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# Due Diligence In Franchise Acquisitions

**T**he acquisition of major franchisors and their franchise networks has accelerated greatly over the past decade.

Just last month, Checkers Drive-In Restaurants was acquired by Oak Hill Capital Partners. Also last month, Restaurant Brands International announced the completion of its acquisition of Popeyes Louisiana Kitchen. Last year, Marriott International acquired Starwood Hotels & Resorts Worldwide and Roark Capital Group acquired Jimmy John's Sandwiches.

Franchise counsel summoned to advise on and help effectuate such complex transactions must address a plethora of business and legal issues—whether the proposed merger or acquisition activity makes economic sense or, conversely, will result in a debt-laden enterprise doomed to falter upon the slightest economic or marketplace downturn; whether there is a sound strategic reason for engaging in the acquisition or, alternatively, it is simply the result of corporate ego run amok, with no synergies to be derived and only overextended management and chaos to ensue; whether the acquired franchise network will be “converted” to the identity of the acquirer and, if so, might negative consumer reaction ensue.

But perhaps the greatest skill set possessed by franchise counsel which will prove integral to a contemplated acquisition is the knowledge and ability to conduct meaningful due diligence of the target franchisor and its franchise network. Ironically, even though franchising is at the very core of franchisor acquisitions, quite typically the investment banks and very large law firms guiding the transaction are more concentrated on mechanics and finances; what structure should be used to effect the acquisition; what

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issues are revealed by the target franchisor's financial statements; what debt service coverage ratios (DSCR) will the banks impose on the post-acquisition franchisor; what “golden parachutes” may be triggered; what tax, labor and environmental issues are extant; and, similar such concerns will be at the forefront. But not necessarily the state of the franchise network itself.

That is where experienced franchise counsel comes in. To ascertain the health of the targeted fran-

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chise network; whether the royalty and other revenues paid to the target franchisor will prove “sticky” (that is, will recur in the future) and will likely grow; whether the franchisor has complied with federal, state and international franchise laws (or, conversely, has violated those laws and exposed itself to government actions and franchisee litigation); whether franchisees will be supportive of the planned acquisition or will take steps to oppose it; whether supply chains will be kept intact; and, most critically of all, whether it can be anticipated that the franchise network will expand or, conversely, will contract due to franchisee financial woes, in the future making today's marvel-

ous target franchisor EBITDA just a glimmer of past glory.

Comprehensive and “deep dive” franchise due diligence is required to ascertain the answers to these questions, the health of the target franchise network and the likely post-acquisition strength of that network.

How many generations of franchise agreements are in effect, what royalties and other payments are due thereunder and how soon will each generation of franchise agreement expire? As well, attention must be paid as to whether there exist franchise agreement amendments, addenda, modifications or “side letter” agreements which have the effect of reducing or waiving royalty and other payments or extending the term of a franchise agreement beyond that specified therein. A review of all domestic and international franchise disclosure documents must be conducted to ascertain their compliance with federal, state and international franchise laws accompanied by a review or all of the targeted franchisor's domestic and international franchise registrations (and whether any such registrations have been delayed, denied or conditioned by any federal, state or international franchise regulator).

Does the targeted franchisor's franchise files reveal franchisee communications advancing or referring to complaints, threats to initiate litigation, threats to file complaints with government authorities or otherwise complaining of the target? And what is the current status of all actions, proceedings or arbitrations disclosed in the latest franchise disclosure document issued by the target (and have any been commenced following the issuance of that document)?

As well, franchise counsel must ascertain whether any government complaint, inquiry, investigation or judicial/administrative action or proceeding has either been brought, threatened or is imminent. A review of the target franchisor's franchise sales advertising materials (print/broadcast/internet/advertising brochures) » Page 6

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## Due Diligence

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must be accomplished to ensure that they have been prepared (and, where necessary, filed) in compliance with federal, state and international franchise laws. As well, investigation must be conducted into whether the target franchisor has entered into any loan, financ-

against franchisees in which the franchisor may become, or already is, a party thereto under any theory including negligence, "vicarious" liability or "joint employer" theories.

Here is the due diligence inquiry which almost always provokes consternation but is absolutely crucial to ascertain the health of the target franchise network: To the target's knowledge, how

whether, in connection therewith, any franchisee will be commencing or has commenced an insolvency or bankruptcy (or similar) proceeding.

What is the state of franchise relations of the target franchise network? Is there one or more franchisee associations and, if so, are they cooperative or combative? What will franchisee reaction be to the planned acquisition? Is the target franchisor required to consult with or secure approval of any third party prior to any acquisition (a bank or other financial institution, a franchisee advisory council or any supplier)? May any supplier contract be unilaterally terminated following an acquisition of the target franchisor? What "golden parachutes" may be triggered by the change of control following an acquisition (which may result in the franchisor being drained of its core talent)?

These are but a few of the more important due diligence inquiries which franchise counsel—familiar with the norms, structures, economics and relationship aspects of franchising—need to advance, persistently when necessary, in order to best serve the proposed acquiror of a franchise network.

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ing or other financial assistance or arrangements with its franchisees and, as to each, the nature thereof, the term thereof, repayment schedules, repayment status, default status, waivers and/or releases from such obligations.

It is critical to ascertain what participation franchisees may have (formal or informal, optional or mandatory) in any of the target franchisor's decision-making processes. Important as well is to ascertain the exposure of the target franchisor to third-party actions

many domestic and international franchised units are considered non-viable; scheduled and/or predicted to close within two years; and/or whose gross revenues are 15 percent or more lower than those which pertained two years ago? A companion inquiry concerns how many of the target franchise network's franchisees and/or franchised units are in the midst of a workout or other financial restructuring; the nature thereof; whether, in connection therewith, any unit will close; and