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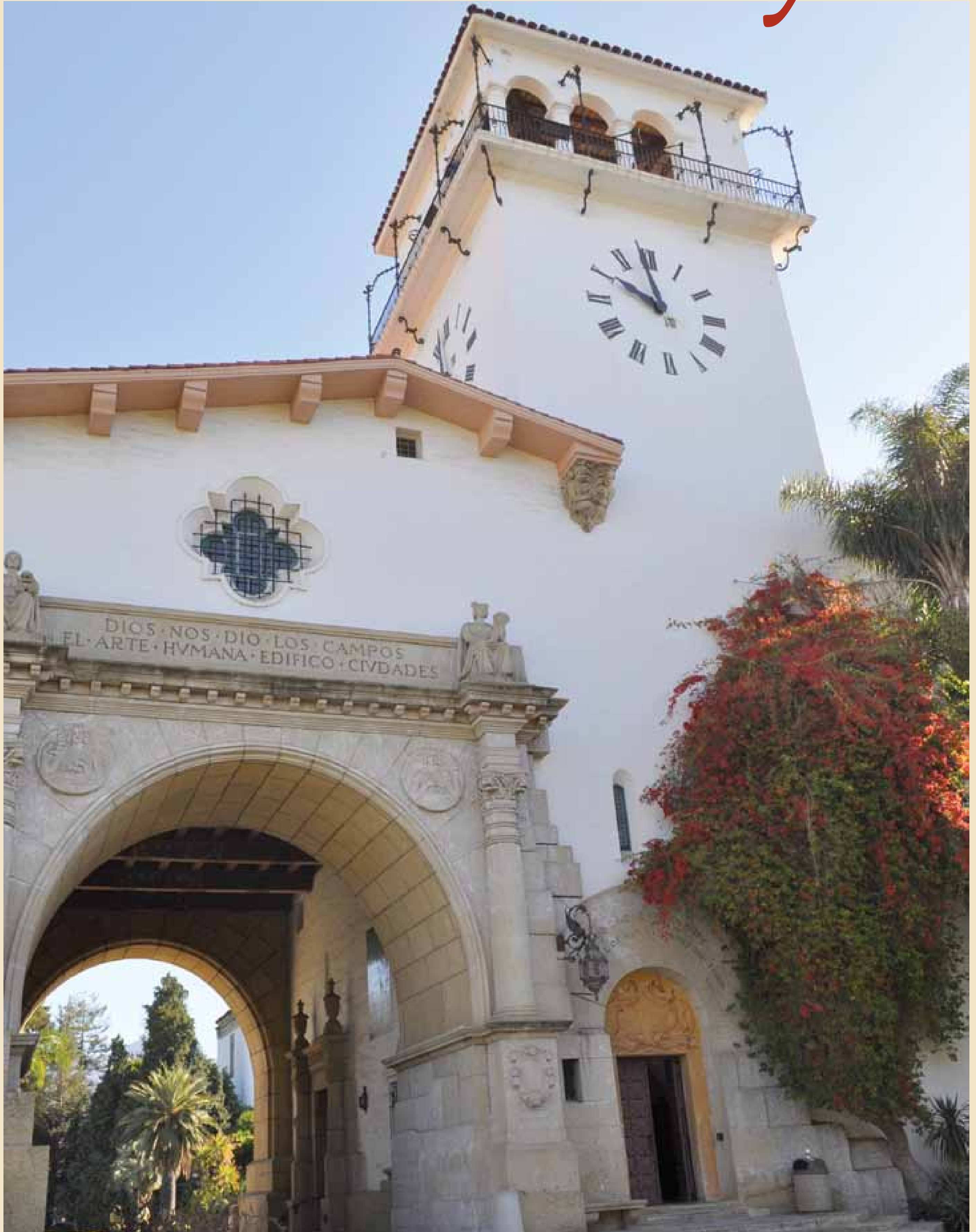

# The Leap of Faith: How to Acquire a Franchisor

By Barry Kurtz

Thinking about acquiring a franchise operation? Get ready for twice the due diligence of a traditional deal – but maybe twice the pay-off, if you do it right.

Indeed, caution is the by-word in considering the acquisition of a franchisor, since any such deal gets the buyer a unique distribution system consisting of scores, perhaps hundreds, of franchisees who will prove key to the success of the deal.

The franchise business is all about brands and franchisees, and the two concerns interact. The brand is promoted to attract quality franchisees, and then the franchisees are supported to promote the brand. Successful franchisees are critical to the success of any franchise system, so a potential buyer must focus its due diligence on the financial and legal health of both franchisor and franchisees, because a system that is inherently unprofitable for franchisees will likely be a bust for the franchisor.

What does it take to do the right kind of due diligence when buying a franchisor? Where can trouble crop up? And how can one leave room to structure the final terms of the deal to fit the reality uncovered?

The first step is to inspect the uniform franchise disclosure documents (FDDs) used by the franchisor in each state where it has done business over the last five years. Thirteen states – California[1], Hawaii[2], Illinois[3], Indiana[4], Maryland[5], Minnesota[6], New York[7], North Dakota[8], Rhode Island[9], South Dakota[10], Virginia[11], Washington[12] and Wisconsin[13] – seek to protect franchisees by requiring franchisors to disclose a great deal of information in the FDD and place it in the public record, usually by registering the FDD with the state's attorney general.

Six states – Florida[14], Michigan[15], Nebraska[16], Kentucky[17], Texas[18] and Utah[19] – require franchisors to file only a one-page form, and the others permit franchisors to operate as long as they meet the requirements of at least one of the 13 "registration" states. In addition, irrespective of these differing state requirements, federal law requires franchisors to give copies of their disclosure documents to all prospective franchisees[20].

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This inspection of the records reveals whether the franchisor has properly registered its offering circular where required, and whether it has faced state disciplinary action or litigation by franchisees[21]. The FDD must detail the franchisor's business experience and that of its senior executives, including any bankruptcies and securities violations[22]. As a result, the inspection will reveal at least a cursory notation of any such difficulties, and lead to inspection of other records (i.e., court filings, regulatory records, etc.) that describe any problems or deficiencies in detail.

In each case, it is important to understand the nature of the complaint, the franchisor's explanation or defense, and the result. Was the violation serious or minor? Was it intentional or the result of clerical error? Was it an isolated incident or part of a pattern of behavior? A buyer needs this information to be properly prepared to draw up the necessary warranties and representations of the purchase agreement that will keep the seller on the hook for any trouble that may not be fully known at closing.

The next step is to inspect the franchise agreements in use in each state in which the franchisor operates, checking their terms against those of the standard agreements in the FDD. The object here is to discover whether the franchisor entered into any special arrangements with one or more of its franchisees. An example might be providing special terms to favored franchisees, such as giving a franchisee in Los Angeles the right of first refusal when new or additional franchises are available in neighboring Orange County.

This is important to the buyer of a franchising company because it takes on all the obligations of the seller, except those that are expressly left behind in the purchase agreement. A buyer probably cannot escape a side deal such as granting a right of first refusal, assuming it is a valid arrangement, but it can adjust the terms of the deal to reflect the impact of the agreement on post-acquisition plans. If the agreement proves to be too restrictive, such as limiting expansion plans in Orange County, it could impel the buyer to back out of the deal altogether. In any event, the buyer is at minimum informed of the situation.

For the same reasons, it is also important to track down

the agreements with franchisees in all states in which the franchisor operates. It may be impractical to check each agreement. These agreements may number in the hundreds, or even in the thousands, making it costly and time-consuming to inspect every one. The solution is to collect a fair sampling and require the franchisor to warrant that there are no undisclosed side deals with franchisees that materially affect the terms of the purchase.

In checking these records, the acquirer's investigators must take special note of all obligations taken on by the franchisor regarding training, advertising, marketing, and other business functions, all of which represent costs affecting the value of the deal.

For the same reason, the buyer must look for other financial arrangements between the franchisor and its franchisees. A primary target for inspection should be the promissory notes and security agreements that are in place if the franchisor offers financing to help purchase the franchise.

It is equally important to inspect the franchisor's records of all leases tied to its franchise agreements. In some cases the franchisor itself will lease the property in question and sub-lease it to the franchisee. In others, the franchisee will lease the property directly. Either way, a buyer must match up each lease with its respective franchise agreement, making sure that the terms agree. The buyer also must be certain that no third-party clearance is needed, such as approval of lease transfers by real estate owners.

A great deal of examination can be done in the offices of the franchisor, where other important but unpleasant items may be found (i.e., notices of late payments or default by franchisees, correspondence regarding disputes between franchisor and franchisee, or records detailing the processes followed in terminating franchise agreements). In essence, the goal here is to find out what went wrong between franchisor and franchisee so that the purchase agreement requires the seller to stand behind appropriate representations and warranties.

In all of this, it is crucial to step carefully, since few deals close without a hiccup or two.

There are risks for both buyer and seller in any acquisition involving a franchisor, but don't let that make you run away from the idea. The due diligence necessary to any such acquisition is tough, but it's really just a measure of the possible pay-off.

The business lawyer doing due diligence in the purchase of a franchise company must track down a great deal of documents to gain an accurate picture of the relationships between the franchisor and its franchisees. Then the real work begins, since it is also necessary to inspect the documents in detail and draw up representations and warranties holding the seller of the franchise company responsible for any agreements or information contrary to or inconsistent with the documents inspected or information provided during due diligence. In deals involving large numbers of franchisees, it becomes impractical to obtain and inspect every document, of course. In such cases, the lawyer should sample a number judged reasonable by the client and shape the language of any representations and warranties accordingly. ■

Barry Kurtz *has practiced franchise law for over 30 years and is a Certified Specialist in Franchise & Distribution Law by the State Bar of California Board of Legal Specialization. He maintains his practice in Santa Barbara, CA and Woodland Hills, CA.*

Endnotes

1 Cal. Corp. Code § 31000
2 Haw. Rev. Stat. § 482E-3
3 815 ILCS 705
4 IC 23-2-2.5
5 Md. Code Ann., Bus. Reg.§ 14-214(a)
6 Minn. Stat.§ 80C
7 N.Y. Gen. Bus. L.§ 683
8 N.D. Cent. Code § 51-19
9 R.I. Gen. Laws § 1928.15
10 S.D. § 37-5B
11 Va. Code § 13.1-557
12 Wash. Rev. Code § 19.100.010
13 Wis. Stat.§ 553
14 Fla. Stat. § 817.416
15 Mich. Comp. L.§ 445.508
16 Neb. Rev. Stat. § 87-401
17 KY. Rev. Stat. Ann.§ 367.805
18 1Tex. Admin. Code § 97.1
19 Utah Admin. Code R152-15-2
20 16 C.F.R. § 436.2
21 16 C.F.R. § 436.5
22 *Id.*

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