MERGERS AND ACQUISITIONS
OF FRANCHISE COMPANIES

Due Diligence on Franchise Systems
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from the book

Mergers and Acquisitions of Franchise Companies,
Second Edition

published by

American Bar Association
Forum on Franchising

July 2014

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Due Diligence on Franchise Systems

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1. Overview and Goals of Franchise Due Diligence

Mergers and acquisitions involving franchise companies and franchise systems have many unique characteristics that differentiate them from acquisitions of other businesses. Franchise companies are not simply an amalgamation of hard assets such as real estate, factories, and widgets. Franchise companies include, and are built upon, many intangible assets and multiple layers of relationships with franchisees and vendors. These intangible assets are an addition to, and often dwarf, the company-owned businesses (e.g., restaurants, retail stores, etc.), which would be the typical assets of a target company. Prospective purchasers 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/investment decision. 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). In addition, the ability to operate successfully after the transaction may depend in large measure on the relationships inherent in a franchise system, including the relationships with franchisees, with the system as a whole and with vendors. Therefore, certain aspects of the due diligence investigation of the franchise assets and relationships differ from the evaluation of other types of businesses.

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 franchise systems, 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 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-heavy process. Further, as a result of there being different stakeholders in the franchise network—the franchisor’s management team and investors, franchisees, prospective franchisees, suppliers, and vendors, franchisees of a competing acquiring brand, and customers of the franchise system—the due diligence must also evaluate these individuals, groups, and entities, and their relationships with one another.

A. DUE DILIGENCE—GENERALLY

In any merger or acquisition transaction, whether the target is a franchise company or not, the buyer (and the seller) must assess the strength and defects of the assets, evaluate potential liabilities, and predict future growth and profitability. The buyer will consider and try to answer several threshold questions: (1) What assets will be acquired in the transaction? (2) What liabilities will be acquired? (3) Where is the value in the target company? (4) How should the assets and liabilities be valued—for pricing of the transaction and for future growth? (5) What will the surviving entity do with the business after the acquisition or investment? and (6) To what extent is the existing management capable of expanding and growing the enterprise after the acquisition? Whether the acquiring company is purchasing assets, purchasing the equity of another company, or purchasing less than a controlling interest, the buyer must obtain detailed information to answer these questions. How the buyer acquires that knowledge is the heart of due diligence.

B. ANALYSIS OF SYSTEM AND ASSETS

The fundamental purpose of due diligence is to enable the buyer (or seller) to evaluate the underlying value of the assets and/or the business, and, sometimes more important, the liabilities and “defects” in the assets, and to critically assess

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1. Violation of state franchise laws may give rise to claims by franchisees for actual and punitive 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 Franchise Rule may result in civil penalties, injunctive relief, consumer redress, or cease-and-desist orders issued by the FTC.
the financial and operational viability and health of the target franchise network. In addition, due diligence should be designed to enable the prospective purchaser to review and analyze the seller’s operational, financial, marketing, and legal structures, the seller’s compliance with applicable laws, 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 or portfolio of businesses, if applicable. While an asset sale will generally allow the purchaser to avoid acquiring many of the liabilities of the seller, many of the due diligence considerations will be the same if the transaction is an asset sale or stock sale. The buyer must investigate and evaluate the franchise company’s assets, its management, its franchisees and franchise relationships, its compliance with franchise laws (and other laws and regulations), its operations, potential liabilities, and many other aspects of the franchise system. Franchise due diligence is not simply, or solely, about the franchisor’s compliance with franchise laws and the franchise agreements, and assessing hard asset value. This due diligence is also about analyzing the various relationships that comprise a franchise network.

As part of the due diligence evaluation of franchise agreements, legal compliance, and franchisee operations, a prospective buyer will evaluate, among other things, the following elements of a franchise system:

1. **Unit-Level Economics:** A meaningful part of the due diligence process is spent digging into unit-level financial and operational performance. No other measurement is as critical—if the franchisees are not successful, the brand will have difficulties growing, and all of the other positive attributes of the system have little or no value.

2. **Senior Management:** The leadership behind a franchise concept often determines the overall success of the franchisor. Some franchise networks, despite

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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. The four recognized exceptions to the general rule of successor liability include: (a) an express or implied assumption of liabilities; (b) a consolidation or merger of two corporations; (c) the mere continuation of the seller in the form of the purchaser; or (d) the transaction is entered into fraudulently in order to escape responsibility for debts and liabilities. For a discussion of successor liability issues in franchise company transactions, see Schwartz v. Pillsbury Inc., 969 F.2d 840, 845, Bus. Fran. Guide (CCH) ¶ 10,059 (9th Cir. 1992); Sterling Vision DKM, Inc. v. Gordon, 976 F. Supp. 1194, 1201, Bus. Fran. Guide (CCH) ¶ 11,271 (E.D. Wis. 1997); Wine Imps. of Am., Ltd. v. Gerolmo’s Liquors, Ltd., 563 F. Supp. 163, 166 (E.D. Wis. 1983); Buske v. IHSS, Inc., 499 N.W.2d 300, Bus. Fran. Guide (CCH) ¶ 10,160 (Wis. Ct. App. 1993); and Ata-Boy, Inc. v. Nat’l 60 Minute Tune, Inc., Bus. Fran. Guide (CCH) ¶ 10,011, No. 90-673-FR, 1992 WL 35868, at *2–3 (D. Or. 1992).
great promise, may never fulfill their potential because of the leadership and/or errors in execution. The senior level executives’ skills, experience, and vision, will affect the buyer’s investment decision. These attributes may determine whether a buyer wishes to retain or replace management after the transaction. While much of the due diligence process involves reviewing documents, it is critical for the buyer to meet and interview executives, as well as managers and other individuals who play a vital role in the franchise network’s day-to-day operations.

3. **Franchisee Satisfaction**: Closely tied to unit-level economics is the relationship between the franchisees and the franchisor. The franchisees’ confidence level and trust in the leadership of the brand are strong indicators of the health of the system. In due diligence, the buyer will want to interview a number of franchisees regarding their view of the franchisor and its management, new development, marketing, and franchise support. The prospective purchaser will want to know what the franchisor does well and what areas need improvement to help overall franchisee performance.

4. **Infrastructure**: It takes more than just a good idea to successfully grow a franchise chain. In many franchise systems, a solid operating platform in areas such as training, marketing, real estate, and technology is as crucial to ongoing and successful development of the concept as the founder’s vision and the “buzz” created by the brand. Due diligence should reveal strengths and/or weaknesses in the target’s infrastructure.

No purchaser or investor expects perfection, but buyers and investors are looking at the overall health of the franchise network and the prospects for continued growth.

**C. Buyer and Seller Due Diligence**

The due diligence review of a franchise company is generally considered the purview of the buyer and this chapter is written from the perspective of the buyer. However, a due diligence investigation of the franchise company need not be limited to the buyer. A seller should also undertake its own due diligence. Due diligence enables the seller to identify any “skeletons in its closet,” and to remedy problems before they are discovered by a purchaser or bidder. Also, even if the defects are not curable, due diligence will enable the seller to better assess

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3. Franchisors, for a variety of reasons, may wish to prohibit these interviews or discussions until the proposed deal is publicly announced.
the value of its business and the assets it is selling, and to negotiate and draft appropriate representations and warranties, and/or establish caps or limits on its post-closing obligations or indemnifications. Further, pre-sale or pre-bid due diligence by the seller enables the seller to prepare disclosure schedules and exhibits for the purchase agreement. There is an old saying: "time kills all deals." If thorough pre-sale due diligence by the seller enables the seller to address issues before they become problems and greases the wheels of the transaction by providing the buyer (or bidders) with relevant information and schedules, the likelihood of closing a sale increases.

Another consideration for the seller—and one that is not "legal" in nature—is the relationship between the seller and the prospective buyer and its counsel during the due diligence. The seller should treat the buyer and its counsel and representatives as welcomed and valued potential partners or investors, and not as enemies or invaders. By providing reasonable access to the requested materials and prompt responses to buyer’s investigatory questions, the seller creates a positive relationship that is likely to enhance the prospect for a deal. Conversely, the buyer should tailor its due diligence investigation and its document requests to those items, materials, and issues that are necessary for its evaluation—focusing on substantively valuable information and not a massive quantity of documents. Sellers are likely to resent unfocused, scattershot investigations or fishing expeditions.

**D. Timing**

The “how” and “when” of due diligence may vary due to the nature of the transaction, including whether there is one potential purchaser or multiple suitors in a bidding process. If a franchisor, with advice from an investment advisor or an investment bank, solicits offers from multiple suitors in a bid or auction process, the due diligence review by the prospective bidders will likely occur early in the process. Sometimes the bidders’ due diligence may be conducted in two or more parts—the first or initial cut will be done as the bidders are formulating a bid, and additional and more thorough due diligence may be undertaken only if one or more bidders are selected to move to the next phase of the bid or auction process.

The parties may have a tendency to delay due diligence until “business terms” are settled 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. From the buyer’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 buyer’s likely due diligence, the documents
to be reviewed, and the individuals to be interviewed, many sellers may prefer to delay the intrusive nature of the due diligence until the parties have reached some preliminary understanding concerning significant deal points, and until a significant portion of the purchase agreement has been drafted. The timing of the due diligence may be subject to negotiation between the parties much like other aspects of the transaction.

Just as one franchise system is not exactly the same as another, the method, scope, and timing of a franchise due diligence will likely vary from deal to deal, and from franchise network to franchise network. However, many of the fundamental issues, critical analyses, and processes will be similar. The balance of this chapter will address some of these fundamental due diligence issues.

II. OVERLAP WITH GENERAL CORPORATE ISSUES; COORDINATING WITH OTHER (USUALLY CORPORATE) COUNSEL

A. Educating Other Counsel
Franchising is simply a method of doing business. Consequently, franchise companies engage in many of the same business activities as other business entities. Many aspects of the due diligence review of a franchise company can be undertaken by counsel experienced in those practice areas (e.g., corporate compliance, intellectual property, leases, environmental, etc.). Nevertheless, depending on the franchise system, a franchise lawyer may have to educate other counsel on how the franchise company may conduct its business in certain practice areas. At the very least, the franchise due diligence team will have to educate the lead counsel (usually a corporate lawyer) on those distinctions and characteristics, and perhaps participate in a review of what would be the purview of a lawyer experienced in the review matter. The discussion below highlights some peculiarities of franchise company operations that may have to be taken into consideration when conducting due diligence in specialized practice areas.

B. Coordinating Document Review and Purchase Agreement Drafting
Often by the time experienced franchise counsel is asked to participate in the due diligence review, the lead counsel for the buyer may have already provided the seller with a due diligence checklist. That initial checklist rarely fleshes out all of the important areas of the franchise due diligence, and one of the first
responsibilities of the franchise lawyer is to provide the lead counsel with a detailed specific checklist of franchise due diligence requests.

Typically, the first drafts of the purchase agreement will not provide significant detail on the franchise specific provisions that need to go into the document. The seller’s franchise representations can be relatively simple and straightforward if the seller is providing guarantees or assurances to the buyer, but may have to be more specific and detailed if the franchise system exhibits some weaknesses or failures. Whichever way the representations are drafted, they have to reflect the nuances of the franchise system being sold. The lead counsel almost always asks the franchise lawyer to suggest and/or review specific franchise-related provisions in the purchase agreement.

C. RELIANCE ON SELLER’S REPRESENTATIONS WHEN BUYER DOES ITS OWN DUE DILIGENCE

The seller may take the position that it does not have to give specific franchise representations or guarantees because the buyer will have performed its own due diligence. This belief is somewhat disingenuous. Like a computer, garbage in equals garbage out. From a buyer’s perspective, despite the fact that it did its own due diligence, oftentimes the buyer’s counsel is reviewing only the documents posted in the data room or otherwise made available by the franchisor and talking only with persons designated by the franchisor. The buyer has absolutely no assurances that it is receiving everything that is relevant, even if it makes an on-site visit to the franchisor’s offices. The buyer still needs the protections afforded by the seller’s representations and warranties.

An issue that has been raised in several reported decisions is whether a buyer can still rely on a seller’s representations and warranties when the seller has made its due diligence materials available to the buyer and the buyer has examined those documents in some detail. In *Wikoff v. Vanderveld*, the Seventh Circuit held that warranties that survived the closing and were intended to protect the buyer against all undiscovered liabilities not disclosed in the financial statements and the warranties, were not rendered ineffective by the buyer’s own investigation. The court explained that the buyer could protect itself prior to the closing by conducting an investigation, which, if unfavorable, would release it from proceeding to close the deal. However, after the closing, the warranty provisions become important. Since the stock purchase agreement provided that the warranties will survive the closing,
the warranties protected the buyer against any undisclosed liabilities, including the accuracy and completeness of the seller’s financial statements.7

The court in Wikoff stated that “although it is no doubt true that [the buyer] relied primarily upon its investigation of [the seller] to ascertain the financial situation of the company, this fact does not preclude [the buyer’s] reliance on the warranties as well.”8 However, the Seventh Circuit remanded the case because the trial court had not reached the question of whether warranties had been breached.9 The court also remanded the case for specific findings of fact regarding whether the breach of warranty defenses available to the buyer had been waived.10

The Wikoff case suggests that it is advisable to include provisions in the agreement that the buyer can rely on representations and warranties of the seller that survive the closing, notwithstanding that the buyer has undertaken its own due diligence. Note, however, that in the typical public company acquisition, representations and warranties do not survive the closing.

### III. FRANCHISE-SPECIFIC (OR FRANCHISE-CENTRIC) DUE DILIGENCE ISSUES

#### A. Scope of Due Diligence

The scope of due diligence will be unique in every acquisition, but some generalizations are applicable to all or many due diligence reviews. Franchise counsel must understand their role in the process. It may range from being tasked with all of the legal due diligence for the transaction to serving as special counsel for franchise related issues. The manner in which franchise counsel proceeds obviously depends on the scope of the assignment. For purposes of this chapter, we discuss only franchise law due diligence. This section focuses on the core of franchise law due diligence: the franchise law issues and some of the documents that are specific to franchising. Section IV below covers some of the issues that, while not pure franchise law issues, are important for franchise counsel to review and consider in conjunction with the pure franchise law due diligence review.

The first step will usually be to obtain the franchisor’s current FDD. With several state franchise administrators publishing disclosure documents on their state websites, counsel can often find one of the franchisor’s recent disclosure

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7. Id.
8. Id. at 240.
9. Id.
10. Id.
documents. A review of the disclosure document provides the purchaser with a starting framework for the due diligence process and assists buyer’s counsel in preparing an initial due diligence request list.\footnote{Reviewing the FDD is not absolutely necessary to prepare an initial due diligence request list, but it is very helpful. This review will enable buyer’s counsel to exclude questions that are clearly irrelevant. For example, if the franchisor has only been in existence for three years and lacks any predecessors, asking for the disclosure documents for the last five years does not make any sense. At the same time, an initial due diligence request should not be too narrowly tailored to the FDD. For example, if the FDD states that the franchisor collects no vendor rebates, the buyer will still want to confirm this information by asking the question directly of management through a due diligence request. The FDD describes only the current franchise offer and the current state of the franchise system; therefore, the FDD may not reflect all historical elements of the system, some of which may still be relevant. Furthermore, not all franchisors review their FDD thoroughly and some of the information in the FDD may in fact be incorrect or incomplete.}

\section*{B. Large Franchise System Due Diligence}

“How deep should we dig?” is always an issue in due diligence review. The answer will often depend on how much money the buyer wants to spend on due diligence, how many man-hours are available, and how much time is available to perform the review. The question becomes even more complex when the review involves a large franchise system. For smaller systems, as long as the buyer has money and time, counsel can easily review all relevant franchisee agreements and files, or create a representative sample that will give the buyer and its counsel reasonable certainty that the key important issues have been reviewed. However, when the number of franchise locations is in the thousands, even creating a representative sample can be challenging.

The decision on how to create a representative sample in the case of large franchise systems is driven by many factual considerations, such as:

1. Is the large franchise system truly one system, or are there different sub-sets within the system?
2. Does the franchisor's FDD or other sources indicate that the system has any particular problem areas?
3. Are there many large franchisees who can be treated as sub-sets (i.e., because they have likely negotiated similar deals for all their locations)?
4. Have agreements been heavily negotiated?
5. Has the form of agreement been significantly revised over the years?
6. Is the current legal department/franchisor management team familiar with the history of the system and do they have a good grip on negotiated agreements?
7. How risk averse is the buyer?
When a large franchise system is the target, the money, man-hour, and time restrictions are put to the test. Often the buyer will not be able to review all system documentation. The buyer’s legal team will have to fine-tune the sample documentation they are requesting to ensure that their decision to focus on certain documentation is well-informed. In most due diligence reviews, the initial franchise due diligence request will be relatively broad with supplemental requests narrowing in on the issues highlighted through the responses to the initial request. However, for large franchise system reviews, counsel may want to consider taking a slightly different approach. For example, it may be beneficial to have a conversation with the seller at an early stage to gain a better understanding of the full scope of the system and to tailor the initial due diligence request based on that conversation.

In a large franchise system due diligence, it is particularly important for counsel to be fully aware of the buyer’s expectations with respect to the due diligence. Most likely the due diligence review will not be able to uncover all legal issues relating to the franchise system. The buyer is usually not interested in spending the money and time that such a detailed and comprehensive review would require. Instead, buyers tend to be focused on “deal-breaker” type issues. For example, the existence of any threatened class action litigation that, if successful, could be harmful to the system, or indicators that the franchise model does not work (e.g., a large number of franchisees are in default, or other red flags). Most buyers of large franchise systems will understand that their counsel’s due diligence will only focus on key issues, but it is nonetheless important to have these discussions upfront to make sure that the review efforts and expectations are aligned.

C. DUE DILIGENCE IN PRE-BID SITUATIONS

In some cases, companies are sold through an auction process. An auction process, in the setting of the sale of a company, is similar to a regular auction. The target company has hired a broker or investment banker or advisor who solicits interested buyers. The buyers are provided with some level of information about the target company and asked to submit a bid. The bid usually consists of a purchase price offer and a draft purchase agreement. The bidding process is closed and bidders will not know the other bidders, the number of them, or their offers. When a franchise system is sold through an auction process, several restrictions are placed on the due diligence process. The bidder has a much greater level of uncertainty about its ability to buy the system compared to regular negotiations between a buyer and a seller. In an auction process, first the bidder must be successful in the bidding and then it can negotiate a final purchase agreement. Therefore, buyers frequently set limits on the amount of money they want
to spend on the pre-bid due diligence process. In addition, the buyer’s actions and pre-bid requests may impact how likely the seller is in accepting their bid. Thus, many prospective buyers are reluctant to request too much information beforehand out of fear that such request will signal a difficult negotiation and selling process ahead and will scare the seller away. One additional due diligence concern in an auction is time: the deadlines set for completion of the pre-bid due diligence are much less flexible than other deadlines in the acquisition process simply because there may be a number of other bidders who are also involved. However, the diligent franchise lawyer should not fret—usually pre-bid due diligence is supplemented with further due diligence after a bid has been accepted.

**D. DOCUMENTS TO REVIEW**

The documents that need to be reviewed in different franchise systems will vary greatly based on the specific industry and type of business of the system. For example, environmental issues may be important in certain franchise systems, but of lesser importance in others. This chapter, however, does not discuss the legal issues related to all areas of law that arise when a franchisor is sold. Instead, the focus is on franchise-law related issues and the due diligence that should be conducted to review compliance with state and federal franchise laws and, from a legal perspective, to help determine the health of the franchise system.

Even within this narrower scope the documents to review will vary between different franchise systems. However, the basic documents that will be present in most franchise systems include:

1. franchise disclosure documents;
2. registration orders and comment letters from state examiners;
3. standard forms of franchise agreements (as well as negotiated agreements);
4. area development agreements;
5. correspondence between the franchisor and franchisees regarding terminations, renewals, and other important events in the relationship;
6. marketing fund materials;
7. marketing materials used by the franchise system; and
8. franchisee association bylaws and key correspondence between franchisor and franchisees regarding complaints.

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12. Among other areas of the law that will have to be reviewed include corporate matters, real estate, tax, and trademarks.
Each of these categories of documents is discussed below in more detail. For a more complete list of documents to review in the course of franchise due diligence, see the sample due diligence checklist in Appendix B.

1. **Franchise Disclosure Documents**

Nearly all franchise systems in the U.S. will have at least one franchise disclosure document, or FDD for short.\(^{13}\) Franchisors who want to offer franchises in the U.S., and that do not fall within the scope of relatively narrow exemptions, are required by federal and state law and regulations to provide prospective franchisees with an FDD. The FDD contains information that the federal and state governments have deemed important for prospective franchisees to make an informed decision about buying a franchise. As such, in many ways the FDD can be seen as a government-imposed mini due diligence memorandum that the franchisor is required to deliver to the potential “buyer”—the prospective franchisee. Therefore, the FDD is at the heart of franchise law due diligence. However, the prospective buyer should not assume that the FDD will contain all information relevant to their acquisition of the franchise system, and the buyer should understand the limitations of the FDD.

The FDD covers many of the same issues facing a potential buyer of the franchise system. However, in an effort to create uniformity, among other things, the government restricts the franchisor from disclosing information beyond what is specifically required by law. In other words, information that is highly relevant to a franchise system may not even be mentioned in the system’s FDD. Further, it is important to remember that the franchisor prepares the FDD and that it may be biased and phrased with a positive spin. Another limitation of the FDD is that it can be hard to determine from the document alone whether it is correct and complete. Franchisors are required to update their FDDs at least annually, and more often if a material change occurs to the information that is required to be disclosed. The FDD covers so many different areas of the franchisor’s business and the franchise system that it may be hard, even for the most conscientious franchisor, to capture all changes and nuances of the required disclosure. In spite of these limitations of the FDD, it is a useful tool in franchise system due diligence. The FDD contains clues to the information the prospective buyer should be looking for and highlights where at least some of the issues may lie.

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\(^{13}\) Some franchise systems operate solely based on exemptions under federal and state franchise laws and regulations and may be able to avoid preparation of an FDD.
The information in the FDD that may prove to be relevant in analyzing a franchise system will vary, but generally the following information is worth focusing on:

- **Item 1: Corporate structure.** Franchisors must disclose certain basic information regarding their parent and affiliates involved in franchising and providing support to franchisees.

- **Item 2: Key management.** This disclosure requires five-year short-form resumes for anybody in a management position involved in the sale or operation of the franchise system. As mentioned above, understanding the capabilities of franchisor’s key management is an important factor in the due diligence of a franchise system. Item 2 provides information regarding the length of key management’s employment and their current positions.

- **Items 3 and 4: Litigation and bankruptcy.** Certain types of material litigation and bankruptcy matters must be disclosed in the FDD. This includes not only litigation against the franchisor, but also involving key management. The litigation disclosures are helpful in determining if the franchise system is litigious in nature and if there are serious issues facing the system.

- **Item 5: Negotiation of initial fees.** Item 5 includes information on the initial fees that the franchisor charges its franchisees. It should also include information regarding the fees negotiated in the year prior to the issuance of the FDD. Extensively negotiated fees can be a sign of different things including aggressive sales tactics, weakness of the system, or fees that are not aligned with competitors’ fees.

- **Item 8: Rebates and anti-trust issues.** (See Section IV.A and Section IV.E of this chapter.)

- **Item 10: Financing.** (See Section IV.C of this chapter.)

- **Item 11: Computer systems and technology.** (See Section IV.G of this chapter.)

- **Items 13 and 14: Trademarks, patents, etc.** (See Section IV.G of this chapter.)

- **Item 19: Financial performance representations.** Franchisors who wish to disclose historic income data or make income projections to prospective franchisees are required to include this information in their FDD. As opposed to other disclosures, financial performance representations (FPRs, previously known as earnings claims) are not mandatory. The prevalence of FPRs depends in large part on the industry, but it is not at all unusual if an FPR is not made in the FDD. However, if the franchisor chooses not to make an FPR, questions are raised regarding the franchisor’s communications regarding FPRs to prospective franchisees. Certain restrictions are imposed on FPRs, and the franchisor must have a reasonable basis for the information. Even with the legal restrictions on FPRs, franchisors...
have a lot of room to present the information in the light most favorable to their system. As with other information in the FDD, the FPR serves as a good starting point for a buyer’s due diligence, but additional information will be required.

- **Item 20: Franchise system data.** Item 20 of the FDD contains data summarizing the number of franchised and company-owned outlets, the transfers of outlets to new owners, and the growth and departures from the franchise system. This data can be a treasure trove of information regarding the health of the system. Of particular importance is the information about terminations and transfers. High numbers of terminations and transfers are indicative of system problems and warrant further investigation.

- **Item 21: Audited financial statements.** Franchisors are required to attach audited financials to the FDD. 14 Thorough financial due diligence on the seller will usually be performed by the buyer’s financial due diligence team and, therefore, franchise counsel’s review of the audited financials can usually be limited. However, the financials indicate the franchisor’s health, and reviewing the notes to the audited financials are a good way to check the accuracy of the information in the FDD. If there is a discrepancy between the information in the notes and that in the body of the FDD, it may indicate that the FDD may not be completely accurate, thereby warranting further investigation.

- **State-specific addenda.** Since FDDs must comply with both federal and state franchise laws, the common way of preparing FDDs is to present the information required by the FTC Rule in the body of the document and then to attach state-specific addenda to the FDD containing state-specific disclosures. The content of the state specific addenda is fairly standard and based on the state’s franchise regulations. Therefore, they do not differ significantly among franchise systems. However, if there are financial issues with a franchise system, the franchise regulators will require the franchisor to include risk factors, or put in place financial assurances (i.e., fee deferral, escrow of fees, or posting of a bond). The existence of such risk factors indicates that the franchise examiners may be concerned with the viability of the franchisor, or at least its ability to meet its initial obligations to the franchisees.

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14. The FTC Franchise Rule permits phase-in of audited financials for new franchisors. At the stage when a franchise system is being sold the audited financials have usually been completely phased in and this exception is rarely relevant.
The FDD includes much more information than what is listed above, and, depending on the franchise system, other sections and other information in the FDD may be extremely important.

It is also important to note that the review of the FDD will likely involve the review of more than one document. It is prudent to look not only at the current FDD, but also to look at several prior years’ FDDs. Furthermore, depending on the structure of the system, different FDDs may have been prepared for different states. The buyer should compare the FDDs to understand these differences. For franchise systems with master franchisees, the buyer should review sample FDDs from the master franchisees to ensure that they are properly registered and legally compliant.

2. Registration Orders and Comment Letters

Part of franchise state law compliance is registration of the FDD with the states’ franchise examiners. Fourteen states require registration or a notice filing under their franchise laws and five additional states have business opportunity laws under which franchisors must also register. Without a current state registration, a franchisor may not offer or sell franchises in that registration state. To determine compliance with the registration requirements, a buyer should review registration orders dating several years back.

In addition to the registration orders themselves, it may also be valuable for the buyer to review correspondence between the franchisor and the state franchise examiners. The correspondence will usually be limited to comments and questions regarding the franchisor’s FDD. While some states are known for commenting on almost every FDD (Maryland, in particular), the number and type of comments may be indicative of the completeness of the FDD.

3. Franchise Agreements

If a franchise system has a large number of franchisees, reviewing each franchise agreement will not be feasible. Therefore, due diligence review of franchise agreements often focuses on the standard form of franchise agreements and those franchise agreements that have been significantly negotiated. When reviewing the standard form of franchise agreements, the buyer should examine the most

15. In Connecticut, if the franchisor’s mark was registered after October 1, 1996, the franchisor must file a copy of the mark with the state in order to claim a business opportunity law exemption. If the franchisor’s trademark is not registered, registration may be required under the business opportunity laws of additional states. Registration may also be required if the franchisor makes certain types of representations to franchisees to induce sales.
common forms of agreements used by the franchisor, and understand their key terms and development over the years.

Each franchise agreement is unique and the focus of the franchise agreement review will vary with each franchise. However, there are certain common issues that warrant particular attention, such as:

- **Ability to amend the system and require updates.** Some of the most important provisions in a franchise agreement are those relating to the franchisor’s ability to amend the system. Franchise agreements are often for a long term. The market will change significantly in that period of time and it may be necessary to amend the franchise system during that time. As the strength of a franchise system in large part depends on uniformity in operation of franchised outlets, the franchisor needs the ability to enforce system changes on the franchisees. System changes can be performed in several ways. For example, the franchise agreement will likely permit the franchisor to unilaterally modify the system operations manual and some system changes can be introduced through manual changes. Also, most franchise agreements permit the franchisor to modify and change the system trademarks with new trademarks. Another common way of ensuring system uniformity is to require franchisees to update and remodel their outlets periodically.

- **Territorial issues.** Many franchisors grant their franchisees territorial exclusivity. Depending on the scope of the exclusivity these grants may restrict future growth of the franchise system, both where the territory is too large for just one franchised outlet or where there are insufficient carve-outs from the exclusivity to allow the franchisor to grow the system outside the exclusive territory, or in the territory itself (i.e., through alternative channels of distribution).

- **Franchisor’s right to operate competing brands.** One particularly important carve-out from territorial exclusivity is the franchisor’s right to operate competing brands. Without such a carve-out a buyer who already operates a competing brand may be deterred from acquiring the franchise system.

- **Termination rights.** Usually franchise agreements grant franchisors broad termination rights upon the franchisee’s default. However, it is important that the defaults be tailored to the franchise system. For example, if the franchise requires extensive build out and construction before opening, the defaults should include failure to timely begin and complete construction. Or, if the franchise includes food handling, defaults should include compliance with sanitation and food handling laws and system standards.

- **Franchisees’ termination rights.** Although many franchise agreements do not address when franchisees may terminate the franchise agreement, some
franchise agreements will give franchisees early termination rights. For example, franchisees may be able to leave the franchise system after a certain number of years without being subject to damages.

- **Franchisor’s buy-out rights.** When a franchisee is terminated or leaves the franchise system without transferring its outlet to a new franchisee, the franchise system can be vulnerable. Depending on how crucial the franchisee’s outlet is to the franchise system, the franchisor may be interested in taking over the franchised location itself.

- **Transfer rights.** Most franchise agreements will include standard provisions allowing the franchisor to transfer its rights and obligations under the agreement without notice or consent, while at the same time restricting the franchisee’s transfer rights. In franchise due diligence, the buyer should ascertain that the franchisor can freely transfer all franchise agreements. An additional issue with respect to transfers is what restrictions are placed on the franchisee’s right to transfer. Upon a transfer by a franchisee it is important to ensure that the transferee fits the system and has the requisite experience and qualifications and therefore that the franchise agreement contains the necessary transfer restrictions.

- **Covenants not to compete.** Franchise agreements commonly have both in-term and post-term covenants not to compete. The enforceability of such provisions will vary depending on state law, but in general the buyer should analyze the geographic scope and term of those provisions to determine if they are reasonable and likely to be enforceable.

When reviewing negotiated franchise agreements, franchise counsel should pay special attention to provisions that may impede system growth, but also to provisions that are so frequently negotiated that they may have an impact on how the system is operated. For example, if territorial exclusivity has been granted for very large territories without an obligation on the franchisee to develop additional units in the territory, the franchisor’s ability to grow may be limited. Negotiation of royalty provisions, deferral, or similar special deals on a one off basis is likely not material, but if they are a common practice it may be a sign of system weakness.

4. **Area Development Agreements**

Although not every franchise system offers franchisees the right to develop multiple locations, area development agreements are a common method of growing franchise systems. These agreements are usually simpler than franchise agreements. While franchise agreements must cover the entire operation of a franchised
outlet, area development agreements only regulate the development of franchised locations in an area. Once the franchisor and area developer agree on a location for an outlet within the development area, the parties will enter into a franchise agreement that regulates the operation of that outlet. The development agreement will often require the developer to sign its then-current franchise agreement; however, this is frequently an item of negotiation. Some area development agreements allow the developer to operate all units under that single agreement.

Inherent in area development agreements is the hope of large returns for both parties—the area developer will operate multiple locations and the franchisor will develop a large area without the same effort as is required when selling single unit franchise agreements. The excitement of both parties often results in unrealistic development terms. The size of the exclusive development area, as well as the pace of the development, may be overly ambitious for the area developer. Therefore, when reviewing area development agreements a buyer should not only look at the agreement itself, but also inquire into the performance of the area developer. If the area developer is falling behind on the development schedule, the franchisor may suffer long term, either by having tied up territories that could be developed by others, or by facing a termination of the area development agreement and potential litigation.

5. Termination, Renewals, and Other Relationship Correspondence
Franchise relationships frequently do not work out the way the parties intended. There are endless reasons for this, but more important than the existence of troubled franchisees (unless it is a sign of inherent problems with the franchise system itself) is how the franchisor handles them. As part of franchise due diligence the buyer should review the correspondence between the franchisor and troubled franchisees.

If a franchisor is not renewing a franchise agreement or has decided to terminate it, the franchisor should take the proper steps and document the reasons. The franchisor’s right to terminate or not renew is regulated in franchise relationship statutes in about half of the states. Usually those statutes require good cause for termination or nonrenewal and further require a minimum number of days’ notice, and many require an opportunity to cure. Determining if the franchisor has complied with those laws requires the review of the correspondence between the franchisor and franchisee with respect to the default, as well as supporting documentation.

Correspondence between the franchisor and troubled franchisees does not always focus on the franchisee’s default. To the extent the franchisor gives its
troubled franchisees special deals, royalty abatements, deferrals, or forgiveness of fees it is important to determine if such special deals are a sign of system weakness or only of a poor operator or poor location.

6. Marketing Fund Materials
Many franchise systems will have a marketing fund to which the franchisees, and often company-owned locations, contribute on a monthly basis. These funds are usually managed by the franchisor and used to promote the system as a whole to the benefit of all outlets. The use and management of the marketing fund can result in conflict between franchisor and franchisees.16

7. Franchise Sales Marketing Materials
From a franchise due diligence perspective, the advertising material that is most important is that used by the franchisor to solicit new franchisees. There are two things in particular that the review of such materials should focus on: whether the franchisor has complied with registration requirements for such materials, and whether the materials include any information that is inconsistent with the FDD. Any materials that contain financial performance representations inconsistent with that in the FDD and do not follow the FTC Franchise Rule regulation of FPR use in media are of particular concern.

8. Franchisee Association Bylaws and Key Correspondence between Franchisor and Franchisees Regarding Complaints
There may be different types of franchisee associations in a typical franchise system. Many franchisors will set up a franchisee advisory committee to get input on marketing fund usage and on programs and policies that may affect the franchisees. Those types of committees can be used to build consensus among franchisees and make it easier for the franchisor to implement new programs, and to enable them to revise or tweak programs before they are ready for roll-out to the franchisees. For a buyer of the franchise system it is important to understand the role of this type of franchisee association. Primarily, it is valuable to go through the bylaws of the association to understand if it is purely advisory, or if it has actual power over how the franchisor operates the franchise system.

16. See, for example, Broussard v. Meineke Discount Muffler Shops, Inc., 155 F.3d 331 (4th Cir. 1998), in which the court of appeals reversed a jury verdict against Meineke for over $590 million. The plaintiffs had on various grounds alleged that Meineke had misused the system marketing fund.
When available, it is also important to review the minutes of the association’s meetings to understand the level of discussions and how the powers granted by the bylaws are implemented.

Another type of franchisee association is the one that is independent and formed by the franchisees themselves, usually as a reaction to discontent with the franchisor. The existence of an independent franchisee association is not necessarily an indication of currently existing problems, but it usually needs to be looked into further. Where a substantial percentage of franchisees in general are unhappy with some of the franchisor’s practices or its support of franchisees, or if they are not making enough money, a franchisee organization is often formed to jointly pursue the complaints.

Not every franchisee complaint will be brought through a franchisee association. Even one, or only a few, franchisee complaints can be a red flag. If a franchisee is making serious allegations against the franchisor or if the complaints are widespread or common, they should be thoroughly investigated to determine the likelihood of litigation or the possibility of large-scale defections from the system.

E. Issues to Look For
The authors have yet to come across a franchise system that is free of any issues, red flags, or potential liabilities. The purpose of due diligence is to find those issues that the buyer should address after the sale, and to find issues that are so serious that the buyer needs to consider adjusting the purchase price or walking away from the deal.

The typical issues that may signal problems with the franchise system or additional unknown issues include:

1. extreme noncompliance with franchise disclosure and relationship laws that may lead to multiple franchisee actions or class actions;
2. inability of the franchisor to meet its obligations to the franchisees;
3. numerous payment defaults by franchisees, indicating that franchisees are not successful;
4. numerous transfers or terminations among franchisees;
5. signs of dissatisfaction amongst the franchisees, such as recent formation of an independent franchisee association;
6. high degree of disorganization of documentation;
7. questions regarding trademark or system ownership;
8. litigation regarding key aspects of the franchise system; and/or
9. low profitability of the franchisor.
F. DUE DILIGENCE WHEN ACQUIRING A COMPETING SYSTEM

Many of the franchise due diligence issues when a competitor acquires a franchise system are the same as when the buyer is an institutional investor. However, there are also unique issues that will arise and that need to be carefully considered before the acquisition. Additional issues include:

1. Are the systems intended to be converted to one of the two brands?
2. If so, what do the franchise agreements of the franchisees whose brand is going away say about changing the trademark?
3. Are there exclusive territories under either system and, if so, will the acquisition result in infringements on such territories?

When a competitor acquires a franchise brand, one of the first issues to determine, and which will help direct the due diligence, is what the buyer’s plans are for the acquired franchise system. There are two main options: to continue to operate the acquired franchise system as a stand-alone system, or to integrate the acquired system into the buyer’s existing brand. If the brands will be operated as independent systems there are usually fewer issues. In that instance, one reason for the acquisition may be to create synergies by consolidating various back office functions of the two brands. While not a pure franchise issue, it may be important in that instance to review the term and termination rights under important supply agreements and other arrangements that will be terminated. (See Section IV.A of this chapter for a further discussion of supply agreements and related issues.) The franchise agreements of the acquired franchise system will need to be reviewed to ensure that they permit the necessary back office changes. For example, if the buyer has a gift card or rewards program that it wishes to apply to both brands it needs to carefully review its contractual right to charge fees on such programs.

Where the buyer intends to integrate the seller’s franchise system into its own system there are additional issues that will have to be reviewed. If the buyer and seller operate in the same markets, the buyer should review the territorial rights of the seller’s franchisees carefully. If either or both the seller’s and buyer’s system franchisees have exclusive territories there may be significant obstacles to overcome before merging the systems, or even before an acquisition can take place. The buyer should examine its own franchise agreements as well as the seller’s to ensure that franchisees’ exclusive territories are not being infringed upon by franchisees from the other system. This may also be an issue where the systems will continue to operate as stand-alone systems if the territorial exclusivity is broad enough to prohibit the franchisor and its affiliates from operating.
in a franchisee’s territory even under a different brand. However, the problem is more common when two brands are merging into one.\textsuperscript{17}

Franchisees are often emotional and upset about having to stop using their brand name. There may be many different reasons for that. Aside from the purely emotional side of being attached to the brand and system that they have bought into, there is also the financial aspect of switching brands. Depending on the franchise system, this may be a costly proposition—signage and decor has to be replaced, management and staff retrained, and services or goods altered. As part of due diligence, the buyer should make sure that the seller’s franchise agreements permits the franchisor to switch trademarks and that the franchisor can require the franchisees to make other reasonable changes to their locations. Maybe most important though in this situation, is that the buyer work with the seller’s franchisees to ensure that the merger will be perceived as something positive by the franchisees and that a transition plan is developed. Examples of litigation in this area are plentiful.\textsuperscript{18}

\section*{G. Discussions with Franchisees or Franchise System Advisory Committees}

Talking to franchisees about how the franchise system is doing will give a buyer a level of insight that is hard to get from talking only to people within the franchisor’s organization. It will provide important information about how well the system is implemented, the level of compliance, and how well the franchisees are doing financially. Additionally, it will provide important clues to how the franchise system will react to changes to the franchise system, both management changes that almost invariably happen after an acquisition, as well as system changes that the new owners may want to implement.

Talking to franchisees, however, is almost invariably a touchy point and cannot be undertaken without the franchisor’s consent. Due diligence happens at such an early stage of the acquisition process that most franchisors do not want to share information about the prospective sale of the company with the franchisees. Therefore, it is unusual for buyer’s counsel to get access to franchisees, at least until later in the sales process. While talking to random franchisees may not be desirable from the seller’s perspective often times some
communications with franchisees may still be organized. Many franchise systems will have some type of franchisee advisory committee. Often times this committee consists of the leaders among the franchisees. The purpose of the committee is to give the franchisor input on advertising and important changes to the franchise system, and also to help sell such changes to the franchisees at large. There is often a level of trust between the franchisor and the franchisees on the advisory committee and even where the franchisor is not willing to let the buyer talk to random franchisees it may be more comfortable with the advisory committee being contacted. In such discussions buyer must keep in mind, however, that the advisory committee members are often handpicked by the franchisor, or otherwise represent large franchisees within the system. While their input is valuable, their views and experiences are not always representative of all franchisees.

IV. FRANCHISE RELATED DUE DILIGENCE—SPECIAL ISSUES

Franchise networks include a web of franchise agreements, trademarks and licenses, franchisee relationships, and franchised outlets, all of which operate under, or are subject to, a fairly significant regulatory and legal landscape that imposes detailed compliance obligations on franchisors and create special challenges for due diligence. Those elements are part of the reason why due diligence of franchise companies differs from due diligence of other businesses. Section III of this chapter addressed many of the special franchise-specific characteristics of due diligence. But franchise systems are more than just franchisees, franchise agreements, and compliance with franchise laws. The nature of how franchise networks operate creates additional, and special, due diligence challenges and issues.

A. PURCHASING AND SUPPLY ISSUES AND REBATES

Nearly every business, regardless of size, function, business sector, or customer orientation, enters into purchasing, supply, and distribution arrangements. One of the principal benefits for franchisees to join a franchise network is the ability to share in system-wide purchasing and supply arrangements. The franchise network’s supply chain structure can provide significant value to the franchisor and to franchisees, but it can also be a source of potential franchisor-franchisee friction and potential legal compliance issues.

A franchise network’s purchasing, supply, and distribution arrangements may be structured with multiple parties (e.g., with franchisees and with company-owned
outlets), may involve multiple revenue streams (including rebates), and may vary geographically depending on the size and scope of the franchise system, and/or the type of products being purchased. These supply and distribution arrangements may involve brand-centric or mission-critical products, such as branded inventory products; confidential or proprietary food, ingredients or recipes for a restaurant system franchise; brand specific décor items for furniture, fixtures, and signage; products that must be purchased to comply with franchise system standards, such as specialized or required equipment; and advertising and marketing materials and programs. Supply arrangements may also pertain to technology support, such as point-of-sale computers and communications systems, or back-office support such as accounting and reporting software and support. Vendor arrangements or contracts may include more mundane products or services, or non-brand-specific products, such as landscaping, security, credit-card and electronic payment processing, or bookkeeping services. Supply arrangements may be long-term or short-term; they may vary based on the location of the franchised outlets and/or the distribution company; and they may vary based on purchase volume and/or number of purchasers or distribution points.

In some franchise systems, some suppliers may distribute products through third-party distribution companies that deliver to franchisees and/or the franchisor’s distribution center; some suppliers may distribute to multiple sites (e.g., to each franchised and company-owned location) or to only a few sites (e.g., to regional distribution centers); some may accept multiple-party billing and collections, or may insist on one billing and payment party (e.g., the franchisor). And, some suppliers grant or pay rebates, allowances or commissions, based on volume purchased. The method of payment, or the allocation of rebates, allowances or commissions, may vary as well. For example, one supplier may make a monthly or annual payment to the franchisor, and another may prefer outlet-by-outlet payments to each franchisee or company-owned unit. Consequently, due to the variations that may exist, analyzing the purchasing, supply, and distribution arrangements as part of due diligence can be complex.

Another factor that is challenging for the due diligence process is that some supply contracts are not in writing, or exist as merely supplier-published rates or delivery schedules, or part of an exchange of emails. Or, there may be a master supply agreement or master distribution agreement, with many subordinate agreements. Also, supply arrangements are not always or necessarily dictated by the franchisor. Some supply arrangements are created and managed by franchisee groups or purchasing cooperatives formed by franchisees. Consequently, it is critical for the buyer to understand who had a “seat at the table” when the contract was negotiated.
The due diligence evaluation of the supply and vendor contracts (by the buyer, or even the seller) should focus on at least three critical issues: (a) the cost of the products/services—to the franchisees, the company-owned units and the franchisor—and whether any cost savings will be derived in the future; (b) the existence, type, and amount of rebates and commissions; and (c) the efficiencies (or inefficiencies) in utilizing certain products, suppliers, or distribution companies. These issues are interrelated, and the results of the due diligence investigation will impact supplier relationships after closing. For the buyer, while the cost of products to each outlet is obviously critical, some of the other aspects may be more important in determining whether the franchisees and the system will be able to derive benefits after the acquisition of the franchise network.

The first step in a due diligence process—for the seller or the buyer—is cataloging all of the purchase, supply, and distribution arrangements. In evaluating the target franchisor, the buyer should request a summary of the purchase contracts and rebates, and evaluate that information against the financial data that appears in other financial reports that are provided as part of the due diligence. A seller that has positioned itself for a sale should have a comprehensive and organized list of supply chain contracts with a summary of principal contract terms (or relationship terms), including products, quantity, pricing, rebates, delivery obligations, term, and any special features. Even for franchisors that are not contemplating a sale, this analysis, or something similar, should be conducted annually by the franchisor. This evaluation is, quite simply, a good business practice. In addition, the franchisor will need some of this data for its annual FDD update (in Item 8). While a franchisor should maintain a list of supply contracts, a potential buyer or bidder may ask for, in addition to a list of all suppliers, a list of the largest suppliers, by volume, by revenue, and by rebates; a spreadsheet of all supply and vendor contracts with a summary of all principal terms, including economic and non-economic terms (such as term of the contract, termination or modification rights, or special distribution conditions) and information about assignability in the case of a change in ownership or control of the franchisor. Verbal contracts should also be investigated.

After the buyer has the list of suppliers, a summary of the key terms of supplier contracts, and has copies of the contracts, a more thorough analysis should be conducted. One critical issue is whether the supply contracts are freely assignable by the franchisor, or whether supplier consent is required. Since the supply and distribution systems can be the lifeblood of a franchise network, franchise system buyers will most likely dig deeply into the contracts to fully understand the franchise system dynamics. Maintaining good, strong, and/or economically
useful supply arrangements after a franchise acquisition will be a paramount concern for the buyer.

Another issue to evaluate as part of the financial review involves rebates and commissions. Rebates can be a sensitive subject. Sometimes they are shrouded in secrecy or misunderstood due to a lack of transparent documentation or an inartful description. Generally, rebates and allowances are not illegal. However, under franchise laws and regulations, they must be disclosed. For franchisee relations, retention of rebates by the franchisor—even if disclosed and legal—may not be viewed by franchisees as fair and reasonable. Rebates, allowances, and commissions may be, and are, structured, in a variety of ways. Rebates may take the form of a volume discount, a future cash payment, a future credit against future sales, payments to an advertising fund, or cooperative advertising and marketing payments to a third-party supplier of advertising, merchandising, or marketing services. The variations are limited only by the creativity of the supplier and the franchisor. Due diligence should discover, and allow the buyer to evaluate, all of these variations.

In addition to financial and operational issues, a review of the supply and distribution arrangements systems will also shed light on franchise law compliance issues. For example, the FDD (in Item 8) must disclose information regarding existing supply arrangements, including revenues received by the franchisor or its affiliates based on franchisee purchases. The FDD disclosures and the supply contracts should be consistent. Discrepancies could be a harbinger of more than sloppy recordkeeping and may illuminate the potential for franchisee concerns about inaccurate disclosures, or improper use or retention of supplier rebates or allowances.

The supply chain due diligence may also require a review of ancillary documents and policies. For example, if the target franchisor is a multiple brand franchisor, or is closely affiliated with other brands, there may be contracts or policies, or merely internal memoranda, that describe inter-company allocations of rebates, marketing cooperative funds, or other financial incentives. These documents may not be readily available to the prospective buyer (e.g., they may not be placed in a data room), and/or the seller’s personnel who are responding to due diligence requests may not know of their existence. It is important to follow the money trail, and ask about possibly hidden or unknown documents or policies. Also, due diligence may require a review of the franchisor’s compliance with, and/or the suppliers’ or distributors’ compliance with, industry-specific laws or regulations. For example, the Food Safety Modernization Act\textsuperscript{19} requires
that companies involved in the food production and distribution chain comply with certain food safety regulations. If the franchisor is a source of products, it may need to comply. In addition, the food production or distribution companies with whom the franchisor has contracts must demonstrate compliance.

In summary, the due diligence review of purchasing, supply and distribution contracts should be designed to determine: (a) accuracy of reporting; (b) proper allocations of monies received and paid; (c) potential future cost savings due to system or network growth (in units or sales volume); and (d) the potential portfolio of existing contracts that may not, or cannot, be renewed or extended. Outside of the franchise agreements, the supply and vendor contracts may be some of the most important contracts that a buyer will review as part of the due diligence.

B. REAL ESTATE

In many M&A deals involving non-franchise companies with multiple outlets, the evaluation of the real estate—property ownership, lease/sublease obligations, valuation, mortgages and liens, required consents to transfer, etc.—is, or should be, a critical element of the due diligence process. In franchise systems, ownership or control over real estate by the franchisor plays a different role than with other businesses. However, in the vast majority of franchise systems, only a small percentage of the system outlets are owned by the franchisor or its affiliates. Likewise, few franchisors lease or sublease real estate to their franchisees. Whether the franchisor owns real estate, or leases the stores/restaurants/outlets, the total number of franchisor or affiliate outlets may be relatively small as compared to the entire network.

Many franchisors do not wish to take on the liability and financial exposure of real estate ownership. This relative lack of real estate ownership and control, however, should not be confused with the notion that franchisors do not wish to control the locations of their branded outlets, or that real estate issues are a relatively minor element of due diligence. The key for a prospective acquirer of the franchise system is to understand how the franchisor treats real estate at the franchisee level and operating unit level, and then implement the due diligence review from that perspective.20

For the buyer, the first step is to obtain an overall picture or snapshot of the real estate ownership issues. Some questions that may arise and merit further evaluation include:

20. See Chapter 4 for a more thorough discussion of real estate issues.
1. Does the franchisor or an affiliate own any of the real estate for the company/affiliate outlets?
2. Does the franchisor or an affiliate lease the real estate for the company outlets?
3. Does the franchisor or affiliate own or lease real estate for the franchised outlets, and then lease or sublease the property to the franchisee?
4. Even if the answer is “no,” or generally “no,” to these questions, does the franchisor exercise control over franchised outlets through other mechanisms?

The answers to these basic questions will guide the due diligence of appropriate real estate documents.

Even if the franchisor or an affiliate does not own or lease many franchisee properties, many franchise agreements provide for a contingent or conditional assignment of a lease, from the franchisee to the franchisor, in the event of a termination of the franchise agreement or the franchisee’s lease. These conditional assignments may be in the form of a lease rider or other amendment to the franchisee’s lease. They may state that the landlord must provide notice of default to the franchisor and an opportunity to cure the default. The buyer should evaluate whether such contingent assignments are standard or required as part of the franchise sale and/or franchisee-lease transaction, including how many outlets have an executed contingent assignment or rider; whether the form varies from outlet to outlet, by landlord, or by the year or time period executed; and what may be the franchisor’s obligations, rights, and liabilities under the conditional assignments. It is also critical for the buyer to determine whether the franchisee and franchisor have actually obtained executed lease riders or similar documents, and whether the correct entities are identified in the relevant documents.21

If the franchisor or an affiliate leases property for its company-owned outlets or for subleasing to franchisees, the buyer must evaluate (a) the terms and conditions of leases, and (b) whether the owner, landlord, or lessor has any pre-approval or consent rights regarding subsequent ownership or operation of the outlet. Most franchise agreements permit the franchisor to transfer the franchise without securing the approval or consent by the franchisee. However, such unfettered transfer rights may not be available under leases. Consequently, a buyer (and a selling franchisor) needs to understand whether (and how many)

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21. The authors have seen many situations in which the franchise agreement is executed in the name of the franchisee entity, and the lease and lease rider are executed by an entity that is not the franchisee, and/or the lease is not executed by the landlord. These deficiencies may make enforcement of real estate rights problematic.
landlords can delay or derail the transaction due to the right or power of a landlord to approve the assignment of the selling franchisor’s interest in the lease. If a landlord has such rights, it will have the leverage to extract concessions and changes to the business, and/or financial terms of the lease.

Another factor to consider is whether any real estate restrictions, covenants, approvals, consents, or other provisions have been recorded in the appropriate real property records. If so, these restrictions create a lien on, or an impediment to a transfer of, the property. While the practice of recording these restrictions as liens is not prevalent in franchising (except in hotel franchising and in franchise networks in which there is a large investment in real estate by the franchisee), the due diligence should investigate these potential restrictions.

Real estate issues may not necessarily create franchise-specific legal or operational concerns for the buyer. However, real estate is an area that nevertheless merits close coordination with other counsel representing the buyer. One possible allocation of resources is to have franchise counsel conduct the initial assessment of the real estate and its impact on the franchisor, the franchised network, and the ability of the buyer or surviving entity to maintain the same level of control over the real estate after the closing. After the buyer and its franchise counsel determine which properties may have real estate issues, then the buyer’s real estate counsel can step in and conduct the detailed real estate due diligence.

C. FINANCING

Few franchisors provide financing, loans, or financial assistance to franchisees. In fact, many franchisors, particularly those that do not have large networks (that is 500 or more outlets), eschew providing financing. Thus, the first line of due diligence inquiry is to determine whether any financing has been or is being provided, and the nature and scope of that financing.

Financing, in franchise parlance and for FDD disclosures, may take many forms. It may be a loan to a franchisee for its initial franchise fee, initial investment costs, or a particular initial (or pre-opening) purpose. Franchisors may also loan money to franchisees during the term of the franchise agreement for renovations, remodeling, new equipment, or the introduction of a new product or service. However, financing may go beyond simply loaning money. Financing also includes serving as guarantor of the franchisee’s note to a bank. Financing may include property or equipment leasing, or a lease guarantee, and may also include arrangements between the franchisor and lending or leasing sources. These arrangements may involve payments or other consideration paid to a lending source to secure or induce the lender to finance a franchisee, or payments by a lending source to franchisor in consideration of the franchisor making its network available to, or
steering franchisees to the lending source. These financing arrangements may involve affiliates of the franchisor. Therefore, due diligence should investigate all direct and indirect financial relationships with franchisees and third-party lending and leasing sources.

One source to review regarding financing is the franchisor’s current and past FDDs. The FDD must disclose (in Item 10) whether the franchisor provides financing or financial assistance to the franchisees (or to a group or subset of franchisees). The FDDs may not be accurate or may not be complete, but they are a good starting point. Also, since an FDD discloses only then-current information about a franchise offering, and financing that may have been offered in prior years may not be disclosed in the current FDD, due diligence should examine older FDDs. The review of the FDDs is necessary to confirm the accuracy of other due diligence and to determine if the FDD disclosures to the franchisees have been consistent with the information revealed during due diligence. Of course, the prospective buyer should start by providing the franchisor a list of questions or preliminary due diligence request that seeks baseline data, and then conduct follow-up by speaking directly to management.

The goals of financing due diligence include: (a) cataloging and understanding past, present, and future financing granted or offered to franchisees and/or relationships with financing sources; (b) assessing potential costs and liability, as well as future revenue streams (and the possibility that those revenue streams may dry up or develop into a bad repayment risk); and (c) evaluating the accuracy of the prior FDD disclosures.

**D. Financial Reporting**

As franchise systems mature, as technology advances, and as franchisors and franchisees adopt and implement new data collection and reporting services, the types and volume of information available to franchisors, and therefore available to prospective purchasers of, or investors in, a franchise system, increases dramatically. A critical outgrowth of these developments is the availability of, and need for, financial reports that reflect franchisee, franchised outlet, and franchise network results. Financial reports include those that franchisees are required to prepare and provide to the franchisor, as well as reports that the franchisor prepares. Depending on the type of business, the revenue streams, and other factors, a franchisor may require that franchisees prepare, or submit data that can be used to prepare, the following financial reports (or at least several of these reports):

1. weekly or monthly sales reports;
2. weekly or monthly royalty reports and royalty payment reports;
3. weekly or monthly advertising and marketing payment or expenditure reports;
4. weekly, monthly, or quarterly, inventory reports;
5. quarterly or annual financial reports, such as a sales, balance sheet, and income statement;
6. quarterly or annual financial statements, which, in some cases or situations, may be audited, or prepared by a third party accountant; and/or
7. periodic delinquency reports and/or accounts receivable reports, that indicate franchisee failure to pay royalties, advertising contributions, and/or product purchases.

These reports are designed to provide a snapshot of the financial health of each franchised outlet, and, if aggregated, the financial health of the franchise network. Franchisors will often create compilation reports from the individual franchisee reports to assess overall network performance and/or to evaluate trends. The picture or pictures created by these reports can be broad, or “macro,” relating to the entire system, or may be narrow, and “drilled down” to a single outlet. The financial reports may be able to highlight poorly performing outlets, and/or top performers. The franchisor may utilize these reports for system-wide comparisons and benchmarking. Therefore, these reports may also highlight poor performance by the franchisor in evaluating and managing delinquent franchisees. The financial reports, and the franchisor’s actions taken in response to the reports, provide keys to areas in which the buyer can focus resources to improve performance after the acquisition.

The first step of due diligence is for the buyer to evaluate what data is being collected, and how it is being used. A corollary of this evaluation is determining what is not being reported and/or what data is being ignored. The buyer also should evaluate how the data is collected, whether there are gaps in collection, and if there are any discrepancies in the reports. These financial reports are the building blocks for the overall network of financial reports and financial statements of the target franchisor. Therefore, the buyer, working with its accountants, should utilize these reports to assess the financial health of the system and use these as part of the price valuation for the transaction.

The financial reports, however, are more than simply keys to develop a valuation or purchase price for the target franchise system. They provide a window into franchise operations, and potential franchise system problems. Which franchisees are delinquent in their payments? What is the magnitude and timing of these delinquencies? Which franchisees are trending upward, or downward, on sales and/or profitability? Are there local or regional differences in sales, productivity,
or profitability? Can changes in financial results be linked to a new marketing campaign or the introduction of a new product or service? Are there differences in productivity or profitability that may be attributable to the size or age of the outlet? Which franchisees are doing well and why? Will possible financial problems at individual outlets become a precursor to operational deficiencies, or are they predictors of late payments to critical vendors or the property owner, or an inability to maintain system standards? The buyer, by evaluating all of the data, can piece together a picture that may highlight areas that may require additional financial or human capital resources following the acquisition.

The due diligence review of financial reports is not only a review of spreadsheets and paper/electronic reports. While the paper review process is critical and time consuming, the buyer’s due diligence should involve follow-up steps. After issues have been identified, the buyer, armed with data and intelligence from financial reports, should contact members of the franchisor’s management and/or operations team to further explore the issues. These management discussions allow the buyer to “get behind” the numbers and understand the personal and operational dynamics that underlie the reporting issues.

Financial reporting is one of the main data sources that a franchisor uses to evaluate its business and network, and the data is critical to developing and implementing plans for growth. This data source is just as critical for the potential buyer of, or investor in, the franchise network. Just as the franchisor should not sit in its office and review data, and must get into the field for a personal hands-on evaluation, the prospective purchaser and its team must be ready to do the same—after reviewing the reports, the purchaser should send follow-up questions and requests, and conduct interviews with the individuals within the franchise network (franchisees and management) to round out the evaluation of the financial reports.

E. Antitrust Issues

For many years, the operation of franchise networks created a host of potential—if not actual—antitrust concerns and issues for franchisors. However, as antitrust jurisprudence has evolved, and, as some commentators say, the antitrust pendulum has swung back to more “permissive” and less rigorous enforcement of antitrust laws, antitrust issues have become less critical to franchise systems. Or at least the specter of painful and costly antitrust investigations and potential damage awards is less likely to arise. Therefore, in that environment, one might assume that antitrust issues are less important in franchise M&A due diligence.
However, even with the ebb and flow of antitrust issues, franchisors and potential buyers of franchise systems cannot, and should not, ignore antitrust issues.\(^{22}\)

Franchise networks can be a virtual “petri dish” of potential antitrust issues. They operate in ways that may invoke “horizontal” restraints; that is, actions among businesses at the same level in the distribution chain, such as franchisee-to-franchisee action and discussion, or franchisor-to-franchisee actions and discussions where the franchisor is also operating retail outlets similar to franchisees. Also, franchise networks, or franchisors, may take actions that invoke “vertical” restraints; that is, a franchisor dictating, coercing, or requiring actions by franchisees who are at a different level in the distribution chain. Franchisors will often seek to influence the prices charged at franchise system outlets for goods or services. Franchisors may negotiate prices at which suppliers will sell or resell products to franchisees. Franchisors may collect rebates or commissions from suppliers based on products sold to franchisees. Franchisors may proscribe the types of products that a franchised outlet may offer, and/or the territory where they may be offered, and/or the customers to whom franchisees may offer or sell products or services. Franchisors may require that franchisees purchase certain products or services from the franchisor, or may require that franchisees purchase a certain level or volume of products. Franchisors may sell products or services to franchisees and/or to company-owned or affiliate-owned locations, and the prices for those products may not be uniform. All of these business practices, while generally legal and permissible—in franchised and non-franchised commercial endeavors—may, if not conducted properly, violate (or be alleged to violate) one or more federal or state antitrust laws.\(^{23}\) Some of the issues that might arise, and/or claims that may be alleged, include: horizontal price-fixing; vertical price-fixing, which could be either maximum resale price maintenance or minimum resale price maintenance (although these claims will more likely arise under state law because of Supreme Court decisions in 1997 and 2007 that generally allowed minimum and maximum resale price maintenance to be evaluated under the “rule of reason”);\(^{24}\) tying arrangements; territorial and

\(^{22}\) See Appendix G for a more detailed discussion of antitrust issues.


customer resale restraints; price discrimination; exclusive appointments and exclusive arrangements; and refusals to deals or group boycotts.

While the pendulum has shifted, and many practices of franchisors are legal or are analyzed under the “rule of reason” standard permitting a wide latitude of actions, a franchise system buyer’s due diligence should (a) identify business practices that may be problematic, (b) identify potential issues, and (c) determine if there exists potential exposure for the franchisor before closing and/or for the franchise network or buyer after the acquisition. If there are lingering potential antitrust concerns, the buyer should address those with the selling franchisor as part of the negotiation process.

One of the first areas of inquiry to uncover potential antitrust issues is the FDD. Item 8 of the FDD (and the franchise agreements) should describe franchisee purchase obligations, rebates and commissions, franchisor sales of products to the franchisees, advertising, pricing policies, and vendor/supplier relationships. In addition, some of the disclosures in the FDD may provide safe harbors for franchisors to engage in restrictive sales practices. However, if the FDD does not accurately describe the product sourcing and pricing practices of the franchise network, this deficiency may signal problematic franchise disclosures. With the FDD disclosures creating an initial roadmap for antitrust issues, the buyer should review the vendor and supply contracts, the financial statements, and the financial reports. The due diligence should also include a review of correspondence with the franchisees and vendors, looking for issues related to prices (such as a collaborative establishment of retail prices), allocation of territory and customers, and payments of rebates, commissions, or kickbacks from, product purchases. Another area of inquiry includes franchisee meetings, including national and regional meetings of franchisees (with or without the franchisor), franchisee advisory meetings, advertising council meetings, and similar network operating groups where several franchisees meet to discuss operations, advertising, and/or pricing. While many of these meetings should not raise antitrust concerns, a buyer needs to understand the network dynamics and, hopefully, gain a sense of whether any improper actions or discussions have occurred.

Another area of potential concern involves termination of franchisees, or adverse actions taken by a franchisor toward a franchisee. A franchisor may have one or more fair, legitimate, and legal reasons to terminate a franchisee, refuse to renew a franchisee, or refuse to grant additional territories or additional units. However, if adverse actions are not taken by the franchisor independently, but are the result of collusion or collaboration with one or more franchisee (who are or may be “competitors” of the targeted franchisee), the franchisor’s actions may be seen as collusion or a conspiracy, and such action may be viewed as a
potential violation of an antitrust law. Therefore, the review of franchisor-franchisee communications becomes critical in analyzing the motives of, and potential liability for, franchisor actions.

As noted earlier with other aspects of due diligence, the review of antitrust issues should include interviews with critical management personnel to gain an understanding and context for various franchisor actions. In addition, in light of the specialized nature of antitrust issues, and nuances in evaluating antitrust concerns, this aspect of franchise due diligence should be coordinated carefully with, or undertaken by, experienced antitrust counsel. (See Section II of this chapter regarding coordination with other counsel.)

F. **Intellectual Property**

Trademarks, and the trademark licenses from the franchisor to its franchisees, are at the heart of the franchise relationship. However, franchise networks have become more complex and sophisticated over the years, and they utilize significantly more technology than they did even five or ten years ago. Therefore, the intellectual property that is employed by franchisors is broader in scope than simply a few trademarks and logos. For example, the types of intellectual property used by franchisors and franchise systems may include:

1. trademarks and service marks;
2. trade dress;
3. copyrights;
4. URLs;
5. website agreements;
6. Internet agreements;
7. social media-related contracts;
8. confidential manuals;
9. trade secrets (recipes, methods of operation, etc.); and
10. proprietary software.

The buyer needs to assess all of these crucial assets.

Some of the critical questions to ask—and questions that will hopefully be answered in the due diligence process—include:

25. See chapter 7 of this book for a detailed discussion of trademark considerations in franchise transfers and acquisitions.
1. whether the franchisor owns all of the IP;
2. whether the IP is freely assignable to the purchaser;
3. whether there are any limitations on the use and sublicensing of the IP;
4. whether there are agreements in place that limit current or future use of the IP;
5. whether there are existing or potential infringers, and how has the franchisor addressed those issues;
6. whether there are any existing or potential claims against the franchisor for infringing use of another person’s or entity’s IP; and
7. whether there are confidentiality and trade secret protection agreements in place with management, employees, and/or third parties or vendors that provide protection for the intellectual property.

Many franchisors maintain (or have outside counsel maintain) a database of marks and other intellectual property. These lists or databases should be an essential due diligence item, along with questions and requests for information that are designed to answer many of the questions or issues noted above.

As with other aspects of the due diligence process, one line of inquiry should begin with the FDD. Items 13 and 14 of the FDD are designed to disclose critical information about the trademarks, patents, and copyrights that are central to the franchise system. In Item 11 the franchisor is required to disclose information related to computer systems and technology. As more franchisors expand their use of technology, and develop social media policies, Item 11 and other FDD items tend to include more intellectual property information. However, the FDD is only the beginning of the analysis. Many elements of the intellectual property are not required to be disclosed. For example, in describing the trademarks in the FDD, a franchisor is only required to disclose the marks that are “the primary trademarks” that “the franchisee will use to identify the franchised business.” A franchisor may have dozens, if not hundreds, of marks (for menu items or products) and slogans that it employs in the business, and many of these will not be in the FDD. Therefore, it is incumbent on the buyer to request, obtain, and review the detailed information on trademarks, trade names, and slogans. Furthermore, these marks may not be limited to the United States. The trademark and intellectual property inquiry should also include all foreign marks and agreements executed for operations, or even potential operations, in foreign companies.

Since a central component of the franchise company’s assets will be its intellectual property, the company’s trademarks and other intellectual property may be quite considerable. In short, the analysis should include a review of schedules of trademarks, service marks, trade names, copyrights, and patents that are owned,
Due Diligence on Franchise Systems

Licensed, or used by the franchisor or its affiliates, including the evidence of all registrations and the agreements. Does the company have records of all filings, renewals, and agreements? Are there any limitations to using, or licensing others to use, the marks? The evaluation should also include a review of all disputes, infringements, or other actions regarding any of the intellectual property and all agreements regarding the intellectual property. The due diligence should include questions as to the status of the marks, including the ownership of the marks, unregistered marks, possible infringements, trade dress infringement, liens, the effect of any state trademark anti-dilution statutes, and any pending controversies involved in the marks. The due diligence process should also include a review and analysis 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 limitations on the purchaser’s use of the marks following the closing.

Trademarks are only the beginning. The intellectual property inquiry should also include domain name registrations, website hosting agreements, intranet agreements, and software development and licensing agreements. The buyer must obtain assurances that the selling franchisor has access to, and ownership of, all critical software and source codes that are necessary to operate and support the franchise system.

Sometimes the inquiry should dig below the surface of the existing files and documents. For example, if the franchisor has hired third-party vendors to create artwork, designs, advertising copy, websites, etc., due diligence should evaluate and determine whether the franchisor executed agreements with these third parties that clearly state that (a) the products, materials, and services were provided on a “work-for-hire” basis, (b) the franchisor owns all copyrights and other intellectual property rights in the derivative works (as well as all preliminary designs, sketches, and work), and (c) the creator has assigned all rights it has or may have to the franchisor. The buyer needs to assure itself that the intellectual property assets that it is acquiring will be transferred without any cloud over ownership and use.

Another intellectual property related issue that arises due to technology and payment issues relates to the franchisor’s and its franchisees’ compliance with Payment Card Industry Data Security Standard (PCI DSS). Retailers of all types that accept payment through credit cards and debit cards (which is just about all retailers) must comply with industry standards for the protection of cardholder information. Prospective purchasers of franchise systems should request and review all policies, processes, communications, and computer programs that are designed to protect this data and comply with the rules.
Although the intellectual property due diligence will start with the review of the critical trademarks, that inquiry is only the beginning. The prospective purchaser must continue to peel back the layers of the intellectual property “onion” to uncover how the franchisor and the system use various components of intellectual propriety, and then obtain assurances regarding proper ownership, use, and licenses of the intellectual property.

In many deals, experienced intellectual property counsel will undertake all or some of this review rather than franchise counsel. Nevertheless, franchise counsel’s input is critical to assessing the impact of that review by intellectual property counsel.

G. Other Franchise-Related Issues

As previously noted in this chapter, each franchise system target and each franchise acquisition will create special issues or challenges, and many of these will relate to the industry in which the franchise system operates. For example, the acquisition of a franchise system in the health care field (e.g., in the elder care assistance business, or a chain of dental clinics, or a chain of urgent care centers) will require specialized due diligence into health care, reporting, federal and state insurance compliance, Health Insurance Portability and Accountability Act (HIPAA) compliance, and other matters. Due diligence of these industry-specific issues should be coordinated with buyer’s other counsel. There are, in addition, other legal, business, or regulatory issues that may arise more frequently in some franchise system acquisitions than in others. Some of these issues, while applicable to many M&A deals and target acquisitions, may have a special “franchise angle” due to the compliance obligations imposed on franchisees. The following list, although by no means exhaustive, illustrates several of these potential issues:

- **Data Protection.** Franchisors and franchisees must comply with federal, state, and foreign country laws and regulations regulating the use, dissemination and protection of customer data, and maintaining the privacy of personally identifiable information. Compliance with these laws and regulations have become more critical over time, and the breaches of data security are likely to have greater negative consequences for franchisors and their franchise systems in the future. Franchisors may (or may not) have established standards and protocols, and may (or may not) have suggested or required that their franchisees follow these rules, procedures, or industry guidelines. Due diligence should evaluate both franchisor and franchisee compliance. Even if the franchisor is not legally responsible for the franchisees’ actions, the negative public relations fallout from a franchisee mistake could be devastating
to the entire system. Therefore, due diligence should attempt to assess the risk of a potential problem.

• **Credit Card Data Protection.** Related to the data protection concern is the protection of credit card information. There is, in the U.S., a standard for protection, called the Payment Card Industry Data Security Standards, or PCI DSS, established by the Payment Card Industry Security Standards Council (http://www.pcisecuritystandards.org). A buyer should evaluate whether the franchisor complies with these standards and requires its franchisees to comply (for example, through requirements in the franchise agreement or the manuals).

• **State Taxation.** While compliance with tax laws, and payment of all applicable state and federal taxes is not a franchise-specific issue, as all companies must comply with state and federal tax codes, there are some franchise-specific issues that may arise. In the past five to ten years, many states, in an effort to increase revenues, are seeking to impose taxes on foreign (out of state) franchisors as well as the revenue received from in-state franchisees. The process has been haphazard, and some franchisors are not even aware of a potential tax obligation until a notice has been received. Therefore, it is critical for the buyer’s franchise counsel to communicate and coordinate with the buyer’s corporate and tax counsel and the CPA to evaluate this potential issue as it applies to the selling franchisor and to the operations post-closing.

• **Gift Cards.** Gift card laws can be present in many types of businesses, but in franchise systems they create additional issues that need to be evaluated. Federal law—Regulation E\(^ {26} \)—governs how quickly gift cards may expire and when/if fees may be charged, and it also regulates the disclosures an issuer-franchisor and/or seller-franchisee must make to purchasing consumers. Because Regulation E is applicable to any entity in the distributive chain, both franchisors and franchisees must ensure they comply. Perhaps just as importantly, Regulation E specifically does not preempt any state gift card law that is more protective of consumers, so franchisors/franchisees must also comply with state gift card law in any state where they operate. Additionally, many states subject unredeemed gift card funds to their abandoned property/escheat provisions, so franchisors should analyze whether they may have to surrender unredeemed gift card funds, so called “breakage,” to the state. Finally, because most state franchise laws do not specifically regulate gift cards, a buyer should analyze whether and how the franchise agreement classifies and treats gift card sales.

V. INTERNATIONAL FRANCHISE ISSUES IN DUE DILIGENCE

Many U.S.-based franchise companies have expanded internationally; therefore, it is not unusual to have an international component to a franchise due diligence project. Although there seldom is any real certainty when reviewing a franchise company’s domestic activities, there will be even less certainty when reviewing a franchisor’s foreign operations.

A. TYPE OF PROGRAM

The first step in conducting international franchising due diligence is to identify whether the franchisor has used single-unit or direct franchise agreements, development agreements or master franchise agreements, or a combination of those approaches. Franchisors may also use joint venture operations or an area representative model in some countries, although those models do not seem to be as common in international transactions as they are in the United States. When a master franchise agreement is in place, there also may be sublicense agreements. Some franchisors commonly use a combination of these approaches in their international operations. The buyer needs to review a copy of all of those agreements.

Some of the critical terms in international franchise agreements often include: (i) territorial exclusivity; (ii) territorial expansion options; (iii) development schedules; (iv) noncompetition clauses; (v) fee structures; and (vi) tax withholdings/gross-ups. It is not uncommon to find exclusive development or master franchise agreements. When those agreements exist, the buyer must determine the extent of the exclusivity, the franchisor’s retained rights, whether the franchisee has met the development schedule, and the franchisor’s remedies if the development schedule is not met. A recent Cornell University study of international food master franchises found that a very large percentage of master franchisees do not meet their development schedules.27

Furthermore, the buyer should review the royalties and other continuing payments. Have they been timely made? Are there currency or exchange control restrictions? Have all applicable withholding taxes been paid? With respect to

withholding taxes, has the franchisor grossed-up the royalties to receive the same net amount after taxes are withheld?

The agreements should also be reviewed to determine whether certain documents can be translated, who bears the costs of the translation, and who owns the copyrights in the translated materials. Other critical provisions to review include: (i) Do the agreements permit assignment to an asset purchaser or to a new entity or person in control of the franchisor with or without the franchisee’s consent? (ii) Can the franchisor freely assign or transfer its rights in the agreements, or sell its stock on a third party? (iii) What restrictions are there on the right of the franchisee to transfer the agreement or its interests? and (iv) Does the franchisor have a right of first refusal to buy the franchisee’s assets? With respect to any subfranchise agreements, the buyer should determine whether the franchisor or its nominee can assume those agreements if the master franchise agreement is terminated.

The purchaser should also determine whether the franchisor adapted its franchise system to the local market and, if so, what changes were made. Will the master franchisee or developer be able to source certain products locally? If so, what approval rights over the local suppliers does the franchisor have? If the franchisor has been supplying certain products to its franchisees, the foreign country’s import or other laws that might restrict the importation of certain types of products should be examined.

**B. THE FOREIGN MASTER FRANCHISEE OR DEVELOPER**

The buyer should determine whether the franchisor conducted its own due diligence when contracting with the foreign master franchisee or developer, and if it took steps during the relationship to ensure that the foreign master franchisee or developer did not violate U.S. or foreign laws. In this regard, the buyer should first determine whether the seller conducted an examination of the Specialty Designated Nationals List data site maintained by U.S. Department of the Treasury, and whether the seller conducted other investigations of the prospective master franchisee or developer. Many foreign master franchisees or developers may be significant players in their own markets and have multiple franchised concepts in their portfolios. As discussed below, that ownership of other brands may require an analysis of those competitive concepts. Many foreign franchisees may be larger than the franchisor, thus changing the franchise negotiating and relationship dynamics. During the course of the relationship, the franchisor will also want to make sure that the master franchisee or developer has not engaged in any activities that could violate the Foreign Corrupt Practices Act or local anti-bribery statutes.
C. Complying with Foreign Franchise and Other Laws

A critical part of the due diligence review is determining whether the franchisor, and in some countries the franchisee, has complied with any applicable local franchise laws or other laws. Some of the legal issues to review include:

1. Are there any local franchise disclosure laws?
2. If yes, was a disclosure document provided in a timely manner?
3. Is any registration required under the franchise laws, intellectual property laws, or other laws, and, if so, by which party? Were those filings made?
4. Are there local relationship laws that would affect the terms of the franchise documents and/or ability to terminate?
5. Do other laws, such as a commercial agency regulation, affect the relationship?
6. Are there any foreign exchange or currency laws restricting the transfer of funds out of the country?
7. What are the local country’s withholding tax rates, and is there a tax treaty with the U.S. reducing the withholding amount?
8. Have the intellectual property rights of the franchisor been properly protected through registrations and filings where needed?
9. Are there any local anti-bribery laws?

As noted above, in some countries the commercial agency laws may apply to the termination of a franchise agreement. This might require the franchisor to make an indemnity payment to the terminated franchisee unless just cause existed for the termination. In some countries, like Brazil, registrations are required with local government offices in order to allow funds to be transferred out of the country.

If the franchisor has an international disclosure document, the buyer should review it to determine whether it truly reflects the agreements provided to the foreign franchisee, or is just a rehash of the U.S. FDD. Some franchisors give their U.S. FDD to foreign prospects with an admonition that it is being provided for informational purposes only and does not reflect the nature of the international franchise arrangement. However, providing a U.S. FDD poses the risk that the information is not relevant to the foreign jurisdiction and could be found to be misleading.

D. Complying with U.S. Franchise Laws

Although U.S. franchise law does not generally apply to the foreign sale of a franchise, there are exceptions. The FTC Franchise Rule only applies to the offer or sale of a franchise to be located in the U.S. or its territories, but the territorial
scope of the state franchise laws also needs to be examined. In particular, the franchise law of the state in which the franchisor is based needs to be reviewed to see whether its law might extend to a franchise to be operated in a foreign country. In some states, state law may apply to the sale of a franchise to a U.S. resident for operation of the franchise in a foreign country. If the franchisor is based in New York, for example, New York claims extraterritorial application of its franchise law. Thus, a New York franchisor would have to provide all prospects, including a foreign franchisee, with a FDD registered in New York, unless an applicable exemption is available.

Some U.S. based franchisors use an international disclosure document even though there is no requirement to do so. Other U.S.-based franchisors refuse to provide a disclosure document unless required to do so by the local law of the franchisee’s territory.

E. Complying with Other U.S. Laws
A variety of other U.S. laws may come into play, such as the Foreign Corrupt Practices Act, various export and import controls, trading with countries on the restricted list, and the Specially Designated Nationals List. Many of these areas may be beyond the expertise of the franchise lawyer. Therefore, a decision should be made early in the due diligence process with the primary corporate counsel to determine which firm will be responsible for ascertaining compliance with these laws. This is another area where appropriate representations and warranties are particularly important in order to protect the buyer.

F. Master Franchise Issues
The master franchise situation presents additional due diligence review issues if the master franchisee has any subfranchise agreements in place. Among the issues to be reviewed are:

1. Are the subfranchise agreements two-party agreements (master franchisee and subfranchisee) or three-party agreements (franchisor, master franchisee and subfranchisee)?

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2. Are the forms of subfranchise agreement based on a model form recommended by the franchisor or are they the master licensee’s own version? If the latter, does the franchisor retain approval rights over those documents?

3. Were any local registration or disclosure requirements complied with by the master franchisee when selling subfranchises?

4. Have the sublicensees complied with the franchisor’s system and made timely royalty payments to the master franchisee? Has the master franchisee in turn made payments to the franchisor?

5. Has the master franchisee made correct remissions of royalties and advertising funds?

6. What happens to the sublicense agreement if the master franchise agreement is terminated or expires? Can all or a select number of sublicense agreements be assigned to the franchisor or its nominee?

G. TRANSLATIONS/COPYRIGHT OWNERSHIP

Many franchisors provide master franchisees with disclosure documents, franchise agreements, manuals, and other collateral documents in the franchisor’s own language. While this is often permitted by the laws of the master franchisee’s jurisdiction, there may be practical and legal reasons why using the language of the master franchisee’s jurisdiction may be necessary, required, preferred or prudent for some or all of these documents.

As an initial consideration, the cost of translating a long disclosure document, agreement or manual can be quite expensive and time-consuming, and there is no assurance that the translation will be accurate and/or convey the intended meaning. For that reason, all documents that are going to be translated should include a clear statement as to which language version is controlling. The buyer should examine whether these agreements have a controlling language provision and should also determine if the master franchisee or developer is fluent in the controlling language. Failure to do so can result in misunderstandings or misinterpretations and result in unintended misrepresentations.

It is important for franchisors to comply with local language requirements. In several countries with disclosure laws, the disclosure document can be provided in the franchisor’s language, but documents filed with the authorities (such as a trademark license) must be in the local language. In those situations, filed documents commonly have side-by-side translations of the document in both languages. Some countries require that all or certain documents be in the local language, and it is important to determine if the franchisor complied with the local language requirements.
Since the costs of translations can be quite high, the franchisor will often find ways to pass these costs on to the master franchisee. The buyer should determine how the franchisor handled the initial translation costs, and whether the franchisor included it in its initial fee structure with no separate charge to the master franchisee. For translations that occur after the execution of the master franchise or development agreements, a determination should be made as to who is responsible for bearing those costs.

When a franchisor allows a master franchisee or developer to translate a sensitive document, such as a manual, into its own language, the franchisor should require that the copyright in the translation be owned by the franchisor, and not by the translator or master franchisee or developer. The buyer should examine the master franchise and/or development agreements to ensure there was a procedure to establish this copyright.

The subfranchise agreements used by the master franchisee almost always will be in a local language. Did the franchisor require the master franchisee to use a prescribed form of subfranchise agreement, or did it instead simply retain approval rights over the terms and form of the master franchisee’s own form of subfranchise agreement? In such situations, did the franchisor require the master franchisee to provide a translation (sometimes a certified translation) of the subfranchise agreement at its own cost?

Whether the translation is certified or not, there will almost always be language nuances that do not translate perfectly, especially if the translator does not have a legal background, and with respect to operations manuals, subject matter knowledge. Every franchisor involved in international sales activities must be aware of the risks associated with these nuances. The franchisor must be able to maintain the flexibility to address and resolve misunderstandings or misinterpretations due to an inaccurate translation as early as possible, preferably in the negotiations before the master franchise agreement is signed. The buyer should search for any existing language disputes.

**H. Exit Strategy/Dispute Resolution**

A careful review of the documents is needed to determine the franchisor’s exit strategy for its foreign franchise agreements. Among things to examine are:

1. Under what circumstances can the master franchise or development agreements and/or any subfranchise agreements be terminated or reformed?
2. What happens with respect to existing open units if the basic agreement is terminated or expires? Do they terminate automatically? Can the franchisor assume them?
3. Are any indemnity payments required to be made under the contract provisions or local law?
4. What is the controlling law and dispute resolution forum?

I. USE OF LOCAL COUNSEL TO ASSIST IN THE REVIEW
A U.S. licensed lawyer cannot adequately determine whether the franchisor has complied with all local foreign laws. Therefore, it is prudent to have local foreign counsel assist in the due diligence review process. However, many buyers may not want to incur the legal costs to do so; therefore, this burden brings additional risk exposure on the U.S. lawyer conducting the review.

VI. TECHNOLOGY-RELATED ISSUES IN DUE DILIGENCE

A. DATA ROOMS—WHO SETS THEM UP, POPULATES DATA, AND ORGANIZES THEM
Technological developments have impacted many aspects of the legal profession, and the M&A due diligence process is no exception. In the past, due diligence often involved the seller and their attorneys assembling large binders of documents and then making them available for the buyer and their attorneys and other consultants to review in data rooms at the seller’s or their attorneys’ offices. While the underlying process is still the same—sellers and attorneys assembling the documentation, and buyers and their counsel reviewing it—the method of doing so has changed dramatically in the last five years. Data rooms today are largely electronic. On small deals, documents may be assembled on discs or made accessible through a law firm’s intranet. However, for larger deals the data room is usually managed by an outside vendor whose sole task is just that.

Electronic data rooms have many advantages. They make it easier to share the data with a larger group of reviewers and easier to update materials. Often times the level of access to documents can be determined on a document-by-document basis. For example, for some documents the reviewers may be able to print them, while other documents will only be accessible for review on the computer screen. The seller can track and examine the documents the prospective buyer is reviewing and the amount of time the buyer is spending on reviewing particular documents or on the site overall. Subsequently, for the reviewers, this opens the

30. This data may be deceiving. Many attorneys prefer to review paper copies of the
do the due diligence review on their own time and from wherever they wish. Furthermore, several reviewers can be looking at these documents at the same time.

Another important aspect of the electronic data room is that reviewers no longer have to travel to the seller’s or their attorneys’ offices to do the review. There are many advantages to this accessibility, but it should be noted that it also affects communication between seller’s and buyer’s counsel. When due diligence was performed on-site, the buyer’s counsel had the opportunity to ask questions regarding the documents directly to the seller’s counsel or the seller’s officers. Such questions often led to the discovery of additional information about the seller that formulated further questions and document requests. Today, such questions must be held for conference calls that sometimes take place many days, or even a week, after the buyer’s counsel reviewed the documents. The seller may not have the document in question in front of them and the discussion over the telephone may not be as fruitful as an in-person meeting with the document present for review.

**B. Technology Review Challenges**

While many aspects of franchise due diligence do not vary based on the size of the franchise system, certain aspects of the process can present challenges for larger franchise systems. For example, the franchise regulatory review will likely be the same, regardless of the size of the system. However, in systems with hundreds, or thousands, of franchisees it would be a Herculean effort to review all relevant documentation, and the buyer is rarely interested in paying for such a review. Each system is unique, but a general approach will be to try to identify sub-groups of franchisees and then to review a sampling of the documentation for those franchisees. For example, franchisees could be grouped by the year(s) that they entered into their franchise agreements, on the assumption that the franchisor used the same franchise agreement for all franchisees that year. In addition, it may be appropriate to group franchisees geographically, if the system has used different franchise agreements in different regions. The seller is then asked to provide a sampling of representative agreements from each group, as well as all agreements for which material amendments were negotiated. To the extent the

due diligence documents and will print all the documents for further review, thus throwing off information gathered by the data room provider regarding time spent on the site or on reviewing particular documents.

31. This situation is often the case where a franchisor historically used master franchisees, but has since acquired the master franchisees.
franchisor has appointed master franchisees, the master franchisee’s registrations and disclosure documents should also be reviewed.

C. AVOID “POST-MERGER DISCOVERY SURPRISES”
Legal due diligence on a target company is supposed to give the buyer a fair idea of what it is buying. A thorough review of legal documents and interviews with management in most instances will highlight the key issues that exist. However, there are many reasons why a buyer may find additional issues after a deal is closed. For example, issues may exist that the seller’s management did not identify as legal issues. Such surprises can be hard to identify from documents alone. Instead, during due diligence the buyer should try to schedule interviews with management to discuss the due diligence checklist. Frequently, such discussions and interviews will lead to the management mentioning agreements and arrangements that they had not disclosed in written responses to the same request.

However, post-merger surprises and difficulties may arise for many other reasons. For example, the sale of a franchisor often results in extensive management changes. While the buyer may have many reasons for wanting to replace management, completely replacing key management may result in loss of a lot of institutional knowledge, making the ownership transition more difficult than necessary. Another common issue is document retention. An interesting article on this topic, “Reducing the Risk of Post-Merger Discovery Surprises in M&A,”32 cautions that the parties to an M&A transaction must preserve physical and electronic materials that may be evidence should there be litigation. The same materials may also be critical for the uninterrupted operation of the franchised business, even if there is no ensuing litigation.

VII. OTHER PRACTICAL ASPECTS

A. VISITING THE FRANCHISOR’S OFFICES
Whenever possible, it is helpful for the franchise due diligence team to visit the franchisor’s offices to examine how records are maintained and to talk with personnel involved in the franchise sales and operation process. The reviewer may learn a lot more about how the franchisor conducts its business operations from such visits than by simply reviewing the documents posted on the data site.

Unfortunately, in many (and seemingly increasing) situations the franchise due diligence counsel is limited to reviewing documents posted on the data site and perhaps discussing by telephone the franchise program with inside or outside counsel and business personnel. In those instances, the franchise team should make sure that the buyer’s business personnel engaging in discussion with the franchisor’s personnel carefully determine how the franchisor operates its business on a daily basis.

**B. DISCUSSIONS WITH THE FRANCHISOR’S IN-HOUSE OR OUTSIDE COUNSEL**

Generally the franchisor will make its in-house counsel available to discuss the franchisor’s sales and operational activities. The discussion with that counsel can be very important. Usually, that counsel will be able to explain why the franchisor took certain courses of action. If that counsel is defensive or uncooperative, their behavior may be a warning sign that problems exist with the system or that the seller’s personnel may be uncooperative once the acquisition is made. Even if the franchisor has in-house counsel, discussions with outside counsel are often important.

Many smaller franchisors do not have in-house counsel. In those situations, the buyer should talk with their primary outside franchise counsel. In addition, often franchisors with in-house counsel involve outside counsel in the discussions, particularly if there is litigation.

One of the concerns counsel for the seller may express is preserving not only the confidentiality of certain information but maintaining the attorney-client privilege. This concern may lead to reluctance on the part of in-house or outside counsel to provide full or frank information. When this situation occurs, the buyer will have to protect itself against incomplete disclosure by appropriate representations and warranties.

**C. WRITING THE REPORT**

Many lawyers find it useful to prepare carefully worded due diligence memoranda summarizing the information obtained and setting forth any open issues that need to be addressed. While such memoranda probably would not be protected under the attorney work product doctrine, they may be protected by the attorney-client privilege if directed to the client.

Some lawyers involved in public offerings choose not to keep records or maintain documents obtained during the due diligence process. Some also choose not to prepare a memorandum of the review. Some even suggest destroying any notes used in the investigation. The reason for this approach is that a party may
later discover an item not on the list or something not carried out or completed. A risk of the detailed checklist is that it is not detailed enough or it is too detailed, and that it could be used against a party or perhaps even the lawyer in subsequent litigation.

The authors are of the view that this approach is not applicable to acquisition of a franchisor, and that both keeping a log of documents received and preparing a carefully worded analysis memorandum can be helpful, particularly if a number of people are involved in the review process. A careful lawyer should not fear the use of a log or an analysis memorandum. They may, in fact, help explain the transaction and hopefully demonstrate the quality and adequacy of his or her work. Moreover, adequate representations and warranties that survive the closing may protect the buyer against an argument that the buyer’s due diligence (as reflected in the lawyer’s analysis) absolved the seller of a duty to stand behind its covenants. If the deal falls apart, a log or analysis memorandum may help the parties identify which documents must be returned and/or are subject to a continuing confidentiality obligation.

D. THE RISK TO COUNSEL

As is apparent from the previous discussion about whether notes should be saved or memoranda prepared, there is a risk for both the buyer’s and the seller’s counsel in performing due diligence. The buyer’s lawyer will be making a report to the client regarding results of the due diligence and providing advice on how to structure the deal to minimize any adverse impact. The seller’s lawyer will help the seller fashion its representations and warranties and may be rendering an opinion to the buyer’s counsel.

Often, clients fail to understand and appreciate the need for the work that goes into an adequate due diligence investigation. When undiscovered problems surface after closing, there is always a risk that the client or the other party may assert that the lawyer’s due diligence activities were inadequate and that those problems should have been discovered or otherwise adequately protected.

VIII. SAMPLE DUE DILIGENCE LISTS

Appendix B to this book is a sample due diligence list. The user is cautioned to tailor the checklist to the specific transaction. Appendix B is intended to be a generic list that requests documents for issues that will generally be of interest to acquisition counsel. However, as discussed in this chapter, the size and type of franchise system, the nature of the franchise business, the geographic scope
of the franchise, and many other factors will shape the specific elements of the
due diligence list. And, unique circumstances that may affect certain systems
may require that some of the items be eliminated and that others be added.
XYZ, INC.

Please provide the documents and lists described below with respect to each franchise program that currently exists or that may have existed. 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. In addition, the due diligence checklist should reflect specific aspects of the target franchise company, its business, and its industry.]

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 nontraditional 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 of FDD;
      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;
      j. any personal guarantees; and
      k. any collateral assignments of any franchise agreements to secure franchisee loan obligations, or comfort letters with leaders.
   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).
   5. Description of any discussions with prospects or existing franchisees relating to the renewal, amendment, or opening of any franchise.
   6. Information on the status of royalty payments (up front fees or continuing, and advertising).
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; and
      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) that 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; and
   c. other brand license or franchise agreements.

D. Former (Terminated, Nonrenewed, 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. A list of all termination or nonrenewal notices sent to franchisees, either pending or implemented;

[Note to reader: Counsel should review the applicable statute of limitations issues when determining which files to review, over which time period.]
c. List of, and copies of, all correspondence and materials related to transferred franchisees;

d. 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; and
      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.

3. A list of all termination or nonrenewal notices sent to franchisees, either pending or implemented.

E. Other Franchisee Defaults
   1. A list of all franchisees in default with respect to any payment of fees or royalties.
   2. A list of any other defaults by franchisees which could have a materially adverse effect on the franchise program.

II. FDDs AND FRANCHISE REGISTRATIONS (INCLUDING ADVERTISING AND FRANCHISE SELLER AND BROKER REGISTRATIONS)

A. General
   1. A list of all jurisdictions in which the franchisor is qualified to do business and a list of all jurisdictions in which the franchisor conducts business or sells franchises, and a description of the business conducted in each jurisdiction.
   2. Any registration applications pending, or in the process of being prepared for filing, under any state franchise or business opportunities registration act.
   3. A docket showing the current effective dates of registrations, notice filings and exemptions, and expiration dates.

B. 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

² For all responses in II.B, from ____________, 20__ until the present.
2. Copies of all correspondence with state and federal (if any) franchise and/or business opportunity law administrators.

3. All disclosure documents, 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 sellers and franchise brokers employed or hired by XYZ, and copies of state salesperson registration forms, if any.

6. List of all franchise sellers and franchise brokers who had been hired or retained by XYZ and who are not currently employed by XYZ.

C. Master Franchise/Subfranchisees/Other Agreements (“Other Agreements”) (If XYZ has offered other forms of agreements in FDDs that are separate from the FDD that includes the unit franchise agreement) provide:

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 disclosure documents, 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 salespersons and franchise brokers employed or hired by XYZ, and copies of state salesperson registration forms, if any.

6. List of all franchise salespersons and franchise brokers who had been hired or retained by XYZ and who are not currently employed by XYZ.
III. FINANCIAL PERFORMANCE REPRESENTATIONS: 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 financial performance representations, earnings claims, or other earnings, revenue, profit, or financial statements or projections made or provided to prospective franchisees (in the FDD or not in the FDD).

C. All financial information that was provided to a prospective franchisee for any situation in which a company-owned outlet or a franchised outlet was sold to a new franchisee (even if this was not a “financial performance representation” under franchise disclosure rules).

D. Requests by prospective franchisees to review substantiation of FDD Item 19 data, and XYZ’s response to those requests, including the material and information provided or reviewed.

E. Correspondence with prospective franchisees regarding earnings claims, financial performance representations, and other financial data.

IV. SYSTEM OPERATIONS (MANUALS, ETC.)
A. Operating manuals currently in use for the XYZ system.

B. Previous versions of operating manuals.

C. All correspondence with Franchisees providing new or modified manuals, directives, specifications, etc.

D. 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.

E. Monthly and annual payment, receivables, and receivable aging reports for franchisees for royalties, advertising payments, and other regular payment obligations of the franchisees. [Note to reader: this varies by system, but may include, for example, software or computer license fees.]

F. Credit Card processing agreements.

G. System privacy policies, and any franchisee privacy policies, including all correspondence or complaints related to franchisor or franchisee compliance or violation or privacy policies or privacy laws.

H. Agreements and arrangements with third parties and with franchisees regarding the use, sale, and administration of gift cards, reloadable stored value cards, and other frequent purchaser or customer preference cards, including legal compliance policies.

I. Any consumer or governmental complaint or inquiry regarding XYZ or franchise compliance or allegation of noncompliance with consumer
protection laws, credit card processing, gift card operations, or any other commercial or consumer matter.

J. Information on any independent franchisee association or franchisor-sponsored franchise advisory council, including copies of bylaws, meeting minutes, or other material correspondence or communications involving any franchise advisory council and/or franchisee association.

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. Reports and records of all rebates, commissions, and allowance received by XYZ and/or its franchisees in the most recent three years, and the allocation, uses, or distribution of those monies to franchisees, to the advertising fund, to the franchisor, and/or other parties, entities, and purposes.
D. All supply and distribution agreements between XYZ and its franchisees.
E. All vendor lists.
F. Copies of plans or studies regarding the possibility of XYZ becoming a supplier of products, equipment, or goods to the franchise system.
G. Documents concerning approval or disapproval of suppliers, including all correspondence on the subject.
H. A list and description of any delinquencies in the settlement of suppliers’ accounts during the past 12 months.
I. The franchisor’s outstanding purchase commitments.

VI. INTERNATIONAL
A. A list of all foreign jurisdictions in which the franchisor conducts business or sells franchises, and a description of the business conducted in each jurisdiction.
B. Agreements: Copies of all agreements and other documents relating to system expansion in foreign countries, including:
   1. any Master Franchise or Development Agreements;
   2. any Franchise Agreements; and
   3. any joint venture or similar arrangements.
C. Disclosure Documents: Franchise disclosure documents used with respect to the offer and sale of franchises in foreign countries.
D. 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) where XYZ has an interest in the real estate, 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 nonmonetary 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. A list of all computer software used in the franchised business, whether owned, leased, or licensed, and copies of all related leases and license agreements; and
10. 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 or for use of any of the XYZ marks.

F. A list of all computer software used in the franchised business, whether owned, leased, or licensed, and copies of all related leases and license agreements.

IX. LITIGATION AND DISPUTES

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 FDDs referred to in II. above.
C. Responses to auditors’ inquiries regarding actual or pending litigation or disputes.

D. Copies of all consent decrees, judgments, settlements, and other dispositions of legal proceedings pursuant to which the franchisor has continuing or contingent obligations of a material nature.

E. Any orders, directives, or inquiries received from the FTC or any state franchising, business opportunities, or other regulatory authority relating to franchising or business opportunities activity.

F. Any inquiries from any state in the past five years relating to state tax liability for sales, income or other taxes arising out of the relationship with franchisees in the state.

G. Any inquiries from any federal or state authority or claims made by franchisees in the past five years claiming the franchise relationship was an employment relationship.

X. ADVERTISING

A. List of any public figures used in advertising.

B. A description of any marketing or advertising fund (domestic and/or international), the amount of monies currently in the funds, whether the fund is a trust, whether the franchisor contributes to the fund, how fund monies were used in the past year, and what happens to the funds if the franchise system is sold.

C. A description of any national accounts program and how franchisees participate in the program.

D. Copies of all franchise advertisements and brochures.

E. Any agreements with the marketing committee related to the advertising fund.

F. Organizational documents of, meeting minutes of, and correspondence with, the advertising fund [and/or the entity that administers the fund].

G. Internal reports, and any reports given to franchisees, with respect to the collection and expenditure of marketing and advertising contributions.

H. An account of advertising deposits currently held, and any correspondence with franchisees relating to advertising deposits.

I. Copies of all organizational and governing documents of any advertising cooperatives.

J. All social media policies applicable to system franchisees.

K. Internal structure chart for handling social media complaints and other emergencies.
L. All correspondence with franchisees relating to violations of the social media policy.

XI. 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.

C. Determine whether franchisees have obtained insurance and whether such insurance permits naming the new officers and directors of the acquired franchisor as additional insureds.

D. Information on predecessors and affiliates of the franchisor.

E. Determine whether the franchisor has recorded any document reflecting its rights of first refusal with respect to any property owned by franchisees which is used for the franchise operation.

F. Determine whether the franchisor has consented to a collateral assignment of any franchise agreement to secure any franchisee loan obligations or entered into a comfort letter with a lender, and copies of such collateral assignments or comfort letters.

G. All material correspondence generally circulated to franchisees during the last 12 months.
**About the Editors**


**About the Co-Authors of Chapter 3**

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