

Mergers & Acquisitions

Contributing editor
Alan M Klein



2017

GETTING THE
DEAL THROUGH

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Contributing editor

Alan M Klein

Simpson Thacher & Bartlett LLP

Publisher
Gideon Robertson
gideon.roberton@lbresearch.com

Subscriptions
Sophie Pallier
subscriptions@gettingthedealthrough.com

Senior business development managers
Alan Lee
alan.lee@gettingthedealthrough.com

Adam Sargent
adam.sargent@gettingthedealthrough.com

Dan White
dan.white@gettingthedealthrough.com



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Franchise M&A

Andrae J Marrocco

Dickinson Wright LLP

Introduction

Franchise systems present a valuable investment proposition for both strategic and financial investors. The franchise business model as an expansion strategy has been on the rise across the globe for many years, and its growth together with its contributions to national gross domestic product and job creation have outperformed other sectors and business models. Moreover, franchise systems have progressed well beyond traditional quick-service restaurants to many other industries and sectors. Unsurprisingly, franchise businesses have increasingly become a focus for M&A deals, some of them large and complex. Take, for example, the recent Burger King C\$14.6 billion acquisition and tax inversion involving Tim Hortons.

Mergers and acquisitions of franchise systems have become more commonplace and more sophisticated over the past decade, a trend that looks set to continue into the future. This is in part owing to increased 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 stream (less subject to swings in the general economy), the proven (often international) business concept, the potential for organic and rapid growth or expansion, the inherent leverage on operating costs once a certain system size is achieved, the pre-existing network of experienced operating partners, together with the goodwill and strength of an established brand that franchise systems can provide. Also important for private equity is 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.

Franchise business model

The franchise business model is by its nature unique. Understanding its framework and its moving parts 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). Accordingly, the assessment of franchise systems is different from the assessment of traditional 'bricks and mortar' businesses.

Franchise systems have also evolved into more complex creatures as various arrangements and structures have been adopted across multiple jurisdictions including joint ventures, master franchising, area development, area representation arrangements, etc. In addition, the franchise sector has been subject to increasing regulation across the world, both direct (through franchise laws) and indirect (eg, through relationship laws), and has typically been a highly litigious area.

In light of its distinctive features, acquiring a franchise system involves a number of unique considerations that are pertinent throughout the process: initial strategy discussions, letter of intent and due diligence stages, the drafting and negotiating of the transaction documents, closing of the transaction and beyond. The following discussion provides some insight into the kinds of unique considerations that are addressed by professionals when advising on franchise M&A transactions.

Strategy in franchise M&A

There are generally four types of buyers of franchise systems:

- entrepreneurs or existing franchisors (the next generation in the life cycle of a franchise system);
- strategic 'distribution network' buyers (looking to acquire a distribution channel for existing products);
- strategic 'competitor' buyers (seeking to obtain additional market share through acquiring a direct competitive brand, a complementary brand or by eliminating a competitor altogether); and
- financial buyers (acquiring the franchise system for a return at some point in the future).

Notwithstanding some overlap, the motivations and resulting strategies for each of these buyers are distinct. It is essential that specific strategic objectives be assessed against the intangible assets of the franchise system to ensure that a prudent and measured investment is made. To illustrate this point, consider the following scenarios.

Franchise agreements clearly describe the products and services that a franchisee may offer for sale from their franchise unit, and expressly set out the rights that franchisors have to make system modifications. Entrepreneurs and strategic 'distribution network' buyers should 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. A strategic 'competitor' should ensure that the target's franchise agreements do not contain any prohibition or obstacles (direct or indirect) on the franchisor owning and supporting competitive brands. Consider, for example, a target franchise system that grants franchisees exclusive territorial rights precluding the franchisor from operating, not only corporate businesses under the same brand in the designated area, but also competitive businesses under a different brand. A strategic 'competitor' buyer acquiring such a brand might find itself in default under each and every franchise agreement upon the completion of the transaction.

Franchise-specific due diligence

At a high level, the fundamental purpose of due diligence is to evaluate the nature and value of what is being acquired together with the associated issues, risks and potential liabilities. The acquisition of a franchise system presents a number of unique considerations, potential issues and challenges which inform and shape the due diligence process. Before discussing these in detail, it is worth noting that the following indicators should raise immediate red flags when considering the acquisition of a franchise system:

- high franchisee turnover and poor franchisee satisfaction;
- weak unit-level economics, declining same-store sales, and challenges with respect to macroeconomic and political environments;
- lack of financial or accounting controls across the franchise system;
- poorly drafted franchise agreements, significant variation between agreements, and incomplete or poorly maintained franchisee files;
- poor management (including with respect to compliance and enforcement) of the franchise system;
- material ongoing litigation; and
- obsolete technology investments (particularly given the importance of cybersecurity in the midst of the data or privacy breach epidemic of recent times).

The following (non-exhaustive) franchise-specific due diligence inquiries provide examples of the sorts of unique questions or issues that arise in the context of franchise M&A transactions.

Brand strength

Does the franchise system demonstrate a proven and replicable business concept, adaptable across markets? Has the franchise system experienced consistent growth by number of franchise units across all jurisdictions? Taking into account the size of the franchise system, has the franchisor built a solid operating platform and sound infrastructure to support existing operations as well as future growth and expansion including with respect to its manuals, training, ongoing consultation, franchisee communication strategies, compliance monitoring, marketing, technology, processes for modification and updating of products and services? Despite brand strength, are there any potential changes to the industry, such as regulatory shifts or emerging market disrupters?

Financial viability

Stress testing the royalty stream is quintessential. The focus should be on the relative certainty and recurring nature of the main revenue source (ie, long-term royalty stream) as distinct from one-time fees (eg, initial franchise fees). Purchasers should consider the remaining term on franchise arrangements (the source of the royalty stream) and the likelihood of renewals, age demographic and level of sophistication of the franchisee population, jurisdiction and regional trends or differences, and whether there are any patterns of payment delinquencies. Consideration should also be given to the future royalty potential, whether through increased sales from existing units, an increase in the number of franchisees, the introduction of new products or services, or other strategies (eg, the purchaser planning to take on the supply of products or services to franchisees for an additional fee).

Unit economics

The financial success of a franchise system is subject in large part to the performance of each member of the franchisee population. Buyers should be concerned with the financial information and trends as they relate to franchisee same-store sales, as well as comparisons or benchmarking between stores in a given jurisdiction. Is there a wide discrepancy in franchisee results and, if so, what are the reasons? Two other important measures to assess include turnkey development costs (the major investment cost for a franchisee) and annual net profit. Are there strategies for increasing revenues (eg, improved products or services), reducing operating costs or reducing development costs (initial and refurbishment)?

Human capital

Unless the purchaser is looking to replace the management team (usually not the case, particularly with financial buyers), then due diligence on each member of the team and their specific roles is crucial. Consider whether there will be required changes post-closing (eg, owing to economies of scale). The purchaser should interview and consult with those executives and managers they believe are important to the long-term plans of the franchise system (particularly those with unique skill sets who are difficult to replace, eg, franchise sales executives and international operations managers), and may also consider incentivising those individuals to remain following the completion of the transaction. Separately, purchasers should investigate and consider unfavourable arrangements and obligations with respect to retirement or termination of senior management (eg, golden parachutes, poor non-compete provisions, etc).

Intellectual property

The intellectual property assets of a franchise system go well beyond the trademark(s) prominently featured outside of a franchise unit location. Franchise systems are often based on trade secrets (know-how, processes, techniques, manuals), which may include proprietary software and copyrights (eg, in the blueprints for unit location premises). Does the franchisor own, or have the appropriate licences to use, all of the intellectual property rights? Such inquiry is particularly crucial where, for example, developers have been involved in the creation of proprietary software. Have the intellectual property assets been correctly classified, protected (whether through registration, negative

covenants and consistent corresponding conduct, or licensing) and policed? Especially with respect to trademarks, are registrations available in jurisdictions where the buyer intends to expand (but where registrations have not currently been 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 as to how they believe the advertising funds can be deployed to best serve their franchise unit(s). Buyers should analyse past performance and consider future obligations of advertising funds. Are there sufficient forecast contributions to pay for contractual obligations to third parties (eg, ad agencies)? Has the franchisor complied with its obligations under the franchise agreements including the percentages of expenditure permitted or required across various forms of advertising and the administrative costs? Has there been any correspondence from franchisees disputing the operation or administration of the advertising funds?

System health

Characteristically, the franchisor operates its franchise system and business through its franchisees. It stands to reason that the relationship between a franchisor and its franchisees is quintessential to the franchise system. Therefore, determining the general attitude and disposition of franchisees toward the franchisor – sometimes referred to as ‘taking the temperature’ of franchisees – is all-important. One helpful metric in this regard is the ‘flip rate’ – the rate at which franchisees leave the franchise system. Discerning the reason for such departures is also meaningful. More broadly, purchasers should review the history of renewals, extensions, terminations, transfers, turnover (trends), events of default, delinquencies, franchisee holding over and franchisees that are in financial difficulty or have been identified as non-viable (predicted to close). Franchisee files can provide great insight into the health of the franchise system by uncovering troubled relationships, potential disputes, (threatened) litigation, general dissatisfaction, non-compliance, as well as the franchisor’s monitoring (or lack thereof) of the franchise system as a whole. In addition, a savvy purchaser will look to identify real and apparent expectations created by the franchisor’s conduct and communications, and gain a sense of the existing franchisor’s strengths and weaknesses.

Franchisee associations

Given various titles, and constituted by various structures, franchisee associations (typically established by a group of disgruntled franchisees) and franchisor advisory councils (most of the time established by franchisors) are bodies or committees set up to represent, and be the voice for, franchisees on matters pertaining to their franchisor and the franchise system. Reviewing an association’s or council’s by-laws, minutes of meetings, website content, together with all correspondence and communications with the franchisor and franchisees, can provide a wealth of information about the performance of the franchisor. Moreover, it can reveal the challenges and issues facing the franchise system. The corollary being that the buyer can gain insight from such review on what may improve the operations and value of the franchise system.

Franchisee disposition

The presence of a franchisee community differentiates franchise systems from other businesses. Perilously, a frequently overlooked element of a franchise system is the cultural or emotional sensibilities of the franchisee community; the organism at the heart of the franchise system. Franchisees tend to band together and carry with them significant power to influence the terms of an acquisition as well as its post-closing success (through both legal and contractual rights). Accordingly, the purchaser is best advised to ‘take the temperature’ of the franchisees as it relates to a proposed transaction, and the likely predilections and inclinations of the franchisee population in this regard (particularly where the purchaser operates a competing brand). Investigate whether franchisees have unified as a group on previous occasions with respect to major changes or, more pertinently, previously proposed M&A transactions. As stated above, information and

records of a Franchisee Association or Franchisor Advisory Council (if they exist) can be a gauge on some of these matters.

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 subject franchisors to multi-level regulatory schemes (eg, in the US, regulation occurs at both the federal level as well as in a number of states). Consequently, due diligence on 'compliance with laws' in such circumstances can be a complex inquiry, but is critical as the remedies available to franchisees are often extensive and even draconian against franchisors. The due diligence process includes scrutinising: (i) the accuracy and consistency of franchise sale documentation and processes (especially for those franchisees whose arrangements are within the 'rescission' period); (ii) earnings projections or financial performance representations; (iii) registrations in the relevant jurisdictions; and (iv) ongoing compliance with franchise-specific laws. Deficiencies in this regard can lead to stricter covenants in the purchase agreement (discussed below) or, if sufficiently serious, can be deal-breakers. Buyers should particularly investigate inconsistencies between franchise disclosure documents provided to franchisees (at the time of sale) and the ultimately executed franchise agreement. Mistakes and misalignments between the two can foil the buyer's future plans for the franchise system, or worse, result in potential future claims.

Franchise agreements

Franchisees are at the heart of a franchise system, and therefore the franchisor's arrangements with franchisees are paramount to an assessment of a franchise system. The inquiry becomes more complex where there are different categories of arrangements entered into by the franchisors (eg, area representation, area development and master franchise arrangements) across various jurisdictions. Buyers should carefully consider specific terms in the 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 purchaser; also watch for 'perpetual' or 'evergreen' contracts);
- royalty rebates and concessions given to franchisees that 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 (eg, to respond to changes in the marketplace or to execute the purchaser's proposed plans);
- 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) to determine whether there are any impediments to the purchaser's plans for expansion;
- change of control or assignment provisions to determine the requirements for the proposed transaction; and
- termination rights; preferably not overly lax for franchisees and not too restrictive on the franchisor (and ideally including a franchisor buyout right). Importantly, buyers should also be aware of the potential for different versions of franchise agreements to exist as well as one-off 'side deals' and other random concessions given to one or more franchisees (particularly where due diligence is undertaken on a sample of franchise arrangements).

Franchise manual and compliance

The franchise manual sets out in finer detail the operational requirements of the franchise system, and is a primary tool used by the franchisor to effect franchise system change. The franchise agreement expressly mandates compliance with the franchise manual. There are two important inquiries with respect to the franchise manual: is the manual drafted sufficiently to ensure that the franchise system operates in a uniform and functional manner, and is the manual's content robust enough to shield the franchisor from potential vicarious liability, including liability with respect to joint employer rulings, cyber security and data breaches, menu labelling obligations, human rights violations, and breaches of disability laws to name a few? In addition, purchasers will want to determine whether the franchise

system has maintained good management of its franchise units and undertaken consistent implementation of compliance measures. Consider the implications for a purchaser in the following scenarios multiplied across several hundred franchise units: (i) the franchisor failing to police insurance obligations (ie, collecting specific insurance certificates naming the franchisor), and the purchaser later discovering that one or more franchisees have not obtained appropriate insurance, or (ii) poor compliance measures being taken to monitor gift card programmes or warranty policies offered by franchisees to their customers (which often have complex terms and conditions) resulting in gratuitous benefits or extensive unintended warranties being granted to customers in breach of system requirements. Avoiding full-blown disputes over non-compliance issues can be desirable within a franchise system, but a laissez-faire approach to enforcing standards leads to a 'weak' franchise system and a potential minefield of issues for an incoming franchisor.

Joint/common employer

Franchisors in various jurisdictions are experiencing increased risk of being classified as a joint/common employer with their franchisees as a result of evolving laws (whether judicial or legislative). Such classification can have far-reaching effects, leaving franchisors exposed to claims by franchisee employees for unpaid wages, overtime or vacation pay, benefits, termination notice, pay in lieu of notice, severance pay, wrongful and constructive dismissal claims, human rights claims and payroll taxes, as well as increased risk of employee unionisation across franchisee lines. Consequently, this is both a serious and chief concern for purchasers when conducting due diligence. Purchasers must carefully review and analyse the existing franchisor's approach to reserving and exerting control over their franchisees' businesses in light of the joint or common employer standards.

Technology and cybersecurity

Has the franchisor maintained, updated and made investments in its technology systems in an optimum manner? Whether it be point of sale systems, inventory software systems, marketing technology or the computer hardware itself (depending on the nature of the business), obsolete technology spells disaster. In addition, the purchaser will want to ensure that the systems used by the franchisor are compatible, and can be integrated, with its own systems. On another front, franchisors are facing a precarious three-way intersection of increased accountability and regulation over consumer privacy, the growing volume and sophistication of cyberattacks on consumer data, and the expanding boundaries of franchisor liability for matters arising at the franchise unit level. Purchasers should closely assess the franchisor's compliance with privacy laws (in all jurisdictions) and PCI requirements together with cybersecurity programmes, policies and measures taken by franchisors, to ensure that they have adequately assessed potential exposure.

There are a few more points worth making with respect to franchise-specific due diligence. Firstly, 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 population 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 each and every agreement may extend beyond the scope of the buyer's due diligence mandate. In those circumstances, it is not uncommon for the scope of due diligence to be limited by segregating the information and documentation by one or more of the following: date, jurisdiction, franchise type, issues of concern, etc, and then proceeding to undertake comprehensive due diligence on a sample from each category.

Purchase agreement provisions

Drafting and negotiating purchase agreements in the context of a franchise M&A transaction involves franchise unique drafting, the inclusion of tailored representations and warranties, and risk allocation mechanisms to address issues raised by the franchise-specific due diligence process. For instance, the definition of 'franchise agreement' in the purchase agreement should be carefully crafted to ensure that

it captures all relevant permutations of the franchise system including joint ventures, partnerships and alternative licensing arrangements (in addition to the various structures referred to above, ie, master franchising, area development and area representation arrangements). In some cases, it may be necessary to include several definitions (for the various arrangements) to give proper meaning to the terms and conditions of the purchase agreement. The chief goal is to ensure that the representations and warranties (and corresponding indemnities) are not undermined by missing or mixing the various forms of arrangement. Customised and detailed representations and warranties addressing franchise-specific matters as well as the above franchise-specific due diligence considerations form an integral part of well drafted franchise M&A purchase agreements. These include statements that speak to the franchise materials and documents in existence, specific regulatory registrations and compliance, the specific obligations of franchisors under the franchise agreements (including administration operations of the advertising funds) and the communications or interactions with the franchisee population. Finally, the purchase agreement will address the deficiencies arising from the franchise-specific due diligence through the representations and warranties, specific indemnities, covenants to remedy (whether post or prior to closing) and other mechanisms (such as holdbacks or escrows).

Deal dynamics and beyond

Ironically, notwithstanding that the franchisee population is at the heart of the franchise system, the buyer's access to the franchisee population (for due diligence purposes) is almost always a contentious issue. The matter is inextricably tied to the franchisor's determination of the most appropriate time to disclose the existence of a potential transaction to its franchisees. Franchisors are reluctant to inform franchisees of an impending sale transaction for a number of reasons including: (i) the distraction that it may cause for franchisees; (ii) franchisees with potential disputes can take advantage in the circumstances of the proposed transaction (eg, by holding out for a larger settlement); and (iii) the potential negative consequences for the system if the deal is not completed. Ultimately, the determination of when to inform franchisees of the proposed transaction, and when to allow the buyer access to the franchisees (as well as what that access will involve), is dependent on a number of factors including the size and condition of the system, the relative bargaining power of the parties, and the due diligence protocols adopted by the buyer. It is worth noting that in some cases franchisors are provided access to the franchisees just prior to completion of the transaction, and in some scenarios only through third-party administered surveys (ie, no direct access).

From a regulatory perspective, there is no statutory obligation to disclose the proposed transaction to existing franchisees, even where they continue to develop and establish new units (pursuant to an existing franchise agreement). However, the situation with prospective franchisees is different. Franchise disclosure laws may require that the proposed transaction be included in disclosure documents. The determination of when the proposed transaction has reached a point in time where its existence must be disclosed to franchisees (typically as a 'material fact') is dependent on the facts and the particular laws of a jurisdiction. Once that point is reached (usually the point in time where the transaction is more than likely to proceed), the franchisor must either include the existence of the transaction in its disclosure documentation or refrain from selling any further franchises (referred to as the practice of 'going dark').

Notwithstanding the point in time at which the franchisees are informed of the proposed transaction, the tone and content of the communication from that point on is crucial. A well-executed communication plan and programme can go a long way to engaging and motivating franchisees to buy into the purchaser's future leadership and plans. Prudent buyers will look to pre-empt the expectations of franchisees by addressing the following kinds of matters (that franchisees want comfort on):

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

Conclusion

Sector and industry-specific considerations exist in most M&A transactions, franchise M&A transactions are no different. An understanding of the franchise business model, the underlying assets, and the sorts of issues and challenges that can arise in that context is critical to competently advising on franchise M&A transactions. This chapter (which is by no means exhaustive) is intended to provide some insight and valuable practice tools for practitioners in this growing area. Private equity has increasingly brought its capital, expertise and other resources to bear on the franchise sector, buying and improving franchise systems. It will be interesting to watch the interplay between franchise systems and private equity, and further consolidation in the franchise sector, over the coming year.



Andrae J Marrocco

amarrocco@dickinsonwright.com

199 Bay Street, Suite 2200
 Commerce Court West
 Toronto ON M5L 1G4
 Canada
 Direct tel: +1 416 777 4046

International Square
 1825 Eye Street NW, Suite 900
 Washington, DC 20006
 United States
 Direct tel: +1 313 223 3646

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