

VALLEY LAWYER

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A Publication of the San Fernando Valley Bar Association

International Business Relations: Lawyers' Guide to Japanese Culture, History and the Law

Earn MCLE Credit

Practicing Law in the New Economy

Using Ratios to Find Hidden Income

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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 a 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 is risk in for both buyer and seller any acquisition involving a franchisor, but don't 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 many 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 on this checklist, 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. 📌

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Legal Due Diligence Checklist

- ✓ Each FDD used by the franchisor in all states in which the franchisor has done business for the last four years, including all state-specific addenda
- ✓ Each signed franchise agreement and area development agreement, if applicable, and all ancillary agreements and attachments used in the last four years
- ✓ All signed amendments to franchise agreements and area development agreements used in the last four years
- ✓ Drafts, proposals, unaccepted or otherwise unsigned amendments to franchise agreements and area development agreements used in the last four years
- ✓ All correspondence to or from any state agency regulating franchise offers and sales in any state in which the franchisor has done business for the last four years, including registration orders and exemption filings
- ✓ All orders and correspondence issued by or received from all such state agencies for the last four years and a list of all pending franchise registration and exemption filings
- ✓ All consent orders, assurances of discontinuance, notices of violation, offers of settlement, settlement orders or other orders or rulings in effect or, to the knowledge of the seller, threatened that would prohibit or impede the buyer's ability to offer or sell franchises or enter into franchise agreements
- ✓ All communications to or from the Federal Trade Commission, if any, or any agency of any state in which the franchisor has done business, or has attempted to do business, for the past four years, whether in the nature of an inquiry or otherwise – for example, communications to or from agencies that regulate offers or sales of business opportunities
- ✓ All royalty relief agreements, forbearance agreements, settlement agreements, general releases, cancellation agreements, termination agreements and purchase agreements (for the reacquisition of franchised units) with franchisees and area developers, whether signed, unaccepted or otherwise unsigned since the date the franchisor first became registered to sell franchises
- ✓ List of all persons who acted as franchise salespersons or brokers to offer or sell franchises and all salesman disclosure forms filed with each state's agency that regulates franchise offers and sales for the last four years
- ✓ All policy announcements, memos to franchisees, newsletters, reports, etc., issued to franchisees and area developers since the date the franchisor first became registered to sell franchises
- ✓ All notices of breach, default and termination issued to franchisees and area developers since the date the franchisor first became registered to sell franchises;
- ✓ All claim and demand letters received from franchisees or area developers since the date the franchisor first became registered to sell franchises
- ✓ All print advertising published to advertise the franchises
- ✓ All flyers and brochures used to advertise the availability or offer or sale of franchises
- ✓ All website advertising availability or offer or sale of franchises
- ✓ List of all pending sales of franchises and area development rights
- ✓ List of all pending transfers of franchises and area development rights
- ✓ List of all pending franchisee outlet openings and closures
- ✓ List of all franchises and area developers not current in the payment of their obligations to the franchisor with the details of such defaults
- ✓ List of all area developers not current under their development obligations with the details of such defaults
- ✓ List of all franchisees and area developers whose franchises and area development rights were transferred, canceled, terminated, not renewed, reacquired or who otherwise left the system since the date the franchisor first became registered to sell franchises
- ✓ List of all litigation and arbitration matters between the franchisor and franchisees and area developers filed, settled, adjudicated or otherwise resolved since the date the franchisor first became registered to sell franchises
- ✓ Copy of all acknowledgments of receipt from each franchisee who received a FDD since the date the franchisor first became registered to sell franchises
- ✓ List of memberships in franchise organizations such as International Franchise Association