

Franchise

Contributing editor
Philip F Zeidman



2019

GETTING THE
DEAL THROUGH 

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Franchise 2019

Contributing editor
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DLA Piper LLP (US)

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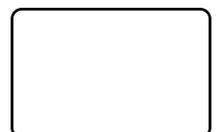


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Preface

Franchise 2019

Thirteenth edition

Getting the Deal Through is delighted to publish the thirteenth edition of *Franchise*, which is available in print, as an e-book and online at www.gettingthedealthrough.com.

Getting the Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

Throughout this edition, and following the unique **Getting the Deal Through** format, the same key questions are answered by leading practitioners in each of the jurisdictions featured. Our coverage this year includes new chapters on the Netherlands, Poland and Ukraine.

Getting the Deal Through titles are published annually in print. Please ensure you are referring to the latest edition or to the online version at www.gettingthedealthrough.com.

Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

Getting the Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. We also extend special thanks to the contributing editor, Philip F Zeidman of DLA Piper LLP (US), for his continued assistance with this volume.

GETTING THE 
DEAL THROUGH 

London
July 2018

Franchise M&A

Edward (Ned) Levitt

Dickinson Wright LLP

Introduction

Acquisitions of other businesses, to strategically grow an existing business or as a financial investment aimed at earning a good return, have been around since the beginning of modern commerce. However, historically, franchise companies grew organically, with traditional financing, as needed. Exit strategies for the entrepreneur-franchisor were often very low on the strategic plan. Today, with the increasing number of boomer-franchisors heading for retirement, the amazing growth of the franchise sector, the acceptance of franchising as a viable business model, a great deal of under-deployed capital waiting on the sidelines for good targets and more and more examples of successful franchise system growth, it is no wonder that we are currently witnessing an incredible increase in franchise mergers and acquisitions. Adding to these factors is the growth of private equity pools of money and the realisation by these funds that franchising presents an excellent investment because of predictable and steady cash flow through royalties, great leverage from deployed capital and existing assets and almost unlimited possibilities for rapid growth (domestic and internationally).

The size and sophistication of some of these franchise systems and the transactions that evolve are impressive and often rival the traditional businesses as to scope and complexity. Certainly, many of the issues, challenges and approaches are the same in franchise and non-franchise M&A transactions. However, for a variety of important reasons, franchise M&A has an additional layer of complexity and risk.

Franchise variables

For the uninitiated, franchising might appear fairly uniform and uncomplicated in an acquisition, but for the knowledgeable, franchising is multifaceted and nuanced in the extreme. M&A in franchising can be quite different if:

- the system is public or private, large or small, and provides services or products;
- the franchisees have multiple units or multiple brands;
- the franchisor has expanded through master franchising; or, perhaps
- the seller is a large master franchisee itself within a broader system.

It is rare for a franchise system to have a lot of hard assets, such as real estate or valuable equipment, even if it has a high valuation. The value of the system resides primarily in its brand, franchise agreements with franchisees and the relationship between the franchisor and the franchisees. The correct value of the system and how the acquisition is executed needs to take into account the strength, durability and transferability of these assets. This leads to a unique set of due diligence issues and choices and, while proper due diligence is important in any acquisition, it is critical in a franchise acquisition.

The acquisition process

If, as is often the case, a franchise acquisition commences with a letter of intent-type document, an interesting question arises as to whether the franchisees should be informed about the sale intention at that stage. There is no legal requirement to do so and most advisers would argue that, at the letter of intent stage, completion is too uncertain to inform the existing franchisees. However, if the franchisor does enter into such a letter of intent it is a strong possibility that this would constitute a material fact requiring disclosure to any prospective franchisees,

if the prevailing franchise legislation requires such disclosure. Upon the signing of a binding acquisition agreement, the argument that disclosure is required for prospective franchisees gets more compelling, but not with respect to existing franchisees. Some franchisors opt to place a moratorium on new franchise sales during a system sale process because of this issue. One should query what a franchisor should do, if, during a sale process, disclosure is required because an existing franchisee is selling its business to a new franchisee or an existing franchisee is renewing its franchise agreement.

The acquisition agreement

In addition to the usual provisions of an acquisition agreement, the franchise acquisition document will contain a number of specific franchise-oriented provisions. The nature and extent of these types of provisions will encompass some or all of the following:

- the existence of various forms of franchise agreements;
- a description of the types of franchise arrangements in use in the system, for example, area development, master franchise, area representative and licensing;
- the existence of any franchisee associations or councils;
- any existing claims by franchisees or facts upon which a claim by a franchisee is likely;
- ongoing litigation, arbitration or mediation;
- the status of all leases and subleases;
- compliance with all franchise-specific statutes, with particular emphasis on franchise sales during any period of franchisee rescission rights;
- access to all franchise agreements and franchise disclosure documents;
- the economic performance of franchisee operator units and corporate units;
- the status and performance of any existing marketing fund;
- strength, durability and suitability of any supply chains; and
- holdbacks for representations and warranties regarding possible franchisee disputes.

Due diligence

As mentioned above, while the conduct of thorough due diligence is important in the acquisition of any business, it is particularly important in the acquisition of a franchise system. This is because of the fact that so much of the value rests on the relationship with the franchisees and the ability of the franchisor to support the franchisees in the system, and to protect the brand.

At the pre-contractual stage of an acquisition, the acquirer is free to approach any of the system franchisees, in any manner desired, to 'take the temperature' of the system. To avoid creating problems for the existing franchisor, this could be done through professional contractors or investigators in an innocuous way. Once the existing franchisor-franchisee relationship is determined, the acquirer could decide to end its pursuit of the acquisition or to shape its offer to take that relationship into account. For example, even if the relationship is troubled, the acquirer might still want to acquire a system, at the right price, in order to solve the problems as a 'white knight'. This type of acquirer is often referred to as a 'strategic purchaser'; being an existing franchisor of a competitive franchise system or a key supplier to the system. Financial acquirers (those interested only in a financial return from the system)

are also interested in this critical relationship, but are less likely to conclude the acquisition if they sense trouble in the relationship between the franchisor and its franchisees. Whenever or however the existing franchisees in the system are approached, it is valuable to engage with franchisees who have been in the system for variety of time periods, as this will provide the acquirer with a picture of the evolution of the system and whether or not the system is trending up or down.

Some of the typical areas for due diligence relate to the financial performance of the franchisor and its franchisees, the content of all franchise agreements and leases, the status of any marketing fund, the condition of all accounting and computer systems and the status of all intellectual property. In addition, however, there are some very important, but less common, due diligence areas an acquirer of a franchise system should consider. For example, what the relationship is like between key management personnel and the franchise community. If it is not a good one, then the acquirer will need to be able to readily replace such people. On the other hand, if the relationship is very good, then the acquirer will want to know what the likelihood is they can be retained after the acquisition is completed. Another is the timing of franchise sales. If too many franchises are sold in too short a period of time, it may indicate trouble in the future because all franchisors have to be able to 'service what they sell' and a quality franchise culture takes time to grow without the pressure of a constantly and rapidly expanding franchisee population. Conversely, if too many franchises are being resold by existing franchisees, there may be trouble lurking in the system. Also, a thorough analysis of what the franchisor spends on site selection, franchisee selection, initial franchisee training and support will be very revealing about the health and viability of the system. Franchise systems that grow quickly and without sufficient resources being deployed in these very crucial areas may present as very successful on the surface, when there is really a lot of rot at the core.

Size of the target system

The size of the target system will have a significant impact on many aspects of an acquisition, the most obvious being the price paid, but also the need for more or less due diligence and how much money needs to be spent on it. When the system is large, there may not be enough time, money and manpower to review all of the existing documentation. The approach then might be to set up samples of categorised agreements, such as the forms of franchise agreement that existed as the system grew through various stages. Then the task would be to have a clear and complete list of any special arrangements made with any and all franchisees. Where the franchisor has expanded through large franchise operations such as area developers or master franchisees, it will be necessary to conduct due diligence on these large franchisees.

Where the franchise system is more modest in size, the task of reviewing all documentation is more feasible, but the need to examine the relationship between management and the franchisee community is more critical. Additionally, with smaller systems, mere guarantees of individuals for representations and warranties in the acquisition agreement may not provide sufficient comfort for the acquirer and consideration might need to be given to actual holdbacks of a portion of the purchase price.

Assessing revenue potential

The most obvious and customary source of revenue for a franchisor are the royalties paid by the franchisees on (usually) their gross revenue. The evaluation of the strength of this revenue stream, absent widespread discontent by franchisees, is relatively easy for a prospective acquirer. More difficult is the evaluation of supplier rebates, the predictability of which rests on the policies of the suppliers and the marketplace factors such as competition, quality of goods and changes in consumer tastes. Similarly, if the franchisor is relying significantly on revenue from landlord incentives, shifting economies may put such revenue streams at risk.

Franchise agreements

Existing franchise agreements are at the heart of every franchise system. The content and quality of these agreements, from the point of view of the acquirer, are key in assessing the acquisition and setting a price that makes sense. This is true whether or not the acquirer intends to make changes to the system or how it runs or not. Even if the acquirer is going to continue running the system as was done in the past, certain provisions of the franchise agreements are necessary to allow the

system to keep pace with the inevitable changes in customer preferences, technology and demographics, to name a few.

Term and renewal

Ignoring other provisions in a typical franchise agreement that require the franchisee to keep the unit up to date, often renewal time is the best opportunity to have franchised units in the system updated and refurbished. Usually, franchisees who have simply lost their drive or behave badly, but not in breach of their agreement, cannot be terminated. The only way to remove them from the system, and therefore improve the overall performance of the system, is to not renew them when the initial term and all renewal terms have ended.

The right of the franchisor to sell

While it is usual to find a clause in a typical franchise agreement that the franchisor is at liberty to assign the franchise agreement without the consent of the franchisee and without any conditions, that provision must be checked early in the process. Otherwise, the acquisition may not be possible.

Changes to the system

Particularly for strategic acquirers, who might be competitors, suppliers or others who want to bring about change to the target system, it is very important that franchise agreements allow the franchisor to revise how the franchised business is run, what products and services are offered to the customer and what brand the franchisee must operate under. While such a provision will not give the franchisor a complete free hand to make such changes, without such a provision, any change will be impossible.

Territorial rights

It is not unusual for new franchisors to grant too large territories to their initial franchisees or to grant rights of first refusal on contiguous territories to jump-start the growth of the system. The acquirer may then be saddled with some unreasonable obstacles to expanding the system to its maximum size. If the acquirer is a competing system and there is overlap in existing territories of franchisees in both systems, the acquirer will have a business and possibly a legal problem, depending upon the language of the franchise agreements.

Assignment rights of the franchisee

To control who can be a franchisee in a system, it is usual for a franchise agreement to have extensive language regarding assignment of the agreement. This type of provision usually gives the franchisor the right to approve the assignee and the right to require an update to the unit. It will also usually require that there are no breaches to the franchise agreement and that the franchisee is up to date on all payments owed to the franchisor. To the extent that this type of clause is absent or weak, it would affect the value of the system and the acquirer's ability to grow the system well.

Guarantees

It is very common to allow franchisees to purchase the franchise through a corporation, but then it is equally common to require the shareholders of the corporation to guarantee all of the obligations of the corporate franchisee under the franchise agreement. Without such guarantees, the ability of the franchisor to control the system can be significantly diminished.

Termination rights of the franchisor

As to substance and procedure, the events of default by the franchisee should be clear and extensive in a well-drafted franchise agreement. Otherwise, the acquirer may be saddled with poor performing franchisees and a deteriorating system. Post-termination, there should be an enforceable non-competition covenant on the part of the franchisee.

Intellectual property

By far the most important asset of a franchise system, after the franchise agreements and franchisor-franchisee relationship, is the intellectual property of the franchisor. Foremost among this type of property are the system trademarks. The franchisor should ascertain that the trademarks are still viable in the marketplace, are owned by the franchisor outright, transferable, registered in all jurisdictions where

the system operates and registerable in any jurisdiction the acquirer intends to expand the system.

These days, important intellectual property of a franchisor extends to copyright in software, know-how, operating manuals and business systems. Further, with the increasing importance of the internet in markets all around the world, the ownership of domain names and social media sites is a key factor in any acquisition of a franchise system.

Operating manuals

The operating manual for the franchise system is a very important tool and asset of the franchise system. Its value, both monetarily and practically, increases with its effectiveness and quality. If the system operates in non-English speaking countries and has good translations of the English version, then there is added value for the acquirer.

However, operating manuals can also present or contribute to legal problems. For example, the topic of joint employer among franchisors and their franchisees has recently received a lot of attention from the courts and regulators. Inevitably, an examination will be made of the system operating manual in any proceeding to ascertain what control the franchisor exerted over the franchisee's hiring processes. Similarly, the operating manual can create issues regarding human rights legislation and in other areas of regulation and vicarious liability.

Needless to say, the operating manual should be carefully scrutinised on any acquisition of a franchise system.

Advertising funds

One of the great attractions of operating as a franchisee is the opportunity to pool funds with the other franchisees to increase the advertising and marketing power of the entire system. Having said that, one of the most common areas of disputes in franchising is the advertising fund and how it is administered. Any potential acquirer of a franchise system is well advised to examine the structure, usefulness, administration and franchisee attitudes towards such a fund. Such an examination would likely entail:

- a market study to ascertain the effectiveness of the system marketing efforts;
- a thorough review of the receipts and expenditures of the fund over several years, including any money charged by the franchisor to the fund; and
- projections of the adequacy of the required franchisee contributions in the future.

Franchisee associations and councils

Franchisee associations and councils can be a blessing or a curse, or completely irrelevant to the operation of the franchise system. However, a prospective acquirer of a franchise system, besides obtaining representations about the franchisor's knowledge of the formation or intended formation of any such franchisee groups, should communicate with the leadership of the group and examine the minutes of their proceedings in recent times. At the appropriate time, the acquirer will want to forge a good relationship with the group and use it in the most effective ways.

Regulation

We are currently witnessing a steady growth of franchise specific regulation and other regulation that affects franchising, such as business opportunity laws, agency laws and licensing laws. Some regulation is heavy in pre-sale disclosure, some regulates the relationship between the franchisor and the franchisee and some requires the approval of a government body before a franchise sale can be made.

Once it is ascertained in what jurisdictions the franchisor operates, then the appropriate professional in each jurisdiction should be selected to review compliance on the part of the franchisor with the local laws that govern or influence franchising. Where compliance is flawed or questionable, either the franchisor should remedy the flaw, if possible, or some price adjustment or holdback should be instituted to cover the acquirer's risk.

Getting comfortable in this area is not easy. For example, it is not just the content of a disclosure document that should be checked for accuracy, but the procedures behind the delivery of the document should also be examined.

Technology

It is difficult to keep up with the rapidly changing technology that affects our businesses and our daily lives. From the point of view of the acquirer of a franchise system, it is important to ascertain the adequacy of the technology employed in the operation of the system or, more realistically, to ascertain how quickly the technology will become obsolete.

Additionally, cybersecurity has become a massive problem for all businesses and institutions and franchise systems are no exception. As a starting point, the acquirer will want to be assured of the system's compliance with various privacy regulations or make provision to rectify any deficiencies.

Conclusion

Much of the same considerations, requirements and issues in M&A transactions with businesses generally apply when an entire franchise system is acquired. Overlaid on all of that is the added franchise-specific considerations, issues and challenges. Most importantly, there is the reality that the franchisor-franchisee relationship is at the heart of any successful franchise system and, in an acquisition of the system, preserving and, hopefully, enhancing that relationship is key. This leads to the reality that how something is done is equally important as to what is done. Further, the ability to zero in on the true state of affairs in a targeted franchise system is more challenging than would be the case in the acquisition of another type of business. Finally, an acquirer has to struggle with the legal framework of the business being franchised and the laws that govern franchising specifically.

It is impossible to include, in just one chapter, all of what needs to be known in the acquisition of a franchise system. However, it is hoped and intended that this chapter will provide the reader with some valuable insight and tools to assist in the task.

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