PRACTICE GUIDES

Franchise

Editor
Philip F Zeidman

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Franchise

Practice Guide

Editor
Philip F Zeidman

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Contents

Preface 1
Philip F Zeidman

Part 1: Regulation of Franchising around the World

1 Global Overview of Specific Franchise Statutes and Regulations 7
Philip F Zeidman and Tao Xu

2 Common Law and Civil Law on Franchising Issues 20
John H Pratt

3 Good Faith and International Franchising 29
Bruno Floriani, Marissa Carnevale and Tanya Nakhoul

Part 2: International Expansion by Franchising

4 Sub-franchising, Master Franchising and Development Agents 41
Jorge Mondragón, Lucía Fernández and Pamela González

5 Selecting the Appropriate Vehicle for International Expansion 50
Jorge Mondragón, Priscila Adalid and Lucía Fernández

6 Joint Ventures in International Franchising 59
Mercedes Clavell

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Part 3: Franchise Agreements

7 Confidential and Proprietary Information, and Trade Secrets 71
Mary Goodrich Nix

8 Covenants against Competition 83
Stewart Germann

9 Approaches to Resolving Cross-Border Disputes between Franchisee and Franchisor 95
Julia C Colarusso and Maisa Jean Frank

Part 4: M&A in International Franchising

10 M&A in International Franchising 109
Andrae J Marrocco

Part 5: Other Legal Considerations

11 Commercial Agency Distributorship Law 123
Beata Krakus

12 Data Protection and Privacy 131
Mercia Shannon Fynn

13 Consumer Protection 142
Luis Diego Barry and María Carolina Abdelnabe Vila

14 Competition Laws 153
Martine de Koning

15 Joint Employer and General Labour and Employment Issues 164
Marlén Cortez Morris and William M McErlean

16 Franchising and Insolvency 185
Jason B Binford

17 Electronic Commerce, Social Media and Franchising 193
Leonard Hawkes and Benoit Simpelaere

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Part 6: Some Regional Perspectives

18 Franchise Registration Requirements in ASEAN Countries 209
Kevin Wong

19 Franchising in the European Union 221
Javier Fernández-Lasquetty Quintana and Alberto López Cazalilla

20 Franchise Disclosure Documents under Statutes in South America 229
Mariana Vicentini Taylor and João Carlos Arieira Harres

About the Authors 237

Contact Details 251

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Preface

Philip F Zeidman[1]

In my introduction to *Lexology Getting The Deal Through – Franchise*, I described an experience many of us have had. I recounted a general counsel's arrival at the office to find a message from his boss, posing a series of questions about franchising in a number of countries around the world – questions to which the general counsel, understandably, has no ready answers. The same experience, of course, is familiar to outside counsel encountering a client's expectations.

A survey of the available sources of information comes up empty. None is sufficiently comprehensive yet digestible. *Lexology Getting The Deal Through – Franchise* seeks to meet that need by posing and answering the key questions one must address about franchising in a country. Now in its 13th edition, it covers 26 countries, and has proven its value many times over. It is a classic 'desk book' that belongs next to your telephone (if you still have one) or your computer.

But what then? After your rapid and impressive response, what happens when you need to delve more deeply into the issues raised by your company's or client's plan to expand by franchising? For that purpose, a book that provides succinct answers to threshold questions, however authoritative, is, as social scientists say, 'indispensable but insufficient'.

By now you know that franchising touches, glancingly or with full force, on almost every legal discipline. And you also know that none of those disciplines addresses franchising as squarely as you would like; that there are shockingly few law schools that include franchising in their curriculum; and that there are no course books that adequately cover the territory you will need to traverse.

Enter Lexology Getting The Deal Through's *Practice Guide – Franchise*.

If *Lexology Getting The Deal Through – Franchise* was designed to be left on your desk, *Practice Guide – Franchise* can perhaps best be thought of as the book you will take on your next flight.

So settle in.

Adjust your seat, your footrest and your reading light.

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You will almost certainly want to begin by examining the fundamental legal doctrines, statutes and regulations that govern how franchising is treated in law. That obviously requires an understanding of how different countries have chosen to regulate franchising explicitly (or declined to do so). So you begin with Global Overview of Specific Franchise Statutes and Regulations, which includes a handy chart at the end, keyed to the various approaches. But you will also want to step back and examine two broader and older legal constructs that are essential. One of those inquiries will be to learn how franchising is treated in the foundational legal structures of different countries, in Common Law and Civil Law on Franchising Issues. Under what circumstances will the analyses under those two systems lead to different results? And, you will need to have a grasp of another overarching theme, depending on how a country has chosen to apply it, or not, as the case may be (see Good Faith and International Franchising).

Now that you have an overview of the legal structures you will need to understand, it's time to get a sense of how franchisors go about selecting the form of expansion that best suits the company's business model, culture and management practices (Selecting the Appropriate Vehicle for International Expansion). One of those techniques – sub-franchising – is given special attention, not necessarily because it is the 'right' choice, but rather because it is the most complex of the hierarchy of approaches to expansion, and because it is much more commonly utilised in cross-border than in domestic franchising (Sub-franchising, Master Franchising and Development Agents).

It is also important to keep in mind that franchising is constantly evolving to take advantage of new techniques and approaches. Prominent among the new techniques are e-commerce and social media (see Electronic Commerce, Social Media and Franchising). There, as you will see, problems that arise are frequently owing to e-commerce not having been addressed adequately in the original franchise agreement and relationship.

The decision of how best to go about the business of expansion is, along with selecting the countries you wish to target, certainly at the threshold of your business and legal initiative. And understanding these critical 'first issues' will surely consume a sizable share of the time on your flight.

Now it's time to turn to the heart of the franchise relationship, and examine how the franchisor and the franchisee choose to express the bargain they have reached. Much of this process is understanding how elements of that bargain can best be articulated to leave as little as possible to be the subject of differing interpretations. But the parties are not entirely free to do whatever they wish, nor is one party free to demand that its wishes be adopted in all respects, because franchise laws and other bodies of law impose limits and restrictions on the parties. Some of the key provisions of the Franchise Agreement are discussed. Confidential and Proprietary Information, and Trade Secrets points out the pivotal role this plays in the essential intellectual property associated with the franchise, and the challenge to protect it in each country where the franchisor anticipates selling franchises. Special attention is given to Approaches to Resolving Cross-Border Disputes between Franchisee and Franchisor, including a separate chapter on the Choice of Law and Choice of Dispute Resolution Mechanism in Cross-Border Franchise Agreements.

Other bodies of law, of course, impinge upon franchising, and an understanding of how they interface is important to a competent franchise lawyer (see M&A in International Franchising). Consumer Protection begins by addressing the concept of a consumer, which may differ by jurisdiction, and discusses the consequence of applying consumer protection laws to franchising.

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Data Protection and Privacy highlights the challenge presented to multinational franchisors in complying with the laws in this area adopted in nearly 120 countries, and suggests some approaches to meeting that challenge. Joint Employer and General Labour and Employment Issues examines the threat posed by this rapidly evolving field of law.

Among the subjects addressed by countries that have chosen to regulate franchising, the most common obligation is probably the duty to provide a prospective franchisee with information on the basis of which an informed investment decision can be made. The most robust embodiment of that obligation is the franchise disclosure document, discussed here in some detail in the chapter on Franchise Disclosure Documents.

Ladies and gentlemen, we are beginning our descent.

You have not, of course, been exposed to every nook and cranny of franchise law. That would require, at a minimum, several trips around the world.

But you can disembark now. You're off to a good start.

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Part 4

M&A in International Franchising

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10

M&A in International Franchising

Andrae J Marrocco[1]

Fundamentals

Introduction

Franchise systems present a valuable investment proposition for both strategic and financial investors. As an expansion strategy of choice, the franchise business model has been on the rise across the globe for many years, and its contributions to national gross domestic product and job creation have outperformed other sectors. Franchise systems have progressed well beyond traditional quick-service restaurants and now encompass businesses across numerous industries and sectors across international jurisdictions. As a result, franchise businesses have increasingly become a focus of M&A activity, some of them large and complex – take, for instance, the C$12.64 billion acquisition and tax inversion involving Burger King Worldwide Inc and Tim Hortons Inc.

The franchise business model is unique. Understanding its framework and business mechanics is paramount for advising on any franchise M&A transaction. Franchise systems mostly comprise intangible assets like intellectual property (eg, trademarks, patents and trade secrets), relationships (eg, supply arrangements, franchisee relations, consultants or agents, and customer goodwill), material contracts (eg, franchise arrangements of all types and supply contracts) and human capital (eg, the management team and key staff managing international operations). Franchise arrangements and transactions have also grown in complexity as various structures have evolved, including joint venture franchising, master franchising, and area development and area representation arrangements (both within the same country and internationally). It is also important to note that the franchise sector has been subject to an increasing amount of direct and indirect regulation across numerous jurisdictions and is increasingly a highly litigious area.

In light of their distinctive features, acquiring a franchise system involves a number of unique considerations that have relevance throughout each stage of a transaction: initial

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strategy discussions, letter of intent and due diligence, drafting and negotiating the transaction documents, closing the transaction, and beyond. This chapter surveys some of the issues that advisers on franchise M&A transactions should consider and address.

Strategy in franchise M&A

There are typically four categories of buyer when it comes to franchise systems: (i) entrepreneurs or existing franchisors continuing the cycle of the system; (ii) strategic 'distribution network' buyers looking to acquire a distribution channel for existing products; (iii) strategic 'competitor' buyers seeking to obtain additional market share; and (iv) financial buyers acquiring the system for future return. While there may be some overlap, each type of buyer has distinct motivations and resulting strategies. The relevant strategic objectives must be considered against the underlying assets and circumstances of the franchise system to ensure that a prudent and measured investment is made.

For instance, consider a system's franchise agreements. The franchise agreement, among other things, describes the products and services that a franchisee may offer for sale from the franchised business and sets out the rights that the franchisor has to make system modifications. Entrepreneurs and strategic 'distribution network' buyers must review the franchisor's rights and obligations under the franchise agreements at the strategy stage to ensure that there is ample scope for the introduction of new products or services within the system. A strategic 'competitor' should ensure that the target's franchise agreements do not contain any prohibitions or obstacles (direct or indirect) to the franchisor owning and supporting competitive brands. For example, a target franchise system may have granted franchisees exclusive territorial rights that preclude the franchisor from operating corporate businesses under the same brand or even competitive businesses under a different brand in a designated area. A strategic 'competitor' buyer acquiring such a system might find itself in default under every franchise agreement upon the completion of the transaction.

Overview of an M&A transaction

The steps involved in an M&A transaction can vary greatly between deals, however, there is a standard process (at least notionally) that characterises an M&A transaction. It typically begins with preliminary negotiations between a buyer and a seller (directly or through advisers). This is usually followed by a high-level agreement of key terms that may be set out in a letter of intent or term sheet, which, in each case, can be binding, non-binding or a combination. At this stage, the parties will have a general sense of the deal structure – particularly whether the acquisition will be structured as an acquisition of assets, or of shares or stock of the target company.

After the parties have reached an agreement in principle on baseline terms, the buyer commences its due diligence of the target. The purpose and objective of due diligence includes: (i) an evaluation of the nature and value of the franchise system, its business and assets; (ii) continued assessment of strategic objectives with regard to the franchise system's circumstances; and (iii) identification of potential obstacles, risks and potential liabilities. Franchise-specific considerations form part of this process. The due diligence findings can translate into one or more of the following: the transaction not proceeding, revision of key terms, adjustments or mechanisms to adjust the purchase price, pre-closing obligations, tailoring of representations and warranties in the purchase agreement (discussed below), and post-closing obligations.

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At some point between the commencement and completion of the due diligence process, a definitive purchase agreement is drafted and negotiated (together with any other applicable transaction documents). In many cases, the most involved aspect is the negotiation of representations and warranties (and associated indemnity and liability provisions), often referred to as the risk allocation exercise between the buyer and the seller. The other main parts of the purchase agreement include the purchase price mechanics and adjustments, covenants (mainly pertaining to the obligations of the seller during the period between the signing of the purchase agreement and closing), pre-closing obligations, closing deliverables and conditions.

Once the purchase agreement is finally negotiated and all of its schedules setting out the factual findings from due diligence have been completed and collated, the buyer and seller (and any other parties to the agreement) sign the purchase agreement. The parties then move to satisfying the pre-closing obligations, as well as obtaining and preparing closing deliverables. The M&A transaction closes on the day where funds are transferred or received, closing deliveries are completed, and all other conditions precedent are satisfied or waived. Following closing, there may be purchase price adjustments (including escrow or holdback of purchase price monies for that purpose), tax and regulatory filings, as well as corporate governance matters.

Franchise-specific terms

The negotiation and drafting of purchase agreements in the context of a franchise M&A transaction requires knowledge and expertise with respect to franchise laws and the franchise business model. Such expertise will help to craft seemingly innocuous terms, such as franchise-specific definitions, as well as more significant parts, such as representations and warranties.

The definition of a 'franchise agreement' in a purchase agreement should be carefully drafted to ensure that it captures all relevant permutations of the franchise system's arrangements. More particularly, the definition may need to encompass joint venture, partnership and other alternative licensing arrangements, in addition to the typical structures such as master franchising, area development and area representation arrangements. In some cases, more than one definition for the various arrangements may be necessary to group different kinds of arrangements and facilitate separate treatment. The overall objective should be to prevent ambiguous and incomplete definitions from undermining the purchase agreement's terms and conditions.

Representations and warranties must address franchise-specific matters and, in particular, the franchise-specific due diligence considerations discussed below. This may require provisions that address the franchise system's specific materials and documents, regulatory registrations and compliance, obligations of franchisors under the franchise agreements (including administration and operation of advertising funds), and communications or interactions with the franchisee community. Deficiencies discovered during due diligence in particular may also necessitate provisions providing for specific indemnities, covenants to remedy deficiencies, holdbacks or escrows, or other mechanisms.

Franchisee community

Given the centrality of the franchisee community to the franchise system, it is perhaps ironic that a potential buyer's access to franchisees (eg, for due diligence purposes) is often a contentious issue. Existing franchisors are understandably reticent in informing franchisees of an impending sale for a number of reasons. These include: (i) concern that the distraction may cause problems for franchisees; (ii) franchisees with potential disputes may leverage the circumstances of the

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proposed transaction; and (iii) there may be serious negative consequences for the system if the deal is ultimately not completed.

Ultimately, as it relates to deal dynamics, the decision of when to inform franchisees of the proposed transaction and when to allow the buyer access to the franchisees (as well as the extent of that access) depends on factors like the size and condition of the franchise system, the relative bargaining power of the parties, and the due diligence protocols adopted by the buyer. For instance, a financial buyer (eg, a private equity firm) might be afforded greater access for due diligence purposes, whereas a strategic buyer (eg, a direct competitor) may be permitted more limited access, at least until the transaction becomes more advanced. It is not uncommon for buyers to be provided access to franchisees only days before completion of the transaction and, in some cases, only through third-party administered surveys (ie, not direct access).

Regarding legal and regulatory requirements, there is typically no statutory obligation to disclose a proposed transaction to existing franchisees even where they continue to develop and establish new franchised business units pursuant to an existing franchise arrangement. However, franchise disclosure laws may require that the proposed transaction be disclosed to prospective franchisees through the franchise disclosure document if it rises to the level of a 'material fact'. The determination of if and when such disclosure is required depends on the particular laws of a jurisdiction as applied to the particular circumstances. In many cases, where franchise-specific laws exist, once a proposed transaction reaches the threshold of materiality, which, for example, could be determined based on the probability of the transaction proceeding to completion, the franchisor must either include the existence of the proposed transaction in its disclosure documentation or refrain from selling any further franchises (referred to as the practice of 'going dark').

Beyond the question of timing, the tone and content of the franchisee communication itself is crucial. Indeed, a well-executed communication plan can greatly assist with engaging and motivating franchisees to buy into the buyer's future leadership and plans. Franchisees may have a number of questions or concerns that buyers may wish to pre-emptively address, including:

- Will the buyer understand, and be committed to, the franchise business model and its associated obligations?
- Will encroachment issues result from the buyer's intended expansion or its existing competitive brands?
- Are significant changes contemplated and will they involve additional investment by the franchisees?
- What will the management team look like post-closing?
- What are the likely effects or changes to the culture of the franchise system following the acquisition?

Franchise M&A due diligence considerations

Broadly speaking, the fundamental purposes of due diligence are to evaluate the nature and value of what is being acquired as well as identifying potential issues, risks or liabilities. The objectives of the buyer include ensuring that it receives the expected value in exchange for the consideration paid, evaluating any obstacles that may stand in the way of carrying out its strategic objectives for the business, and to avoid, ameliorate or allocate (to the extent possible) potential and actual risks associated with the franchise system. There a number of unique franchise-specific considerations that inform and shape the due diligence of a franchise system.

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Certain indicators can serve as immediate 'red flags' at the outset of due diligence. Such indicators include high franchisee turnover or poor franchisee satisfaction, weak unit-level economics or declining same-store sales, lack of financial or accounting controls across the system, poorly drafted franchise agreements or significant variation between agreements, incomplete or poorly maintained franchisee files, material ongoing litigation and obsolete technology.

Beyond these immediate red flags, the following franchise-specific due diligence inquiries provide examples of the sorts of unique questions and issues that may arise in carrying out due diligence on a franchise system.

Brand strength

A franchise system's brand forms an integral part of its value. Accordingly, a buyer must consider the strength, resilience, stability and future potential of the system's brand. Is the business concept proven, replicable and adaptable across markets? Is the operating platform and infrastructure (in the form of manuals, training, ongoing consultation, franchisee communication strategies, compliance monitoring, marketing, technology, and processes for modification and updating of products and services, among others) well suited to supporting both existing operations as well as future growth? Are there any factors or changes, such as regulatory shifts or emerging market disrupters, that may affect brand strength?

Financial viability

The royalty stream must be analysed and stress-tested. Focus should be on the relative certainty and recurring nature of this fundamental long-term revenue source (as distinct from one-time sources like initial franchise fees). Part of assessing and testing the royalty stream involves considering: the remaining term on franchise arrangements, which includes the obligation to pay the royalty fee, and the likelihood of renewals; the age demographic and level of sophistication of the franchisee community; jurisdictional or regional trends or differences; and any patterns of payment delinquencies. Future royalty potential through increased sales from existing units, an increase in the number of franchisees, the introduction of new products or services, and other strategies should also be assessed.

Unit economics

The financial success of a franchise system is, in large part, a function of the performance of each member of the franchisee community. Financial information and trends with regard to same-store sales, as well as comparisons or benchmarking between stores in a given jurisdiction, are central concerns to be analysed. Is there a wide discrepancy in franchisee results, and, if so, what are its causes? What are the turnkey development costs for a franchised business unit (the major investment cost for a franchisee)? What is the average annual net profit per franchisee? Are there strategies for increasing revenues (eg, through improved products or services), reducing operating costs, or reducing initial development and refurbishment costs?

Human capital

Unless the buyer intends to replace a franchise system's management team, which, particularly in the case of financial buyers, is not typically the case, due diligence on each member of the team and their specific roles is crucial. Buyers should interview and consult with the executives and managers they believe are important to the long-term plans of the system, particularly those

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with unique skills who may be difficult to replace, such as sales executives and international operations managers. Is it necessary to incentivise those with unique or difficult-to-replace skills to remain after the completion of the transaction? Will any post-closing changes be required (eg, as a result of economies of scale)? If so, consideration of any unfavourable arrangements and obligations with respect to retirement or termination should be carefully reviewed.

Intellectual property

The intellectual property assets of a franchise system extend well beyond its core trademarks. Franchise systems often rely on trade secrets (eg, institutional know-how, processes, techniques and manuals), proprietary software and copyrights (eg, blueprints for unit location premises). Does the franchisor own, or have the appropriate licences to use, all of its intellectual property assets? Have intellectual property assets been correctly classified, protected (eg, through appropriate registration, negative covenants and consistent corresponding conduct, or licensing) and policed? Particularly with respect to trademarks, are registrations available in jurisdictions where the buyer intends to expand, but where registrations are not currently filed?

Advertising funds

A unique feature of franchise systems and often a common source of disputes between franchisors and franchisees is the administration of advertising funds. Franchisors typically have broad discretion over the application of advertising funds, and franchisees usually have a clear idea of how they believe advertising funds should be deployed to best serve their franchise unit. Buyers should analyse past performance and consider future obligations of advertising funds. Are there sufficient expected contributions to pay for contractual obligations to third parties such as advertising agencies? Including with respect to permitted or required expenditures across various forms of advertising and administrative costs, has the franchisor complied with its obligations under the franchise agreements? Has there been any correspondence from franchisees disputing the operation or administration of advertising funds?

System health

Franchisors operate their franchise systems and business through their franchisees and therefore the relationship between a franchisor and each franchisee is of central importance to the due diligence process. Determining the general attitude and disposition of franchisees toward the franchisor – sometimes referred to as 'taking the temperature' of franchisees – is a crucial step in due diligence. One key metric is the rate at which franchisees leave the franchise system (the 'flip rate'). Buyers should determine the reasons for departures; review the history of renewals, extensions, terminations, transfers, turnover, and related trends, events of default, as well as delinquencies; and assess available information relating to franchisees that are in financial difficulty or have been identified as non-viable. Examining franchisee files can provide great insight into the health of the franchise system by uncovering troubled relationships, potential disputes or litigation, general dissatisfaction, non-compliance and the franchisor's monitoring (or lack thereof) of the franchise system as a whole.

Franchisee associations

Franchisee associations (typically established by a group of disgruntled franchisees) and franchisor advisory councils (typically established by franchisors) are bodies or committees set up to

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represent and be the voice for franchisees on matters pertaining to their franchisor and the franchise system. Such associations may be named differently and constituted with various structures. Reviewing an association's or council's by-laws, minutes of meetings, website content, and correspondence and communications can provide information about the performance of, and challenges or issues, facing the system. These inquiries may also assist a buyer in determining where improvements can be made to the franchise system, the relationship between the franchisor and franchisees, or both.

Franchisee disposition

As noted above, the presence of a franchisee community differentiates franchise systems from other business models. To the detriment of many buyers, a frequently overlooked element of a franchise system is the cultural or emotional sensibilities of the franchisee community – the core of the franchise system. Franchisees can organise together and carry significant power to influence the terms of an acquisition as well as its post-closing success through both legal and contractual rights. Accordingly, buyers ought to take the temperature of franchisees regarding to a proposed transaction and assess the likely inclinations of the franchisee community (particularly where the buyer operates a competing brand). For instance, one area of investigation may be whether franchisees have unified as a group on previous occasions with respect to major changes or, more specifically, previously proposed M&A transactions.

Regulatory compliance

Franchise disclosure, business opportunity and relationship laws regulating franchise systems are increasingly being enacted (and re-enacted with more stringent obligations) across more jurisdictions. Some jurisdictions also subject franchisors to multiple levels of regulation. In the case of the United States, franchise-specific regulation occurs at both the federal and state levels (in many states). Due diligence on regulatory compliance can thus be complex, but it is nonetheless crucial as remedies available to franchisees against franchisors are often extensive and even draconian. Regard and scrutiny must be given to, among other things, the following:

- the accuracy and consistency of franchise sale documentation and processes (especially for those franchisees whose arrangements are within the rescission period);
- earnings projections or financial performance representations;
- registrations in the relevant jurisdictions; and
- ongoing compliance with franchise-specific laws.

Deficiencies may warrant stricter covenants in the purchase agreement or, if sufficiently serious, abandonment of the transaction. Buyers should, in particular, investigate inconsistencies between franchise disclosure documents provided to franchisees at the time of sale and the executed franchise agreements. Mistakes and inconsistencies between the two can potentially foil a buyer's future plans for the franchise system – or worse, result in future claims.

Franchise agreements

The franchise agreement between the franchisor and franchisee is central to the relationship between the two, and thus to the overall franchise system. However, assessing such agreements becomes more complex when one considers the different arrangements that may be entered into by franchisors and franchisees (and, in many cases, across multiple jurisdictions): area

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representation, area development, master franchise, joint venture and others. Buyers should therefore carefully analyse key terms in franchise agreements, such as:

- Term and renewal provisions – numerous contracts coming up for renewal in the short term may be desirable or undesirable depending on the plans of the buyer; buyers should also be on the look out for 'perpetual' or 'evergreen' contracts.
- Royalty rebates and concessions given to franchisees – such provisions can erode the royalty stream.
- The precise terms and breadth of rights that the franchisor has to modify and implement changes to the franchise system.
- The nature and scope of the territorial rights granted to franchisees (including exclusivity), together with the rights reserved to franchisors (eg, with respect to other franchise or business activities) – restrictions may impede the buyer's plans for expansion.
- Change of control or assignment provisions.
- Termination rights – such provisions should not be overly lax for franchisees and overly restrictive for the franchisor (and ideally should include a franchisor buyout right).

Buyers should also be wary of the potential existence of different versions of franchise agreements, as well as one-off 'side deals' or other unexpected concessions given to one or more franchisees. This is a particularly salient concern when due diligence is undertaken on a sample of franchise arrangements.

Franchise manual and compliance

The franchise manual sets out the operational requirements of the franchise system in detail, and is the primary instrument used by the franchisor to shape the franchise system. Unsurprisingly, franchise agreements must expressly mandate compliance with the franchise manual. Two inquiries with respect to the franchise manual are particularly important: (i) whether the manual is drafted adequately enough to ensure that the franchise system operates in a uniform and functional manner; and (ii) whether the manual's content is robust enough to shield the franchisor from potential vicarious liability, including with respect to joint employer rulings, cybersecurity and data breaches, menu labelling obligations, human rights violations, and breaches of disability laws.

Buyers should determine whether the franchise system has maintained good management of its franchise units and undertaken consistent implementation of compliance measures. For instance, discovering that franchisees have not obtained appropriate insurance because of a failure to police insurance obligations, or that gratuitous benefits or unintended warranties were granted to customers because of poor compliance monitoring of gift card and warranty programmes may have serious implications (especially when multiplied across hundreds of franchise units). There is certainly an incentive to avoid disputes over non-compliance issues within a franchise system, but a laissez-faire approach leads to a weak system that, in turn, gives rise to a minefield of issues for a buyer.

Joint or common employer

Franchisors in various jurisdictions face an increased risk of being classified as a joint or common employer with their franchisees as a result of evolving laws. Such a classification can leave a franchisor exposed to claims by franchisees' employees for unpaid wages, overtime or vacation

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pay, benefits, termination notice, pay in lieu of notice, severance pay, wrongful and constructive dismissal claims, human rights claims, and payroll taxes. A buyer should assess the existing franchisor's approach to reserving and exerting control over their franchisees' businesses in the context of joint or common employer standards.

Technology and cybersecurity

Whether in terms of point-of-sale systems, inventory software systems, marketing technology or computer hardware itself, outdated or obsolete technology can have serious and costly consequences. Due diligence should include assessing whether the franchisor has maintained, updated and made investments in its technology systems and infrastructure. Moreover, buyers should ensure that systems used by the franchisor are compatible and can be integrated with those that the buyer intends to use.

Lastly, with increasing expectations and regulation of consumer privacy, coupled with the growing volume and sophistication of cyber attacks on consumer data, cybersecurity risk is an important area of focus for due diligence. Indeed, such risks are exacerbated by the expanding boundaries of franchisor liability for matters arising at the franchise unit level. Buyers should closely examine the franchisor's compliance with privacy laws and PCI requirements, as well as the privacy and cybersecurity policies and measures adopted by franchisors, to ensure that they have adequately addressed potential exposure.

Other considerations

Two other points are worth making with respect to franchise-specific due diligence. First, where a franchisor has entered into one or more master franchise arrangements, it is important to note that there is no privity of contract between the franchisor and the once-removed unit franchisees (which are the franchisees of the master franchisee). Accordingly, due diligence on the franchisee community under a master franchise arrangement must be assessed through the master franchisee. Second, when dealing with a franchise system comprising global operations and various structures or arrangements, the task of reviewing every agreement may be beyond the scope of the buyer's due diligence mandate. In those circumstances, it is common for the scope of due diligence to be limited by segregating the information and documentation by, for example, date, jurisdiction, franchise type or issues of concern, and then proceeding to undertake comprehensive due diligence on a sample from each category.

Post-sale integration

As with any business, the purchase and sale of a franchise system involves a great deal of time and effort from executives and employees at various levels within the respective organisations. In many cases, particularly where the franchise system is purchased by a strategic investor that continues to operate other franchise systems or a financial investor that holds various franchise systems within its portfolio or fund, much of that time and effort is spent integrating the target system into its existing eco-system of franchise businesses. The steps involved in the post-sale integration are highly specific to the dynamics of the particular transaction and largely informed by the purpose or objectives behind the acquisition. For example, was the buyer looking to acquire a complementary brand to augment its existing systems, take a competitor out of the market or acquire a distribution channel? The following are three common areas to address as part of post-sale integration.

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Intellectual property

As one of the key assets of a franchise system, it is crucial for a buyer to carefully consider what it intends to do with the intellectual property acquired. Subject to the plans of the buyer, any rectification work not undertaken as a condition to closing will need to be addressed (eg, protecting, registering and policing trademarks in international jurisdictions). There may be intellectual property assets that the buyer intends to make available across other franchise systems or businesses, or that it intends to license to third parties (eg, proprietary software). Alternatively, the buyer may have plans to rebrand the franchise system by replacing the existing trademarks. In each case, it will be incumbent on the buyer to review the franchise agreements (and other franchise documentation) to ensure that it has the right to undertake such activities.

Synergies and economies of scale

Strategic and financial investors involved with one or more existing franchise systems will likely look to achieve economies of scale by utilising existing infrastructure and personnel for the target system. This may involve an integration or reshaping of redundant business divisions (eg, where both the target franchise system and existing business infrastructure have marketing and legal teams). In other cases, the acquisition may result in the buyer utilising newly acquired key personnel and relationships (internal or external) across its existing businesses (eg, a more sophisticated in-house accounting department or a major international supplier of products). Finally, it may be necessary to streamline certain third-party service providers with existing ones that are familiar with the buyers existing business structure and operations (eg, an external accounting firm or outsourced technology services).

Human capital and franchisees

One of the most unpredictable and challenging aspects of the post-integration process is managing the human capital and the franchisee principals of both the target franchise system and the existing business. Creating and maintaining a corporate culture is difficult, and integrating and shaping two cultures can be formidable. Following the acquisition, buyers may face, among other things, disengagement by executives, employees and franchisee principals. One valuable approach is to identify 'champions' for various objectives and across different facets of the franchise system, for example, identifying reliable individuals within the franchisee community and the franchise development or consulting divisions may be critical with respect to system changes. Where the buyer is looking to integrate a newly acquired division (eg, marketing) with its existing business infrastructure, obtaining specific buy-in from key managers and executives would be a prudent approach. It may be necessary to provide incentives (upfront or performance-based) to bolster the process and obtain a larger number of champions for the relevant cause.

Conclusion

The increasing frequency and sophistication of franchise system M&A transactions over the past decade looks set to continue into the future. This is in part because of greater interest and investment from private equity. Franchise systems have caught the attention of private equity firms attracted by the robust, long-term and diversified royalty revenue streams; the proven, and frequently international, business concept; the potential for organic and rapid growth; the inherent leverage on operating costs once a certain system size is achieved; the pre-existing network of experienced operating partners; and the goodwill and strength of an established

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brand that franchise systems can provide. The low capital investment required to expand franchise systems (as compared with other business structures), as well as the fact that the financial and investment community is now familiar with and supportive of the franchise business model, provide further incentives for such transactions. It is imperative that advisers become familiar with the unique characteristics and requirements of franchise M&A transactions. As demonstrated above, these unique considerations apply to all stages of the M&A transaction.

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Appendix 1

About the Authors

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Andrae is a partner in the business law group and co-chair of the franchise and distribution law group in the Toronto office of McMillan LLP. His transactional practice is focused on advising domestic and international businesses on franchise and distribution matters and corporate/M&A transactions. He has particular expertise in complex franchise arrangements, franchise system mergers and acquisitions, and cross-border/international transactions. He works with businesses and franchise systems (from start-ups to mature international enterprises) across a broad range of industries, including professional services, technology, automotive, restaurant, fitness and healthcare, childcare and education, manufacturing, and commercial services.

Andrae frequently presents at Canadian and international franchise conferences and events, and routinely writes for national and international franchise journals and publications. He is an active member of various North American franchise organisations and serves on several steering committees.

Andrae has been awarded the 'Certified Franchise Executive' designation by the Institute of Certified Franchise Executives and is repeatedly named on the prestigious list of Legal Eagles by *Franchise Times*. He is also recognised by *Chambers Canada*, *Who's Who Legal: Franchise*, *Who's Who Legal: Canada*, *The Canadian Legal Lexpert Directory*, the *Lexpert Guide to the Leading US/Canada Cross-Border Corporate Lawyers*, and *Best Lawyers* in Canada. Andrae authored the chapter on 'Franchise M&A' in *Getting the Deal Through: Mergers & Acquisitions* 2017 and *Getting the Deal Through: Franchise* 2018.

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