are charged, how has the franchisor leveraged its volume of litigation to drive rates down, and what internal activities might be outsourced and vice versa? These are questions the buyer should ask. The buyer will also want to consider how effectively the franchisor has anticipated and managed litigation, as reflected in the accuracy of its annual budgeting over recent years. That assessment may be used to evaluate litigation-related representations and warranties and consider appropriate means of securing those, such as indemnities, holdbacks, and escrows.

FRANCHISE AGREEMENTS AND DISCLOSURE DOCUMENTS

Reduced to its simplest components, the immediate value of a franchise system is the value of the opportunities that the contractual relationships with franchisees afford the franchisor, less the costs of taking advantage of those opportunities and meeting the obligations imposed by those contracts. Therefore, it is imperative that in due diligence a buyer understand the parties' respective rights and obligations under the different forms of franchise agreements in effect in the system. At the same time, the buyer should feel comfortable that the terms of the franchise offered have been adequately and properly disclosed in the franchisor's disclosure documents.

Transfer Provisions

A good starting point in reviewing the franchise agreement is its terms regarding transfer because if the franchisor is not entitled to transfer or if the agreement imposes restrictions on transferability or assignment, the buyer's inquiry may be at an end. As a practical matter, most modern franchise agreements allow the franchisor to transfer without restriction.

Most franchise agreements also prohibit the franchisee's transfer except with the franchisor's consent, and then only when specific conditions have been met, such as the franchisee's compliance with the agreement and other system requirements, the transferee's willingness to sign a then-current form of franchise agreement, and the transferring franchisee's agreement to provide the franchisor with a general release. The buyer will want to understand these terms and conditions and determine whether in practice the franchisor has enforced these restrictions.

Franchisor's Obligations

To understand the ongoing costs associated with the acquisition of a franchise system, the buyer must understand not only the obligations that the franchisor expressly assumed under the terms of its franchise agreement but also the services that the franchisor may be performing above and beyond the requirements of the agreement. Past practice may contractually require a buyer to continue to provide enhanced services not specified under the franchise agreement; and, even in the absence of a requirement, the sudden disappearance or withdrawal of those services may cause discontent and rancor among franchisees.

Even if there is a contractual obligation to perform certain services under the franchise agreement, the buyer should determine whether the frequency, extent, or scope of the obligation is, as is often the case, to be determined by the franchisor "in its discretion" or "as [the franchisor] deems appropriate" or "sees fit,"[11] and whether there is a mechanism to modify it. Because it is increasingly common for franchisors to make even material modifications to the franchise program through changes in their operations manuals, it is important to review these manuals to get an accurate picture of the parties' obligations.

Territorial Rights

When the franchise agreement has granted some degree of territorial exclusivity, it is important to understand that right, both to make sure it is honored and to assess how it affects the franchisor's rights and opportunities. Franchisee territorial rights or exclusivity impacts franchisors in two ways. First, those rights may not only restrict the franchisor's ability to grant additional franchises within a protected area, they may also restrict the franchisor's ability to sell its product or service through alternative channels of distribution. Therefore, it is important to understand the scope of any such territorial right granted.

Second, the acquisition itself may have an effect on those territorial rights. When the buyer or its affiliates or subsidiaries operate or franchise in a competitive line, the anticipated acquisition could place the acquired franchisor in violation of its territorial covenants by reason of the buyer's (or its affiliates' or subsidiaries') other activities.

Franchisor Flexibility

The buyer should also consider the franchisor's ability to change or modify elements of its franchise program. For example, in the acquisition context, the buyer often intends to fold one system into another. A franchise agreement that does not permit the franchisor to require franchisees to rebrand by changing the name, mark, logo, or look of the operation may preclude that type of consolidation.

Similarly, the right to add, eliminate, or change the products or services offered by franchisees in the operation of their business is critical to expand the business or to steer it in a new or more competitive direction. When the franchise agreement specifically expresses that right, franchisees will have greater difficulty resisting change.

Finally, franchisors can generate revenues for themselves or their affiliates and drive down the prices franchisees pay to suppliers by restricting sources of supply to the system and charging suppliers for access to the system. To do this, the franchise agreement must require franchisees to buy only from approved suppliers and must entitle the franchisor to receive rebates or other consideration on account of franchisee purchases and to use such payments as they see fit. Accordingly, in due diligence, it is important to examine all forms of the franchise agreement in effect to ensure that they support any existing supplier program or that the buyer will have the opportunity to develop a supply program in the future.

Covenants Against Competition

In certain types of franchise systems, particularly those that are less cohesive or brand-oriented or those that are still emerging, noncompetition covenants are often the glue that holds the system together. Because courts disfavor and strictly construe noncompetition covenants, it is important in evaluating a franchise system to ascertain not only whether the franchise agreement includes a covenant, but whether the covenant is enforceable.

There are two critical analyses that a buyer should perform. The first considers a covenant's restraints in time, place, and conduct. Generally speaking (and with certain important exceptions), courts will only enforce covenants that are reasonable in the scope of the activity they restrict, duration of the restriction, and geographic scope. A covenant will most likely be enforced if it is narrowly tailored to protect only the franchisor's legitimate and protectable interests.

The second analysis is which state's laws will apply to the question of enforcement and, perhaps even more important, which state's courts will determine enforceability. States vary widely in their enforcement of restrictive covenants. For example, a buyer should assume that a covenant against competition contained in a franchise agreement governed by California law is unenforceable because under California law, only very narrow use restrictions are enforced.[12] Although Georgia law is not as restrictive as California law, a buyer should carefully scrutinize a covenant governed by Georgia law as well.[13] Even in states that historically support noncompetition covenants, enforcement is far from certain. If the prohibited competition occurs in a state like California or Georgia because that is where the covenantor lives, a court elsewhere may determine that California or Georgia law should apply because that state has a materially greater interest in the issue of enforceability. The key inquiries are where the particular franchisee is located, where it is likely to compete posttermination, what the proper and likely venues for litigation might be, and which state's interests might be deemed to be at stake in any enforcement action.

ASSESSING LITIGATION RISKS

Once the buyer has identified potential liabilities, the buyer must evaluate them and take appropriate measures to protect itself through price adjustments, indemnities, holdbacks, escrows, or other means. The buyer's evaluation of litigation risks involves the nature of the claims that the franchisee might assert, the remedies available, applicable limitations period, and any mandatory dispute resolution mechanisms.

The first step in gauging the risk associated with a potential liability is understanding the types of claims that franchisees might assert and the nature of the proceeding (civil, enforcement, or criminal) in which the franchisee would bring them. For example, a technical disclosure violation might give rise to a civil claim for rescission under a state's franchise law. But when no state franchise law applies, the exposure is limited, because a truly technical violation will rarely support a reliance theory of damages, and there is no private right of action under the FTC Rule.[14] Thus, although an enforcement action is theoretically possible, it is unlikely when the violation is technical, singular, and discrete.

At the other extreme, a material misrepresentation contained in a widely disseminated disclosure document will give rise to private claims for violation of the antifraud provisions of applicable state franchise laws and other state antifraud laws (so-called Little FTC Acts) and for common law misrepresentation, among others. In these cases, plaintiffs typically seek damages or rescission, double or treble damages where provided by statute, punitive damages, fees, and costs. This sort of violation might also result in a state or federal enforcement action and, in rare cases, a criminal prosecution.[15]

Two factors that a buyer should carefully consider are the applicable statute of limitations and any mandatory dispute resolution provisions of the relevant franchise agreement. State law will supply the limitations period applicable to statutory or common law claims. Franchise agreements frequently include provisions purporting to shorten otherwise applicable limitations periods. Courts will usually uphold these provisions, except when the provision purports to shorten the time within which to pursue claims under state franchise laws that provide a longer period.

State franchise law limitations periods can be tricky; a buyer should examine them carefully. The Illinois Franchise Disclosure Act, for example, imposes no fewer than four separate time limits on claims brought under the act: a thirty-day limitations period on claims for rescission after an offer of rescission has been made; a ninety-day limitations period for claims brought after a notice of violation has been given; a general one-year limitations period upon discovery; and a maximum three-year limitations period, assuming the other limitations periods have not already expired.[16] On the enforcement side, the five-year limitations period applies to enforcement actions seeking civil penalties under the FTC Rule.[17] In assessing potential liabilities, a buyer must take great care in identifying the appropriate limitations periods applicable to all potential claims, both common law and statutory.

The buyer should also consider mandatory dispute resolution and limitation of liability provisions in assessing the risks associated with potential liabilities. Many franchise agreements include mandatory arbitration clauses, jury and punitive damage waivers, and other devices. Courts routinely uphold and enforce these provisions, which often serve to limit a franchisor's exposure.

NEGOTIATING DEFINITIVE DOCUMENTS

Franchise Representations and Warranties

Once the buyer has completed due diligence and assessed litigation risks, it is time to negotiate the definitive acquisition agreement. Much of the definitive agreement will be no different than agreements for the acquisition of any other business. However, the buyer of a franchise company should insist on certain franchise-specific representations and warranties. Although they are no substitute for effective due diligence, properly drafted representations and warranties can help address information that the buyer did not discover or that was incomplete.

To that end, sufficient due diligence is essential in order for the buyer to craft the most appropriate representation or warranty. For example, the buyer must know if there are international franchisees in order to know whether to ask for a representation concerning foreign disclosure requirements. If the seller claims that it receives no rebates in the franchise disclosure document, the buyer should ask the seller to represent and warrant that it does not receive any rebates because the seller's failure to disclose rebates would violate federal and state franchise laws.

Ideally, the same person who conducted the due diligence would draft these representations and warranties. The lawyer who understands the franchise system and the risks uncovered during due diligence can most effectively negotiate representations and warranties to protect the buyer.

Definition of Knowledge

Most franchisors will want to limit certain representations and warranties to the actual knowledge of certain individuals. Before agreeing to such a limitation, the buyer must determine the identity of key individuals involved in franchise sales and operations. More often than not, people other than the franchisor's principal officers and directors deal with franchisees on a day-to-day basis. However, the seller will seek to limit its "knowledge" to the actual knowledge of principal officers and directors, which may not provide the buyer any effective or meaningful protection. For example, a representation and warranty regarding compliance with state disclosure requirements that is limited to the knowledge of the chief executive officer will not give the buyer any comfort if the chief executive officer has no direct involvement in franchise sales. Even if the chief executive officer is involved in franchise sales, he may not have knowledge regarding any violation of franchise law if he has not been trained in franchise law compliance. Therefore, if a representation or warranty includes a knowledge qualifier, the buyer should make sure that the limitation includes key people who would have the relevant actual knowledge. A buyer may also want to make sure that the actual knowledge standard includes an "after due inquiry" representation so that the people included have some obligation to make inquiry of others prior to signing the agreement.

Survival Period

A representation and warranty is largely worthless if it does not survive closing. How long should the survival period be? When negotiating the survival period, the buyer should keep in mind the limitations periods applicable to potential liabilities identified in due diligence. In the buyer's perfect world, the seller would agree to a survival period coextensive with the longest applicable statute of limitations. In the real world, few sellers would agree to a survival period of that length. In addition to statutes of limitations, a buyer should also consider its assessment of litigation risk. If, based on the due diligence conducted, the buyer believes that the seller has not complied with applicable laws in dealing with prospects or franchisees, then it should insist on an appropriate survival period to cover the liability. A buyer should bear in mind that even if there is no litigation in the franchise system at the time of the acquisition, a change in ownership and management may create uncertainty and generate litigation. Therefore, the probability of franchisee-initiated lawsuits may very well increase after any such change. A buyer will want to make sure that the indemnification period is long enough to afford new management the opportunity to settle in and achieve acceptance with franchisees.

Often private-equity investors will purchase a majority interest in a company, or even all of the company, but leave the same management team to continue operating the franchise system. If the management team consists of the prior owners, these individuals may have little incentive to inform new ownership of any breach of representation or warranty until the survival period has expired. When former owners would wind up indemnifying the new owner for any such breach, they have a disincentive to give notice. Under these circumstances, the buyer should require that the survival period be extended until the latter of management change or the new owners' receiving actual knowledge of any event constituting a breach of representation or warranty.

Indemnification

An indemnification provision is ineffective unless the seller has the wherewithal to cover its obligations; thus, the buyer should make sure that appropriate security is in place to back up those obligations. For instance, a buyer may hold back part of the purchase price in escrow or may obtain personal guarantees from individual sellers. Obtaining these protections is especially important when buying a franchise company, because the laws governing the offer and sale of franchises and franchise relationships are not self-executing. Violations can lie dormant for extended periods of time until a disgruntled franchisee loses hope and elects to sue. For these reasons, the buyer needs to ensure that it is able to enforce indemnity obligations without incurring significant additional costs.

CONCLUSION

The acquisition of a franchise company presents unique challenges. The buyer must understand the laws and regulations governing the offer and sale of franchises and the ongoing franchise relationship; appreciate the impact that the quality of the ongoing franchisor-franchisee relationships has on sources of franchisor revenue; and identify potential liabilities so that the buyer can properly value the targeted franchise company, develop and execute a meaningful due diligence plan, and craft the acquisition agreement to provide sufficient protection.

Endnotes

1. The likelihood of the necessity to amend the disclosure document may have increased even in a stock purchase transaction in light of the revised FTC Rule, which now mandates disclosure of parent entities under certain circumstances. *See* Disclosure Requirements and Prohibitions Concerning Franchise and Business Opportunity Ventures, 16 C.F.R. § 436.5(a)(1).

2. 16 C.F.R. §§ 436, 437.

3. California (Cal. Corp. Code §§ 31303, 31304 and 31405); Hawaii (Haw. Rev. Stat. §§ 482E-.10.6(f), 482E-.10.5(b)); Illinois (815 Ill. Comp. Stat. 705/24, 705/25, 705/27); Indiana (Ind. Code § 23-2-2.5-30, 23-2-2.7-6); Maryland (Md. Code Ann., Bus. Reg. §§ 14-210(c), 14-211(b), 14-227(e)); Michigan (Mich. Comp. Laws § 445.1533); Minnesota (Minn. Stat. § 80C.17(5)); New York (N.Y. Gen. Bus. Law § 691.4); North Dakota (N.D. Cent. Code §§ 51-19-12.5, 51-19-14.4, 51-19-09.3, 51-19-11.6, 51-19-13.3); Oregon (Or. Rev. Stat. § 650.020(6)); Rhode Island (R.I. Gen. Laws §§ 19-28.1-22, 19-28.1-20(c), 19-28.1-18(c)(3)); Virginia (Va. Code Ann. §§ 13.1-571(b), 13.1-569.C); Washington (Wash. Rev. Code § 19.100.200); Wisconsin (Wis. Stat. § 553.51(4)).

4. California (Cal. Corp. Code §§ 31000 - 31516); Hawaii (Haw. Rev. Stat. §§ 482E-1–482E-5, 482E-8, 482E-9, 482E-11, 482E-12); Illinois (815 Ill. Comp. Stat. 705/1–705/44; 815 Ill. Comp. Stat. 602/5-1–602/5-145); Indiana (Ind. Code §§ 23-2-2.5-1–23-2-2.5-51; Ind. Code § 24-5-8-1–24-5-8-21); Maryland (Md. Code Ann., Bus. Reg. §§ 14-201–14-233; Md. Code Ann., Bus. Reg. §§ 14-101–14-129); Michigan (Mich. Comp. Laws § 445.1501–445.1545); Minnesota (Minn. Stat. §§ 80C.01–80C.22); New York (N.Y. Gen. Bus. Law §§ 680–695); North Dakota (N.D. Cent. Code §§ 51-19-01–51-19-17); Rhode Island (R.I. Gen. Laws §§ 19-28.1-1–19-28.1-34); South Dakota (S.D. Codified Laws §§ 37-5A-1–37-5A-87; 37-25A-1–37-25A-54); Virginia (Va. Code Ann. §§ 13.1-557–13.1-574, 59.1-262–59.1-269); Washington (Wash. Rev. Code §§ 19.100.010—19.100.940, 19.110.010–19.110.930); Wisconsin (Wis. Stat. §§ 553.01–553.78).

5. Alabama (Ala. Code § 8-19-5(20) (2008); Alaska (Alaska Stat. § 45.66.010 (2008); California (Cal. Civ. Code §§ 1812.201 - .221 (2007)); Connecticut (Conn. Gen. Stat. §§ 36b-60–36b-80 (2008); Florida (Fla. Stat. § 559.80 - .815 (2008)); Georgia (Ga. Code. Ann. § 10-1-410 to 10-1-417 (2007); Illinois (815 Ill Comp. Stat. Ann. 602/5-1–602/5-135 (2008); Indiana (Ind. Code Ann. §§ 24-5-8-1-

.21(2008); Iowa (Iowa Code § 551A.1–.13 (2008)); Kentucky (Ky. Rev. Stat. § 367.801–.819, 367.990 (2008)); Louisiana (La. Rev. Stat. Ann. §§ 51:1821–1824 (2008)); Maine (32 Me. Rev. Stat. § 4691–4700-B (2007)); Maryland (Md. Bus. Reg. Code Ann. § 14-101–14-115 (2008); Michigan (Mich. Comp. Laws §§ 445.902; 903b. (2008)); Minnesota (Minn. Stat. § 80C.01–.22 (2007)); Nebraska (Neb. Rev. Stat. § 59-1701.01–1761 (2008)); New Hampshire (N.H. Rev. Stat. Ann 358-E:1–E:6 (2008)); North Carolina (N.C. Gen. Stat. § 66-94–100 (2007)); Ohio (Ohio Rev. Code. Ann. § 1334.01–.99 (2008)); Oklahoma (71 Okla. Stat. §§ 801–828 (2008)); Oregon (Or. Rev. Stat. §§ 646.605–652 (2007)); South Carolina S.C. Code Ann. §§ 39-57-10–80 (2007)); South Dakota (S.D. Codified Laws §§ 37-25A-1–54(2008)); Tennessee (Tenn. Code Ann. § 47-18-101–117 (2008)); Texas (Tex. Bus. & Com. Code § 41.001–.303 (2007)); Utah (Utah Code Ann. §§ 13-15-1–13-15-6 (2008)); Virginia (Va. Code Ann. §§ 59.1-262–.1-269 (2008)); Washington (Rev. Code Wash. §§ 19.110.010–.930 (2008); District of Columbia (D.C. Code § 28-3901–3908 (2008)).

6. 16 C.F.R. § 436.2.

7. In a typical asset purchase transaction, one method of dealing with debt is to exclude it from the assets being acquired and to reduce the purchase price accordingly. However, this is not a realistic solution with respect to debt from existing franchisees. The buyer certainly would not want the seller to initiate legal proceedings against an existing franchisee that is still operating the franchised business. That would create undesired tension in its relationship with the franchisee.

8. In one instance known to the authors, a franchisor emerged from bankruptcy after renegotiating the terms of its franchise agreements with most of its franchisees. The renegotiated terms included consecutive five-year terms and reduced royalty rates. Five years later, when most of the franchise agreements in the system came up for renewal, the franchisees acting together were able to wrest control of the system from the franchisor by threatening a mass exodus.

9. Arkansas (Ark. Code Ann. §§ 4-72-201–4-72-210); California (Cal. Bus. & Prof. Code §§ 20000–20043); Connecticut (Conn. Gen. Stat. §§ 42-133e–42-133h); Delaware (Del. Code Ann. tit. 6, §§ 2551–2556); District of Columbia (D.C. Code §§ 29-1121–29-1128); Hawaii (Haw. Rev. Stat. § 482E-6); Illinois (815 Ill. Comp. Stat. 705/18–705/20); Indiana (Ind. Code §§ 23-2-2.7-1–23-2-2.7-7); Iowa (Iowa Code §§ 523H.1–523H.17); Maryland (Md. Code Ann., Com. Law §§ 11-1301–11307); Michigan (Mich. Comp. Laws § 445.1527); Minnesota (Minn. Stat. §§ 80C.14; Minn. R. 2860.4400); Mississippi (Miss. Code Ann. §§ 75-24-51–75-24-63); Missouri (Mo. Rev. Stat. §§ 407.400–407.410, 407.413, 407.420); Nebraska (Neb. Rev. Stat. §§ 87-401–87-410); New Jersey (N.J. Rev. Stat. §§ 56:10-1–56:10-29); Rhode Island (R.I. Gen. Laws §§ 6-50-1–6-50-9); Virginia (Va. Code Ann. § 13.1-564); Washington (Wash. Rev. Code §§ 19.100.180–19.100.190); Wisconsin (Wis. Stat. §§ 135.01–135.07).

10. Claims arising out of the termination of a franchise agreement may be brought both under state relationship laws imposing good cause or other standards, or under common law for breach of contract. In determining how far back to examine terminations, the buyer should consider both the general statute of limitations applicable to breach of contract claims as well as any limitation provision of the applicable relationship law.

11. Because language that would appear to vest complete discretion in the franchisor might, under some states' laws, in fact limit the franchisor's flexibility, *see, e.g.,* LIAC, Inc. v. Founders Ins. Co., 2007 U.S. App. Lexis 6193 (6th Cir., Mar. 13, 2007) (quoting Dayan v. McDonald's Corp., 466 N.E. 2d 958 (Ill. Ct. App. 1984)), it is important to identify these modifiers and determine how they have been treated under applicable law.

12. Cal. Bus. & Prof. Code § 16600.

13. *See*, *e.g.* Manuel v. Cenvergys Corp., 2004 U.S. Dist. Lexis 29879 (N.D. Ga. Oct. 18, 2004).

14. Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, 16 C.F.R. §§ 436, 437 (2007).

15. *See, e.g.*, IFDA 815 ILCS § 705/25 (classifying willful violation as a Class 2 felony).

16. 815 ILCS § 705/27.

17. 28 U.S.C. § 2462.