DEAL MAKERS REFRANCHISING:

Not Just Another M&A Deal

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Over the past several years, numerous franchising systems have engaged in ambitious refranchising programs in an effort to transform and grow their brands. Refranchising involves the sale by a franchisor of one or more company-owned units to a third party to operate the business going forward as a franchised unit. While franchisors often make one-off sales of underperforming or non-strategic company-owned units, launching a chain-wide refranchising initiative is often a transformative measure representing a philosophical shift in the franchisor's approach to development. A system-wide refranchising initiative is often driven by a desire to shift financial risk away from capital-intensive company-owned units (and the related corporate overhead and balance sheet exposure they entail) to a more cash-flow friendly and profitable royalty stream. Often, a refranchising deal is accompanied by the execution of a multi-unit development agreement requiring the refranchise purchaser to develop an agreed number of additional franchised units within a defined territory—shifting the burden of continued market growth from the franchisor to the refranchise purchaser.

Shifting the balance in favor of more franchised units and fewer company-owned units also means that a franchisor must think even more strategically about the value the franchisor is providing to franchisees. The paradigm shift from brand owner with readily apparent "skin in the game" to a brand owner with more limited unit-level operations may raise questions for existing franchisees and refranchise purchasers. A brand engaged in a system-wide refranchise program may need to simultaneously redouble its efforts in terms of brand development through an enhanced focus on new product ideas, system improvements, promotions and ad campaigns aimed at increasing unit-level sales for its franchisees (and thereby increasing its royalty base). This allows the brand owner to become less distracted by the day-to-day operation of units and more focused on the strategic evolution of the system for the benefit of the entire franchise network.

Moreover, overlaying a long-term franchisor-franchisee relationship on top of the buyer-seller relationship creates a unique dynamic that does not exist in a typical asset or business sale transaction. In a typical asset or business sale transaction, a bridge-burning approach might be possible because the relationship between the parties after closing may be limited to some nominal transition matters and waiting out the indemnification survival period. By contrast, a truly successful refranchise transaction involves a mutually beneficial long-term relationship, making the balance between appropriate seller protections and franchisor-franchisee harmony difficult to achieve.

This article examines some of the key documents and other considerations that are unique to refranchise transactions and that distinguish the way in which a franchisor sells a business to a franchisee from how a typical seller would approach documenting, negotiating and closing the sale of its business.

Pre-Sale Due Diligence

Prior to entering into discussions with a potential refranchise purchaser regarding a potential transaction, the franchisor should have an in-depth understanding of the franchise units being sold and the potential diligence issues that are likely to arise in the refranchise transaction. Such issues have the potential to materially affect the valuation, sales process and legal documentation of the transaction. Some of the most commonly encountered due diligence issues include: lease terms and real estate control, liquor licensing, deferred maintenance issues, litigation, environmental issues and employee benefits. A thorough pre-sale due diligence process allows the franchisor to proactively address known issues prior to even signing a letter of intent ("LOI"), rather than dealing with concessions later in the negotiations when the franchisor's leverage is reduced. Three critical diligence issues involving potential consents from third parties are:

- *Lease Terms*: The franchisor and its counsel should have a clear understanding of the assignability of any real property leases prior to initiating the proposed refranchising transaction. The franchisor should also understand whether a continuing guarantee of the franchisor is required in connection with a proposed lease assignment or if the landlord is likely to release the franchisor from liability in connection with an assignment.
- *Liquor Licensing*: To the extent the franchised business involves the sale of alcoholic

beverages, the franchisor should consult local liquor counsel well in advance of the transaction in order to adequately address such matters and define an appropriate timeline for closing of the refranchise transaction. The regulatory scheme for liquor licensing matters can vary greatly from jurisdiction to jurisdiction and various licensing arrangements may exist that can affect the timing for closing or the risk of liquor liability to franchisor.

o *Deferred Maintenance*: The franchisor should have a thorough understanding of the physical condition (including any deferred maintenance issues) of the premises and assets it is selling, as a buyer conducting physical due diligence may discover potential repair issues. In addition, some deferred maintenance issues may be the responsibility of a landlord requiring pre-sale negotiation with the landlord, which can take time to negotiate and is best done prior to entering into discussions with a refranchise purchaser. The franchisor should require the refranchise purchaser to conduct inspections and other due diligence with the clear understanding that the refranchise transaction is on an "as is, where is and with all faults" basis. This is especially important for the health of the relationship between the parties immediately before and after closing, as franchisor does not want the refranchise purchaser to raise deferred maintenance and other asset condition issues on the eve of closing or immediately after closing.

The Non-Disclosure Agreement

Discussions around any refranchise transaction must begin with a strong non-disclosure agreement ("NDA") with the prospective refranchise purchaser—particularly when these discussions involve a refranchise purchaser that is not an existing franchisee. In one sense, this is no different than the approach a franchisor would take in selling a franchise. However, there are additional sensitivities involved when discussing the sale of a company unit. First, the refranchise purchaser will want access to detailed financial reports on the franchised units to be acquired. This may be particularly sensitive information to the franchisor (especially when dealing with underperforming units) that it would not want to be disclosed if a proposed transaction is not ultimately consummated.

Second, the mere knowledge that the sale of company-owned units is being considered may have immediate negative consequences to the business—in particular, in relation to the employees of the affected units or corporate employees who may not be privy to the pending transaction. Accordingly, the franchisor should include an express non-contact provision requiring all communications regarding the proposed transaction to be directed to a specific franchisor employee in charge of the transaction and a prohibition on contacting franchisor's employees, suppliers, and landlords, except as specifically authorized by franchisor in writing.

Additionally, not only should the NDA protect against disclosure of the transaction itself, but the franchisor may want to include non-solicitation provisions covering, at a minimum, its key employees and general managers of company-owned units, senior managers, and executives. The franchisor may ultimately be happy to have the refranchise purchaser hire certain employees in connection with a refranchise transaction; however, the franchisor will want to ensure that none of its employees are "poached" by the refranchise purchaser if they would have an important role in the franchisor's organization going forward.

The Letter of Intent

While every LOI necessarily addresses a number of key business and legal terms (i.e., non-binding until definitive documentation is executed, franchisor may withdraw from discussions at any time, etc.), in the refranchise context it is critical that the LOI include other terms, such as:

o The specific franchised units to be purchased and, if possible, the purchase price allocated to each unit;

o The initial franchise, royalty and other fees to be charged for the franchised units;

o Any required remodeling, redecorating or renovation of the franchised units to be purchased, including detailed information regarding the minimum and maximum expenditures and schedule for completion;

o If applicable, a development schedule setting forth the additional franchised units to be developed in the restricted territory by the refranchise purchaser;

o Given the franchisor and refranchise purchaser will be entering into a long-term relationship post-closing, it is critical that the parties have a clear understanding that the franchised unit is being sold on an "as is, where is and with all faults" basis with limited franchisor indemnification. The scope of indemnification should be clearly defined so that the parties have an understanding of post-closing responsibilities and are able to avoid (to the extent possible) protracted disagreements that could

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adversely affect the franchised unit and the ongoing relationship between the parties; and

- To the extent applicable, any agreed exclusivity period and an acknowledgment by the refranchise purchaser that it will be responsible for all of its own costs and expenses in connection with negotiating and documenting the proposed transaction.

Definitive Purchase Agreement

Refranchising transactions are frequently documented using an asset purchase agreement ("APA") between the franchisor and the refranchise purchaser. As with any purchase transaction, key terms—particularly those relating to purchased assets, excluded assets and assumed liabilities—must be properly defined.

The "Purchased Assets" definition should be limited to include only those assets utilized solely in connection with the franchised units. Ideally, the franchisor should endeavor to include only assets set forth on a schedule within the definition of "Purchased Assets." In addition to furniture, fixtures and equipment, it is also typical to transfer franchisor's leasehold interest in specified leased properties, certain scheduled contracts, and, to the extent transferable under applicable law and at no cost to the franchisor, certain licenses and permits.

- The "Excluded Assets" definition should, among other things, expressly acknowledge that all rights provided by franchisor with respect to the franchised units (including, without limitation, the trademarks and the franchisor's system and goodwill associated therewith) remain the property of franchisor. The definition should also clearly provide, among other things, that all benefit plans and employee or personnel files, all insurance policies, all rights under contracts not expressly assumed by the refranchise purchaser, and any proprietary software remain the sole property of franchisor.
- Franchisors typically assign the lease or sublease the real property utilized for the franchised location to the refranchise purchaser. If the franchisor will not be released upon assignment, then the franchisor should require the refranchise purchaser's principals to deliver a guarantee to the franchisor guaranteeing the refranchise purchaser's obligations under each assigned lease or sublease.
- The APA should include an express acknowledgment by the refranchise purchaser that it is purchasing the Purchased Assets on an "as is, where is and with all faults" basis. The APA should also include an acknowledgment from the refranchise purchaser that, except as otherwise specifically set forth in the APA, the franchisor is not making any express or implied representations regarding the Purchased Assets. Because franchise relationships can be a 20 or 30 year prospect, the parties must clearly understand their rights and responsibilities from the outset. While clear disclosures by the franchisor regarding the condition of the Purchased Assets is critical, it is just as critical that the refranchise purchaser value the transaction with this in mind to avoid future disagreements that could damage the ongoing franchise relationship.
- The APA should explicitly address the refranchise purchaser's obligations to the franchisor's current employees at the franchised units. To mitigate the risk of potential employment liability for both parties, qualified employment counsel should be involved to review the structure of any transition of employees from the franchisor to the refranchise purchaser, including the terms of employment offered to the affected employees (i.e., whether commensurate salary and benefits will be provided, whether accrued vacation will be honored, etc.) and any release, transfer or termination documentation. The APA should also require that the employee transfer be appropriately structured to avoid the application of the federal Worker Adjustment and Retraining Notification ACT ("WARN") and any state equivalent or, to the extent WARN or a state equivalent is applicable, that the refranchise purchaser will ensure compliance with the duties and obligations associated with the transaction.
- As referenced above, if the franchised business involves the sale of liquor or other alcoholic beverages, the parties will need to coordinate closely with local liquor counsel. In some jurisdictions, temporary or conditional liquor licenses or the entry into interim beverage management agreements may be necessary.
- Indemnification in the refranchise transaction context is unique given the ongoing relationship between the parties following closing. Because the refranchise purchaser is buying an operating business along with furniture, fixtures and equipment, it will want to look to the franchisor if issues arise post-closing. However, as noted above, the LOI should clearly provide that the purchased assets are being sold on "as is, where is and with all faults" basis. Consequently,

the franchisor should consider reasonable liability caps and baskets for any indemnification, and the parties should reach a clear understanding that the ongoing franchise relationship may not be used as a negotiation tool in connection with post-closing indemnification.

Changes to the Franchise

Disclosure Documents

In addition to the transaction-specific documentation described above, initiating a systematic refranchising program requires changes to the Franchise Disclosure Document ("FDD") to address the refranchising program and its effects on the franchise system, including:

Table of Contents / Exhibits	The form refranchising program documents should be attached as exhibits to the franchisor's FDD. Such documents typically include the NDA, LOI, APA and other ancillary forms. Additionally, any addenda to the form of franchise agreement and development agreement that address standard changes to the form agreements that are applicable in refranchising transactions should also be attached.
Item 1	This item should be modified to address the nature of the proposed refranchising program and identify the primary documents to be signed in connection with a refranchising transaction.
Items 5, 6 and 7	To the extent initial or ongoing fees are different, may be negotiated, or are not applicable in connection with a refranchising transaction, this should be disclosed. Required escrow or similar deposits should also be disclosed.
Item 10	To the extent the franchisor seeks to assign or sublease leases for franchised units in connection with a refranchising transaction, the terms of such arrangements must be disclosed. If a franchisor guarantees leases for franchised units in connection with an assignment, the terms of the guarantee must be disclosed.
Item 11	The fact that certain obligations in this item (site acquisition/selection and unit conversion/construction) would not apply in connection with refranchising transactions must be disclosed.
Item 20	The charts and related lists should be modified as franchisor-owned units are sold as franchised units. If a significant number of franchisor-owned units are sold in any year and the result is a "material change" to this item, a mid-year amendment to the FDD may be advisable.
Item 22	The refranchising program documentation should be listed.

Summary

Many franchisors have embarked on refranchising programs with the goal of changing their business model, often with a complementary goal of expanding the reach of the brand and the franchise system. The process of transforming the franchisor from a chain owner with significant capital investment to a strategic developer of a brand system, new product producer and marketer presents significant opportunities but also numerous pitfalls and risks. As outlined above, a successful refranchising program requires advance planning, careful due diligence, coordination and, not to be overlooked, execution of key legal documents that define the rights and obligations underlying a long-term, mutually beneficial relationship. The factors inherent in a refranchising transaction require the franchisor not to view the refranchising transaction as an ordinary M&A transaction, but part of a larger systemic change and realignment for the franchisor and its brand. ■